UNIVERSITÀ DEGLI STUDI DI MILANO

Department of Italian and Supranational Public Law
Public, International and European Union Law PhD
XXXII Year
Curriculum in Constitutional and Administrative Law

PhD Thesis

Taxation of cross - border services in the current International, European and Italian context

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Academic Year: 2018 / 2019

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INTRODUCTION

This PhD thesis is entitled to the study of the rules concerning the taxation of services in the International, European and Italian context. The decision to study the taxation of services stems from the prominent position of these activities in today's economy: such a consideration applies both to developed countries, as well as to developing countries. Although exports of services originate predominantly in developed countries, such exports have grown indeed rapidly in recent years also in several developing countries such as Brazil, China, India and Israel.

The OECD and UN provisions dealing with income from services were developed at a time when services, other than certain types of high-profile services (e.g. construction and entertainment services), were not nearly as important in the global economy as other business activities, such as the development of natural resources, manufacturing and retailing. Moreover, the digital economy was far from happening. As a result of the fact that times have changed and that services have become an increasingly important part of cross-border trade, both source and residence states are keen to guarantee themselves the right to tax this income.

Because of such even more "service – oriented" structure, the taxation of services has been under scrutiny for at least thirty years: lately this issue has been brought to the forefront of international taxation debate, in relation to which the taxation of services appears to be nowadays one of the most controversial topic.

The present work is structured in three chapters, which focus on the taxation of cross border services in the current international tax system (chapter 1), on the taxation of cross - border intra-group services in light of its main transfer pricing implications (chapter 2) and on the taxation of digital cross - border services (chapter 3). Each of the three mentioned chapters starts with an introductory question, followed by the analysis of the main aspects related to the international and European frameworks. The domestic level is also considered: those domestic frameworks that appear to be of most interest for the analysis performed in each chapter have been

indeed selected. The last chapter 4 discusses the conclusions of the present analysis in light of the Italian experience.

The aim of chapter 1 is to examine the treatment of cross - border services in the current international tax system. In order to perform such analysis, paragraph 1 aims to answer to the following preliminary question: how can the term “service” been properly defined? After answering such preliminary question, the OECD Model Tax Convention on income and on capital (hereinafter also referred to as the “OECD Model Convention”) is analyzed: moving from an overview of the changes in the tax treatment of cross - border services occurred upon its several revisions (paragraph 2), the relevant articles of the current version of the OECD Model Convention attributing the taxing rights on the services fees are analyzed (paragraph 3). It will emerge the preference for taxation of business profits, including income from services, at source solely when a permanent establishment exists in the source country.

As it is explained in the following paragraph 4, the treatment of cross - border services included in the UN Model Convention between Developed and Developing Countries (hereinafter also referred to as the “UN Model Convention”) provides for several deviations from the OECD Model Convention: such deviations represent the answer to the claims coming from developing countries for the attribution of taxing rights on the services fees in the source countries.

Even the most cursory glance at the tax treaties currently in place is sufficient to reveal the very significant variety that exists in respect of the treatment of services. The tax treaty policy of Brazil and India – as examples of developing countries which reserve attention to the topic under analysis – is investigated in the last paragraph of chapter 1.

The aim of chapter 2 is to examine the treatment of cross – border intra – group services in the current international tax system. In order to perform such analysis, paragraph 1 aims to answer to the following preliminary question: how / why is the topic under analysis (i.e. the taxation of services) relevant within a multinational group? After answering such

preliminary question, chapter 2 discusses the main transfer pricing aspects related to the provision of cross border intra – group services, i.e. the benefit test, the determination of the arm's length service fee, the safe harbors provided for several categories of services and the peculiarities applicable to the provision of financial intra – group services (see paragraphs 2, 3 and 4).

The discussion is based on the OECD Transfer Pricing Guidelines[1] and the UN Manual on Transfer Pricing[2], which both deal extensively with the topic of the cross – border intra – group services[3]. At this aim, also the Communication from the European Commission on the analysis performed by the EU Joint Transfer Pricing Forum on low value adding intra-group services[4] (hereinafter, also referred to as "EU JTPF Guidelines") is taken into consideration.

Paragraph 6 takes into consideration the EU framework, with reference to the EU fundamental freedoms and the state aid law. The domestic framework is discussed in the last paragraph 7: the Netherlands, India, Brazil and USA have been selected as the most interesting examples for having a complete picture on the object of chapter 2.

The aim of chapter 3 is to examine the treatment of cross – border digital services. To perform such analysis, paragraph 1 aims to answer to the following preliminary question: which is the impact of the digital economy on the topic under analysis (i.e. the taxation of services)? Paragraphs 2 and

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[1] OECD, *Transfer pricing guidelines for multinational enterprises and tax administrations*, 2017, available at <www.ibfd.org>.

[2] UN, *Practical Manual on Transfer Pricing for Developing Countries*, 2017, available at <www.un.org>.

[3] See Chapter 7 of the OECD Transfer Pricing Guidelines.

[4] See *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals 1. Guidelines on low value adding intra-group services and 2. Potential approaches to non-EU triangular cases, Brussels, 25.1.2011, COM (2011) 16 final*, available at ec.europa.eu.

The expert group of the EU Joint TP Forum was set up by the Commission in October 2002, to find pragmatic solutions to problems arising from the application of the arm's length principle within the EU. The interpretation and application of the arm's length principle indeed does vary between both tax administrations and tax administrations and business. This can result in uncertainty, increased costs and potential double taxation or even non taxation. These impact negatively on the smooth functioning of the internal market.

3 describe the current state of the debate, which is on-going at the international level, OECD and UN respectively. Paragraph 4 takes into consideration the proposals made by the European Commission in March 2018: even if it is now clear that the unanimity of all the Member States required for their approval is lacking and that – as a consequence – the European Union calls to keep on working on a global solution at the OECD level (see the outcome of the EU Finance Ministers' meeting held in March 2019 in Brussels), the proposed directives appear to be still of interest, since they represent the first legislative tentative coming from a regional organization to face the challenges posed by the digital economy. In last paragraph 5, the domestic framework is taken into consideration, with reference to the Indian equalization levy.

The last chapter 4 discusses the conclusions of the analysis performed in the three preceding chapters – as above summarized –: the conclusions are set out considering the Italian experience, the one which the PhD student is most familiar with.

Before going into the analysis, special thanks to Professor Marino and Professor Ragucci for having constantly driven and supervised my steps during this 3-year PhD program.

CHAPTER 1
TREATMENT OF CROSS – BORDER SERVICES IN THE CURRENT SYSTEM OF INTERNATIONAL TAX TREATIES

Summary: 1.1. Some preliminary remarks about the term "service" – 1.2. Historical analysis of the treatment of cross – border service fees in the OECD Model Convention – 1.2.1. The 1963 OECD Draft Model Convention – 1.2.2. The 1977 OECD Model Convention – 1.2.3. The subsequent revisions of the OECD Model Convention – 1.2.4. The impact of the Base Erosion and Profit Shifting Project – 1.2.4.1. The BEPS Project: focus on Action 7 on preventing the artificial avoidance of permanent establishment status – 1.3. The treatment of cross – border service fees in the current version of the OECD Model Tax Convention on Income and on capital – 1.4. The treatment of cross – border service fees in the current version of the UN Model Convention between Developed and Developing Countries – 1.5. The treatment of cross – border service fees in the tax treaty policy of Brazil and India – 1.5.1. Brazil – 1.5.2. India.

1.1. Some preliminary remarks about the term "service" – As already anticipated, this first chapter will focus on the treatment of cross – border service fees in the current system of international tax treaties. In common language, service fees are the amounts paid by the service recipient for having received a given service from the service provider: from a tax perspective, the service fee is the income item for the service provider / the cost item for the service recipient resulting from the provision of a given service from the first to the latter.

The term "service" is neither defined in the UN Model nor in the OECD Model Convention nor in the existing tax treaties. In principle, a definition of the term "service" for the purposes of the OECD and UN Model Conventions would be necessary only if the two mentioned models would provide for a treatment for the income from services, which would be different from that provided for the income coming from other types of activities. As it will be better investigated in the following paragraphs, article 7 of the 2017 OECD Model Convention – the only provision that deals with income from services in general – does not differentiate between income from services and income from other types of businesses. This is not the case under article 7 of the UN Model Convention because it applies if a

taxpayer furnishes services in the source country for more than six months for the same or a connected project. In that case, the taxpayer is deemed to have a permanent establishment in the source country under article 5(3)(b) of the UN Model Convention. If, however, the taxpayer is not considered to be furnishing services, the taxpayer does not have a permanent establishment, unless the activities are carried on through a fixed place of business in the source country or the taxpayer has a dependent agent in the source country who has and habitually exercises an authority to conclude contracts on behalf of the taxpayer. The same issue arises under the OECD alternative services permanent establishment rule concerning the meaning of the term “performs services”. Moreover, the provisions of both Model Conventions provide for special rules for specific types of services, such as professional and independent services and artistic and sports activities.

In any case, none of the mentioned provisions includes a general definition of the term “service”.

In this respect, some illustrative examples are worth mentioning. The former article 14(2) of the OECD Model Convention entitled to the independent personal services did not provide for any general definition of the term “services” but only for a non-exhaustive list of covered professional services. The mentioned paragraph stated indeed that “[t]he term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants”[5]. The same approach is confirmed by article 14(2) of the 2017 UN Model Convention, according to which “[t]he term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants”.

[5] OECD, *Income and capital model convention and commentary*, 1 June 1998, available at <www.ibfd.org>.

The newly introduced article 12A of the 2017 UN Model Convention – entitled to the fees for technical services – confirms the same approach since it does not provide for any general definition of the term "services" but only states that the term "fees for technical services" covered by the mentioned article 12A means "any payment in consideration for any service of a managerial, technical or consultancy nature".

This implies that – for the application of the relevant tax treaty – the definition of service should be found within the domestic legislation of the specific country involved, in accordance with article 3(2) of the 2017 OECD and UN Model Conventions providing that "[a]s regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State"[6].

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[6] See article 3(2) of the 2017 OECD Model Convention. Article 3(2) of the UN Model Convention states as follows: "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State".

Moreover, for the special types of services for which a specific tax treatment is provided, the Commentaries often provide helpful guidance for purposes of determining the type of services covered by particular articles. This guidance in the Commentaries may limit the necessity to refer to domestic law under Art. 3(2) in applying these provisions and reduce the problems that would arise if the domestic meanings in the contracting states differ significantly.

For an in-depth analysis of article 3(2) of the Model Conventions, see J. AVERY JONES ET AL., *The interpretation of tax treaties with particular reference to article 3(2) of the OECD Model - I*, in *British Tax Review*, 1984 (no. 1), p. 17; J. AVERY JONES ET AL., *The interpretation of tax treaties with particular reference to article 3(2) of the OECD Model - II*, in *British Tax Review*, 1984 (no. 1), p. 90; K. VOGEL ET AL., *Klaus Vogel on Double Taxation Convention*, 1997, Kluwer Law International, p. 169. For an interesting analysis of the expression "unless the context otherwise requires" included in article 3(2) of the Model Conventions, see also M. SADA GARIBAY, *An Analysis of the Case Law on Article 3(2) of the OECD Model (2010)*, in Bulletin of International Taxation, 2011 (65), p. 8. For a general analysis of the origin of the expressions within the OECD Model Convention, see VV.AA., *The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States*, in *Bulletin – Tax treaty monitor*, 2006, p. 220; L. VERDONER, *Major economic concepts in Tax Treaty Policy*, in *Intertax* (Volume 31 – Issue 4), 2003, p. 147.

Having in mind the purpose of properly defining the term "service" and taking into consideration the documents issued by the international organizations, the opinion expressed by UNCTAD is worth mentioning: it is "difficult to formulate a clear-cut definition of services. No commonly accepted definition exists"[7]. Activities can generally be divided into chargeable services and non-chargeable activities.

Looking to the doctrine, there are two main and basic approaches that appear to be different. According to the activity-related approach, a service is a process, demanding synchronous contact of a service provider and a service beneficiary to fulfil certain demands of a customer. In contrast, the result-orientated concept considers services as products characterized by their similarity to intangible assets[8].

The Oxford English Dictionary defines service broadly as "the action of helping or doing work for someone". This definition appears to be inappropriately broad for purposes of tax treaties because it includes voluntary or charitable services. The definition in Black's Law Dictionary is, therefore, perhaps more appropriate, i.e. "the act of doing something useful for a person or company for a fee"[9].

In light of the above, the last definition mentioned is taken into consideration for the purposes of the present research: in other words, within the present analysis, we will refer to the term "services" with the meaning of any work done for another person for remuneration.

Services – defined as above mentioned – can be provided in different situations with the consequence that the income so derived is dealt with under various treaty articles. Consequently, the treatment of activities that

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[7] UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, *World Investment Report 2004: The Shift towards Services*, 2004, p. 145, available at http://unctad.org/en/docs/wir2004_en.pdf.

[8] See F. SIXDORF – S. LEITSCH, *Taxation of Technical Services under the New Article 12A of the UN Model – Improved Taxation or a Step in the Wrong Direction*?, in *European Taxation*, 2017, p. 235.

[9] See B. J. ARNOLD, *The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess – Expanded Version*, in *Bulletin for International Taxation*, 2010 (2), p. 65.

in common parlance are covered by the term “services” in the widest sense is not limited in tax treaties to one specific income allocation regime.

With regard to a number of categories of services tax treaties provide indeed for a specific regime, such as:

i) supervisory and other services relating to construction activities in article 5(3) of the OECD Model and article 5(3) of the UN Model;

ii) services provided by agents within the meaning of article 5(5) of the OECD and UN Models;

iii) services provided by insurance agents within the meaning of article 5(6) of the UN Model;

iv) services relating to international shipping and air transport in article 8 of the OECD and UN Models;

v) dependent personal services performed by employees within article 15 of the OECD and UN Models;

vi) services performed by artists and sportspersons within article 17 of the OECD and UN Models.

As the services in these areas have a specific treaty regime, they do not form part of this research. The research concentrates on general provisions for entrepreneurial services in tax treaties, i.e. legal persons and individuals deriving income from carrying on a business or performing independent personal services for other persons.

1.2. Historical analysis of the treatment of cross border service fees in the OECD Model Convention – The history of the current OECD Model Convention dates back to the work of the League of Nations in the 1920s. The discussion below provides an overview of the evolution of the different model conventions and related studies of the League of Nations and its successor, the Organization for European Economic Cooperation (OEEC), later reorganized and renamed the OECD: the following analysis will be limited to those aspects that appear to be of the most interest for the object of the present thesis.

International double taxation came into vogue after the First World War because: (i) income tax systems spawned worldwide, mainly as a way to cope with the expenses incurred during wartime; and (ii) the business scope of enterprises was becoming more international[10].

Recognizing that something should be done to avoid the double taxation of income to allow international business to prosper, the League of Nations, an organization established at the end of the First World War[11], designated a special committee composed of four renowned economists of the time, to prepare a report analyzing the aspects and effects of double taxation. In other words, the four economists were given the task of analyzing the economic consequences of double taxation for the equitable distribution of burdens and its interference with economic liaisons and the free flow of capital.

The report issued by the four economists[12] took into consideration the experience of countries that had already signed double tax treaties and studies on the matter. In their seminal work, the four economists recognized that, based on the economic allegiance concept, it was justified to levy taxes on the origin and domicile states. Despite acknowledging that states showed a preference for origin taxation, the four economists favoured exemption at origin, i.e. exclusive residence taxation of income. Thus, the

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[10] The first modern double tax treaty was signed in 1899 between Prussia and Austria – Hungary, which is generally considered the first "modern" tax treaty (see Treaty of 21 June 1899 between Austria-Hungary and Prussia for the avoidance of double taxation which can result from the application of the tax laws in force in the kingdoms and lands represented in the imperial council and in the kingdom of Prussia, 21 June 1899).

Article 2(1) of mentioned treaty includes a definition of the permanent establishment; such definition was then included in domestic Prussian-German tax legislation in 1909 and a similar definition can still be found in the domestic legislation currently in force in Germany (see General Tax Code - Abgabenordnung).

[11] The League of Nations was an intergovernmental organization founded on 10 January 1920 as a result of the Paris Peace Conference that ended the First World War. The League lasted for 26 years: the onset of the Second World War showed indeed that the League had failed its primary purpose, which was to prevent any future world war. The United Nations (UN) replaced it after the end of the Second World War and inherited several agencies and organizations founded by the League.

[12] LEAGUE OF NATIONS, *Economic and Financial Commission, Report on double taxation, submitted to the Financial Committee of the League of Nations by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Geneva, 5 April 1923. In this respect, see N. TADMORE, *Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age*, in *Bulletin for international taxation*, 2007, p. 2.

four economists recognized that residence taxation could hamper the sovereign taxing rights of source states. In spite of their support for non – taxation at origin, they conceded that such allocation of taxing rights would vary in accordance with the position of countries in the international economy, and that whenever countries were not economically balanced it was necessary to device another method to avoid double taxation. Moreover, they recognized that even if a country is classified as mainly origin or domicile state, the proportion of these economic liasions may vary depending on the economic partner, which could justify the adoption, by the same state, of different allocations of taxing rights on double tax treaties.

The mentioned report was the first step towards the development of the first draft model convention elaborated by the League of Nations: the 1928 Draft Model Treaty. Following the release of the 1923 Report, the League of Nations established indeed a Committee of Government Experts with the purpose of analyzing the administrative and practical questions regarding the double taxation of income. This committee argued[13] that, in order to achieve a more equitable distribution of the tax income, lessen the burden of double taxation and avoid the defrauding of tax revenues, countries should sign double tax conventions. Additionally, the Committee thought that, in their negotiations to sign double tax conventions, countries would benefit from the existence of a model draft convention on the avoidance of double taxation, so it suggested that such a document should be drafted. The work conducted on that matter culminated in the 1928 Draft Model Treaty.

Concerning the drafting of the 1928 Draft Model Treaty[14], it is interesting to note that this first League of Nations draft convention recognized the existing difference between countries' practices and provided for three draft conventions. Originally, there would be only one

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[13] LEAGUE OF NATIONS, ECONOMIC AND FINANCIAL SECTOR, FINANCIAL COMMITTEE, *Report submitted to the Financial Committee by the Government Experts on Double Taxation and the Evasion of Taxation*, Geneva, 10 June 1923. Its initial members were Belgium, France, Great Britain, the Netherlands, Italy, Switzerland and Czechoslovakia.

[14] LEAGUE OF NATIONS, *Double taxation and tax evasion, Draft of bilateral convention regarding double taxation*, London, 8 April 1927.

model draft but disagreements regarding its provisions led to the draft of alternatives by the United States and other countries and all three models were incorporated in the 1928 Draft Model Treaty.

Already in these draft conventions, the taxation of business profits at source, including fees from services, was linked to the existence of a permanent establishment, as it was prescribed that income from any industrial, commercial or agricultural undertaking or from trade or professionals shall be taxed in the state in which a permanent establishment is located[15]. The option for this permanent establishment threshold is no surprise, since in the late 1920s the permanent establishment concept was already part of most double tax conventions signed between European States, as well as the domestic legislation of these States. Hence, the preference was given to taxation of business profits in the residence state of the income earner, with taxation at source being restricted to permanent establishment situations.

Furthermore, income not expressly mentioned in the model convention was taxable solely at the domicile of the income recipient.

In light of the above, the reference to the permanent establishment concept as a threshold for taxation at source and the exclusive residence taxation of income not referred to in the draft illustrates that the 1928 Draft Model Treaty provides for residence taxation on service fees.

Moreover, the 1928 Draft Model Treaty issued by the League of Nations had a powerful symbolic value: since then, indeed, model conventions have become the stalwarts of the international tax regime. However, the impact on the development of the international tax treaty network at that time was not significant: very few bilateral tax treaties were based on these model solutions[16] [17].

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[15] For an in – depth analysis of the work generally done at the level of the United Nations, see also S. JOGARAJAN, *Double taxation and the League of Nations*, Cambridge, 2018.

[16] However, Italy's tax treaties were an exception since many of them were based on the 1928 Draft Model Treaty issued by the League of Nations.

[17] Following the release of the 1928 Draft Model Treaty, the League of Nations proceeded to further study the practice of countries and their domestic law / double tax conventions. Moreover, in the last session of the Fiscal Committee before the beginning of

An higher impact instead had the post-First World War domestic tax reforms of 1919 to 1921 in the United States, which involved the development of the foreign tax credit method to resolve double tax and it was coupled with the introduction of clear source rules to determine the circumstances under which relief was to be allowed. These domestic US tax reforms later had an influence on the development of the structure of the web of Germanic-inspired tax treaties of European countries, particularly when the United States started to conclude tax treaties with them in the period from 1939 to 1945. In essence, Germanic-inspired tax treaties were taken as a base upon which was grafted additional clauses, often as a result of ongoing domestic tax reforms.

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the Second World War, it was suggested that the 1928 Draft Model Treaty should be brought in line with the double tax conventions signed since its release. This revision process culminated in the 1943 Mexico Draft.

After the end of the Second World War, the Fiscal Committee of the League of Nations convened in London for the last time before its dissolution in order to update the 1943 Mexico Draft. As a result, the 1946 London Draft was published (see League of Nations, Fiscal Committee, London and Mexico Model Tax Conventions, Geneva, November 1946).

After the dissolution of the League of Nations, it was expected that the United Nations, its successor, would duly continue its work in the field of tax treaties. The Fiscal Committee of the League of Nations suggested in one of its final meetings that the United Nations should coordinate a revision of the 1943 Mexico Draft and the 1946 London Draft. With this goal in mind, the United Nations created a fiscal commission. However, divergent interests of participants led to a stalemate and the consequent dissolution of this commission. As a consequence, ten years after the creation of the United Nations, the aforementioned drafts had not yet been updated. Furthermore, the coexistence of the two drafts was counterproductive to the expansion of a network of tax treaties, because countries struggled to decide which model should be adopted.

Due to the inaction of the United Nations, the Organization for European Economic Cooperation took a role in such field. In this respect, it is worth mentioning that the Organization for European Economic Cooperation came into being after the Second World War (on 16 April 1948) from the Marshall Plan and the Conference of Sixteen (Conference for European Economic Co-operation), with the aim to establish a permanent organization to continue work on a joint recovery program and in particular to supervise the distribution of aid. The OEEC originally had the following 18 participants: Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, United Kingdom, and Western Germany (originally represented by both the combined American and British occupation zones (The Bizone) and the French occupation zone). The Anglo-American zone of the Free Territory of Trieste was also a participant in the Organization for European Economic Cooperation until it returned to Italian sovereignty.

The Organization for European Economic Cooperation engaged the drafting of a model tax convention that would suit the needs of its members. Following the example of the League of Nations and the United Nations, the Organization for European Economic Cooperation created a fiscal committee and working parties that would be responsible for studying issues concerning double taxation, including the taxation of services and the subsequent drafting of a model convention.

1.2.1. The 1963 OECD Draft Model Convention – The process whereby domestic tax changes influenced the shape and allocation of taxing rights under bilateral tax treaties, followed by a slow process of convergence of tax treaties concluded by major economies with others, reached a zenith with the compilation of the 1963 Draft Convention for the avoidance of double taxation with respect to taxes on income and capital convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital (hereinafter referred to also as the "1963 OECD Draft Model Convention")[18].

The method followed in the period 1956 to 1961 by working parties of civil servants tasked with compiling a model essentially entailed a process of harvesting from existing tax treaties. In all but name, the 1945 United States-United Kingdom income tax treaty formed a blueprint for many of the clauses that found their way into the 1963 OECD Draft Model Convention.

More specifically, following the guidelines established by working parties, the 1963 OECD Draft Model Convention dealt in separate articles with the permanent establishment concept and the taxation of business profits: more specifically, article 5 focused on the conditions for the formation of a permanent establishment, while article 7 established the allocation of taxing rights in respect of business profits. Furthermore, article 12 dealt with royalties, containing the definition of the term and, as a result, allowing it to be determined whether services connected to this concept should be taxed as royalties. Article 14 regulated the taxation of independent personal services as such. Finally article 21 – commonly known as the "catch all provision" – attributed to the resident country taxing

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[18] OECD, *Draft convention for the avoidance of Double Taxation with respect to taxes on income and capital convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital*, 30 July 1963, available at <www.ibfd.org>.

The 1963 OECD Draft Model Convention has been issued by the OECD, since the Organization for European Economic Cooperation OEEC was superseded in September 1961 by the Organization for Economic Co-operation and Development (OECD), a worldwide body. In 1961, the OECD consisted of the European founder countries of the OEEC plus the United States and Canada. The list of member countries has expanded over the years, with 35 countries today.

rights over those items that were not expressly mentioned in other articles of the Model Convention.

From the analysis of the aforementioned articles, it emerges that, also in accordance with the 1963 OECD Draft Model Convention, taxation at source of services not mentioned in specific provision of the treaty could only occur when these activities were conducted through a permanent establishment.

More specifically, article 7(1) of the 1963 OECD Draft Model Convention draft read as follows: “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 that permanent establishment”.

The definition of permanent establishment was provided by article 5 of the 1963 OECD Draft Model Convention. More specifically, paragraph 1 of the aforementioned article defined as permanent establishment “a fixed place of business in which the business of the enterprise is wholly or partly carried on”.

In this respect, it is worth highlighting that the addition of an article to the model convention that dealt specifically with the permanent establishment concept and introduced a general definition of such concept was an innovation by the OECD. The ratio of such an addition was to grant both clarity and ease in the concrete application of the permanent establishment concept for tax purposes. According to the Commentary to the aforementioned article, indeed, it was preferable to have a general definition of the concept of “permanent establishment” which was set out in a separate paragraph and not one which is almost hidden in a list of a number of agreed examples, as in the case of the Mexico and London Drafts of the Model Tax Convention published by the League of Nations.

Having in mind both the aforementioned purposes, the general definition attempted to bring out the essential characteristics of a permanent

establishment, i.e. that it should be a distinct “situs”, a “fixed place of business”. This definition was extremely valuable because it clarified that a place could only be classified as a permanent establishment if it was fixed and the business of the enterprise conducted therein. Therefore, even if a company had a fixed place in the source state, no permanent establishment would be formed if no business was effectively conducted in this fixed place. On the other hand, even if business was conducted, a permanent establishment would only arise if this place was fixed, i.e. it was stable and immovable, considering the traditional definition of a permanent establishment that was prevalent when the article was drafted[19].

Article 5(2) of the 1963 OECD Draft Model Convention dealt with prima facie permanent establishments, including “a) a place of management, b) a branch, c) an office, d) a factory, e) a workshop, f) a mine, quarry or other place of extraction of natural resources and g) a building site or construction or assembly project which exists for more than twelve months”. In this respect, the Commentary on Article 5 was important to clarify that the list of paragraph 2 was non – exhaustive, i.e. fixed places not mentioned in paragraph 2 would also form a permanent establishment if the conditions provided by article 5(1) of the 1963 OECD Draft Model Convention draft were fulfilled. On the other hand, the list of examples represented the common ground on which member states were able to agree.

[19] At that point, there were no discussions on the commentaries on the OECD model convention concerning the power of disposition over the place in question, but considering that traditionally a permanent establishment had been related to the legal disposition over a place, it may be said that a permanent establishment would only arise in cases where the taxpayer owned the premises on which business was being conducted.

Moreover, the OECD decided to differ from previous League of Nations documents, deleting any reference to the productive nature of an enterprise or to the criterion of “profitability”. With reference to the productive nature, the Commentary pointed out that, within the framework of a well run business organization, it was surely axiomatic to assume that each part contributes to the productivity of the whole. On the other hand, however, it does not follow in every case that because in the wider context of the whole organization a particular establishment has a productive character it is consequently an establishment to which profits can properly be attributed for the purpose of tax in a particular territory. With reference to the criterion of profitability, the Commentary pointed out that the concept of profitability did not seem wholly relevant.

On the contrary, article 5(3) of the 1963 OECD Draft Model Convention draft provided for a non – exhaustive list of cases which did not fall within the definition of permanent establishment. More specifically, in accordance with the aforementioned provision, “the term permanent establishment shall not be deemed 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; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise, d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise”. The purpose of the aforementioned exemptions was to foster international trade, as well as to simplify the administration functions of companies.

Exception provided in paragraph 3 e) is worth highlighting: the Commentary expressly “recognized that a place of business the function of which is solely that of advertising, or the supply of information, or of scientific research may well contribute to the productivity of its parent enterprise. To assume so is once more axiomatic. But the services it performs for its parent enterprise are so far antecedent to the actual realization of profits by its parent body that no profits can properly be allocated to it; accordingly, it does not constitute a taxable unit”.

In addition to the above, for the scope of my analysis, also the reference to similar activities included in the last sentence of paragraph 3 e) is particularly interesting. The purpose of such reference was indeed twofold. On one hand, it was intended as a general exemption to the general definition laid down in paragraph 1: the reference to similar activities had the effect of restricting to some extent the effect of paragraph 1, thus

answering to the existing criticism that the scope of the general definition was too wide. It delimited the general definition of permanent establishment provided by article 5 of the 1963 OECD Draft Model Convention and excluded from its rather wide scope a number of forms of business organization which, although they are carried on in a fixed place of business, should not be treated as taxable units. In other words, the last words of paragraph 3 e) refined the general definition in paragraph 1 and, when read with that paragraph, provided for a more selective test. Secondly, since the list was non – exhaustive, the reference to similar activities was intended to cover any further example which was not expressly listed among the exceptions included in paragraph 3 but was nevertheless within the spirit of them.

Article 5 of the 1963 OECD Draft Model Convention also included the concept of agency permanent establishment[20]. More specifically, paragraphs 4 and 5 of the aforementioned article stated that: “4. A person acting in a Contracting State on behalf of an enterprise of the other Contracting State – other than an agent of an independent status to whom paragraph 5 applies – shall be deemed to be a permanent establishment in the first – mentioned state if he has and habitually exercises in that state an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise. 5. 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, where such persons are acting in the ordinary course of their business”.

The underlying concept of the agency permanent establishment was that the activities of a representative give rise to a sufficient degree of nexus between the principal and the state in which the representative performs its activities, i.e. the source state, such that the state would seek to tax the principal on income arising from the activities performed by the

representative. Consequently, there could be a permanent establishment with regard to a principal even without a fixed place of business that falls within the basic rule in article 5(1) of the OECD Model in the source state.

In a sense, article 5(5) of the OECD Model operated as a deeming rule, as it deemed the activities of a person other than a foreign enterprise to constitute a permanent establishment of the foreign enterprise in the source state. In addition, bearing in mind that the main purpose of a permanent establishment is to operate as a threshold for source state taxation, the extension of the basic rule, which, inter alia, required a fixed place of business, to take into account the activities of such representatives was necessary to prevent foreign enterprises from abusing the basic rule and participating in the economic life of a state simply by appointing a representative who would be able to operate on its behalf.

Moreover, the inclusion of the concept of an agency permanent establishment codified the practice of OECD member countries at the time: according to the Commentary, indeed, persons who may be deemed to be permanent establishments must be strictly limited to those who are dependent, both from the legal and economic points of view, upon the enterprise for which they carry on business dealings[21]. The decisive criterion was the nature of the authority entrusted to the agent: when the agent has sufficient authority to bind the enterprise's participation in the business activity of the other country is such that the agent should be deemed to be a permanent establishment. Conversely, where an enterprise has business dealings with an independent agent, this cannot be held to mean that the enterprise itself carries on business in the other state. In such a case, there are two separate enterprises. In other words, not every person acting in the source state on behalf of a foreign enterprise would be considered a permanent establishment of such an enterprise; a permanent establishment would be formed solely when the individual in question worked and

[21] Such a position is expressed also in the Report of the Fiscal Committee of the League of Nations, 1928, page 12.

performed his activities for the company, in the name of the company, i.e. he was not acting in the "ordinary course of his business"[22].

In general, article 5 of the 1963 OECD Draft Model Convention[23] further restricted the possibilities for source taxation by increasing the exceptions to the formation of a permanent establishment. This was a consequence of the agreement between OECD member countries that source taxation should be kept at a minimum. As a proof of this conformity, Canada, which entered the Organization for European Economic Cooperation in 1961 when the final report has already been presented, was the only country to express a reservation to the article by stating that a person acting on behalf of a non-resident enterprise who has a stock of merchandise and regularly fills orders on behalf of this enterprise in Canada will be considered to be a permanent establishment of this enterprise.

As for the taxation of royalties, the 1963 OECD Draft Model Convention attributed exclusive taxing rights to residence states, stating as follows: "[R]oyalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State".

In this respect, it is important to underline that the Commentary mentioned some model conventions previously issued, with the aim to list the rules included therein for the taxation of royalties and similar payments: this shows that the item was already disputable[24]. The 1963 OECD Draft

[22] See also J. EISENBEISS, *BEPS Action 7: Evaluation of the Agency Permanent Establishment*, in *Intertax*, 2016 (Volume 44 - Issue 6 – 7), p. 491.

[23] For the sake of completeness, last paragraph of the proposed article 5 is worth mentioning: it contained the general rule that control would not lead to a permanent establishment relationship, stating that "[t]he fact that a company which is resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either company a permanent establishment of the other". In any case, if a subsidiary was considered a permanent establishment of the parent company, the latter would be limited to the taxation of income that arose due to the subsidiary's activity as a permanent establishment.

[24] More specifically, the Commentary to the 1963 OECD Draft Model Convention mentioned the following model conventions:

i) the Model Convention drawn up by the Fiscal Committee of the League of Nations in 1928, which did not contain any specific rules about the taxation of royalties and similar payments. These could thus only be taxed in the State in which the grantor resided, unless they were obtained in connection with a permanent establishment maintained by the grantor in the other State;

Model Convention followed the Model Conventions drafted in London in 1946 by the Fiscal Committee in the League of Nations and the solutions adopted in many conventions between OECD member countries, in adopting the principle of exclusive taxation of royalties in the state of the recipient's residence.

The only exception to this principle is that made in the cases dealt with by paragraph 3, according to which "[t]he provisions of paragraph 1 shall not apply if the recipient of the royalties, being a resident of a Contracting State, has in the other Contracting State in which the royalties arise a permanent establishment with which the right or property giving rise to the royalties is effectively connected. In such a case, the provisions of Article 7 shall apply". In this respect, the Commentary further clarified that paragraph 3 was not based on the conception of "the force of attraction of the permanent establishment". The paragraph merely provided that in the State of source the royalties were taxable as part of the profits of the

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ii) the Model Convention drafted in Mexico in 1943 by the Fiscal Committee of the League of Nations, which included a special provision on the taxation of royalties and similar payments. A specific distinction was made. On one hand, royalties and similar payments received as a consideration for the right to use a patent, a secret process or formula, a trade mark or other analogous right were only taxable in the State where the right or property was used. On the other hand, royalties and similar payments arising from a musical, artistic, literary, scientific or other cultural work were only taxable in the State in which the grantor resided, unless they were obtained in connection with a permanent establishment maintained by the grantor in the other State;

iii) the Model Convention drafted in London in 1946 by the Fiscal Committee of the League of Nations, according to which the right to tax royalties and similar payments always rest with the State of residence of the grantor. However, where an enterprise of one of the Contracting States paid royalties to an enterprise of the other Contracting State and there was a particularly close economic connection between the two enterprises, then the royalties could be subjected to tax in the State where the rights in question were used.

Moreover, the Commentary to the 1963 OECD Draft Model Convention interestingly mentioned the practice adopted at the time by several OECD member countries. The tax treaties signed at that time by most OECD member countries included the following provisions:

a) the right to tax patent royalties and similar payments was conferred in principle on the State of the grantor's residence;

b) where patent royalties and similar payments were derived in connection with a permanent establishment situated in one of the States and forming part of an industrial or commercial enterprise carried on in the other State by the grantor, or were derived in connection with professional services performed by the grantor in one of the States and the grantor was a resident of the other State, then they were treated in accordance with the rules applicable under the Convention to income from an industrial or commercial enterprise or to income from the performance of professional services, respectively.

permanent establishment there owned by the recipient residing in the other State, if they were paid in respect of rights or property forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In other words, the aforementioned provision states that royalties attributed to a permanent establishment in the source state should be treated as business income, i.e. it would be possible to tax this income at source.

The objective scope of article 12 was defined by paragraph 2 of the same article, according to which the term "royalties" was defined as "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, 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". Looking deeper to the mentioned definition, reference to the supply of information concerning industrial or commercial experience is worth underlining: it was included in the royalty concept because it could be related to a business, trade or professional services, so it was natural that it should be dealt with in the same manner as the latter, i.e. exclusive taxation at residence unless there was a permanent establishment at source[25].

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[25] For the sake of completeness, article 12(4) of the 1963 OECD Draft Model Convention states that "[w]here, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention". Such provision was drafted to guarantee that companies would not take advantage of a special relationship to send business profits abroad under the protection of the royalty article. In such a case, the excessive royalties would be taxable according to the domestic law of the source state.

The Commentary also discussed the deductibility of royalty payments. At the time, it was common practice to allow for the deduction of royalty payments only when they were made to resident individuals; whenever the recipient was resident in another state, there would be no deductibility. Countries acted this way because they judged that, while in a domestic situation the state would still be able to tax the income in the hands of the recipient, cross-border income would be taxed solely in another state. In this respect, the Commentary expressly disagreed with such practice, considering that the deduction should

The Commentary provided for derogations / reservations with reference to article 12. More specifically, looking to the derogations, some member countries (Greece, Luxembourg, Portugal and Spain) were able to maintain the right of a 5% source tax on the gross amount of royalties. Other countries expressed their reservations to the article and their intention to tax royalty income at source, e.g.: i) Austria stipulated a tax up to 10% on this income, ii) Turkey argued for a tax rate of at least 20%, iii) Canada reserved its position[26] and iv) Italy reserved the right to subject royalties and profits from the alienation of rights or property giving rise to royalties to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the rights or property in respect of which the royalties are paid is not effectively connected with such permanent establishment.

Taking the above into consideration, it remains clear that the provisions concerning the taxation of royalties were preferably attributed to the residence state, but there was a slight resistance to this idea. Furthermore, considering that there was no difference in the tax treatment of royalties and business income, it would not have made sense in practice to engage in discussions on whether a payment is a royalty or a business profit.

The 1963 OECD Draft Model Convention was the first model convention to codify the tax treatment of independent personal services as a separate provision in relation to income from employment. More specifically, article 14 of the 1963 OECD Draft Model Convention stated that: “Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar character

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not be forbidden simply because the tax payable by the recipient of such royalties was not levied in the State of source in application of the proposed Article 12.

[26] More specifically, paragraph 30 of the 1963 OECD Draft Model Convention states that: “Canada reserves its position on paragraphs 1 and 2 of this Article. However the Canadian authorities would be prepared to provide an exemption from tax for copyright royalties and other like payments made in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including rents or royalties in respect of motion picture films, including films or video tapes for use in connection with television) derived from sources within one of the Contracting States by a resident of the other Contracting State”.

shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other Contracting State but only so much of it as is attributable to that fixed base. The term "professional services" includes, especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants".

The reason for the introduction of the mentioned article 14 is clearly stated in the Commentary to the 1963 OECD Draft Model Convention, according to which "[t]he provisions of Article 14 are similar to those customarily adopted for income from industrial or commercial activities. Nevertheless it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities. The term "fixed base", which is to be found in various Conventions, has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing professional services would probably not as a rule have premises of this kind in any other State than that of his residence. But if there is in another State a center of activity of a fixed or permanent character, then that State should be entitled to tax the person's activities".

Finally, article 21 of the 1963 OECD Draft Model Convention stated that the items of income of a resident of a Contracting State which were not expressly mentioned in other articles of the same convention were taxable only in the residence State. The aim of the named article, which appears in the same or similar form in most Conventions for the avoidance of double taxation, was to provide a general rule relating to those items of income not expressly mentioned in the preceding Articles of the same convention.

1.2.2. The 1977 OECD Model Convention – The fiscal committee of the OECD was aware that its draft would need to be revised further to

take into account potential gaps originating in the development of new business organizations, new sectors of business activities, as well as the experience of countries in the signing of double tax treaties. In line with this idea, the model convention was updated in 1977 (hereinafter referred also as the "1977 OECD Model Convention"[27]).

The 1977 OECD Model Convention did not diverge too much from the 1963 OECD Draft Model Convention, with most of the revisions amounting to the rewording of provisions[28]. The taxation system provided by the 1963 OECD Draft Model Convention for the service fees has been also substantially confirmed by the 1977 OECD Model Convention, attributing the taxing rights to the residence state, unless a permanent establishment exists in the source country.

More specifically, no change was made to article 7 related to the business profits, the first paragraph of which confirms that 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[29]. This implies that the taxation of services at source was still based on the permanent establishment concept.

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[27] OECD, *Income and capital model convention and commentary*, 11 April 1977, available at <www.ibfd.org>. For a comment, see A. J. VAN DEN TEMPEL, *The OECD and taxation 1977 – 1978*, in *Intertax*, 1979 (no. 1), p. 6.

[28] There were two significant developments that helped shape the update process of the model convention: i) OECD member countries started to consider the influence their work had on non – member countries; and ii) it was prescribed that the double tax treaties already in place when the 1977 OECD Model Convention was released should be interpreted in light of the commentaries of this model convention, even though the wording of the provisions might differ.

[29] Article 7 of the 1977 OECD Model Convention literally states that: "(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 that permanent establishment. (2) Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. (3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is

On the contrary, article 5 related to the permanent establishment was renewed: even if the definition of permanent establishment remained unchanged, there were substantial amendments concerning auxiliary activities. There were already issues concerning the permanent establishment concept in the 1963 OECD Draft Model Convention even before the draft was published: the adherence of the United States and Canada to the OECD raised questions concerning the concept, but the discussion was postponed with the aim of not delaying the release of the 1963 OECD Draft Model Convention.

Focusing on those changes which are relevant for the current analysis, paragraphs 4 and 5 of the renewed article 5 are worth mentioning. The amendments to article 5(4) of the 1977 OECD Model Convention[30] listing the exceptions to the permanent establishment concept were far more restrictive to the taxation rights of source states. First of all, article 5(4)(e) was altered by replacing the expression "and similar activities with a preparatory nature" with "any other activity of a preparatory or auxiliary

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situated or elsewhere. (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. (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. (6) For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary. (7) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article".

[30] Article 5(4) of the 1977 OECD Model Convention literally states that: "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; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

character”. Although this may seem harmless, the new wording further restricted the formation of permanent establishments in source states. Prior to the 1977 OECD Model Convention, only advertising, supply of information, scientific research and activities of a preparatory nature similar to the aforementioned ones would not constitute permanent establishments. Nonetheless, the wording of the 1977 OECD Model Convention stated that all activities of a preparatory nature that were not mentioned in subparagraphs (a) to (d) would not lead to the existence of a permanent establishment. Therefore, the new wording expanded the cases in which exceptions to the permanent establishment principle would arise.

Furthermore, article 5(4)(f) stipulated that a combination of the activities from paragraphs (a) to (e) which are deemed not to be included in the definition of permanent establishment would also not form a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. This is a natural consequence of the auxiliary nature of the activities, so this rule could also be extracted from Article 5(4)(e).

Article 5(5) was also modified: more specifically, the new wording of the paragraph stated that where a person -- other than an agent of an independent status -- is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those deemed to be not included in the definition of permanent establishment by paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment.

Such rewording resulted in an increased coherence to the article: this agency permanent establishment became subject to the same exceptions of Article 5(1), applicable to the regular permanent establishment. At the same time, fewer cases were within the scope of the agency permanent

establishment provision. The exception to the formation of an agency permanent establishment was expanded, encompassing all activities mentioned in paragraph 4, not only the purchase of goods or merchandise.

The most significant amendment to the 1963 OECD Draft Model Convention was the introduction of the beneficial ownership concept in Articles 10, 11 and 12 of the 1977 OECD Model Convention. Limiting our analysis to article 12, the introduction of this concept demanded the revision of paragraphs 1, 3 and 4 of article 12.

Article 12(1) of the 1977 OECD Model Convention maintained the exclusive residence taxation of royalty income, but added that this was only if income was paid to a resident of the other contracting state who was the beneficial owner of the income[31]. More specifically, paragraph 1 of article 12 stated that royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties. As already pointed out with reference to the 1963 OECD Draft Model Convention, the royalty provision was inspired by the 1946 London Draft, which prescribed the exclusive taxation of income at residence.

Considering that the wording of the article stipulated that exclusive residence taxation would be dependent on the income being paid to a resident who was the beneficial owner of the income, article 12(1) could be interpreted as giving taxation rights to source states every time an intermediary was involved, irrespective of the place of residence of such an intermediary. Nevertheless, this was not the interpretation of the OECD, which claimed that the restriction would also be available when the intermediary and the beneficial owner were residents in the same state.

Although the definition of article 12(2) was not changed, the development of new business relations entailed the analysis of complex issues, such as how to treat payments for information concerning industrial, commercial or scientific experience. The drafters of the 1977 OECD Model

[31] Article 12(1) literally states that: “Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties”.

Convention asserted that these constituted payments for know – how, since they were made for the access to knowledge that was not public and this knowledge was transferred between the parties, without any service being performed by the seller. The transfer of knowledge, i.e. the impairment, was established as the criterion for distinguishing between know – how (constituting royalties) and regular contract for service (not constituting royalties).

Furthermore, in article 12(3) it was added that independent personal services performed from a fixed base at the source state would not be within the scope of article 12(1). Therefore, while the 1963 OECD Draft Model Convention was silent on the matter, in the 1977 OECD Model Convention, the drafters clarified that, just like business profits, income from independent personal services would not fall within the scope of the royalty provision. In that case, taxation would be subject to article 14. More specifically, paragraph 3 of the 1977 OECD Model Convention clearly stated that the provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

Finally, countries (i.e. Australia, Austria, Greece, Luxembourg, Canada, Finland, France, Japan, New Zealand, Portugal, Spain, Turkey, Italy and Belgium) were much more active in providing reservations to Article 12 of the 1977 OECD Model Convention than to its predecessor. Italy reserved the right to subject royalties and profits from the alienation of rights or property giving rise to royalties to the taxes imposed by its law whenever the recipient thereof had a permanent establishment in Italy, even if the rights or property in respect of which the royalties are paid was not effectively connected with such permanent establishment.

The reservation made by France is also worth mentioning, because it is one of the most interesting reservation made in that occasion. France reserved indeed the right to retain some tax on royalties of French origin when flows of royalties between France and the other Contracting State are unbalanced to France's disadvantage. In other words, the French tax authorities would retain their right to tax royalties at source whenever there was an unbalanced flow of royalties that was to France's disadvantage.

Taking the above into consideration, it is clear that the royalty provision in the 1977 OECD Model Convention was still a work in progress; although the framework of exclusive taxation at residence was maintained, the application of this article changed considerably due to the introduction of the beneficial ownership concept. Further, as countries expanded their tax treaty network and gained more experience in the application and interpretation of these instruments, the discussion concerning the attribution of exclusive taxing rights over royalty income to residence states intensified.

The provision of article 14 concerning the taxation of independent personal services was transposed almost entirely from the 1963 OECD Draft Model Convention to the 1977 OECD Model Convention. The scope of such article included, among the others, independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. The taxation of independent personal services was focused on the preference for residence taxation of this income, with the adoption of the fixed base as a threshold for source taxation. This treatment is similar to the taxation of business profits, albeit in the latter case reference is made to the permanent establishment concept.

Finally, the provision (article 21) related to all the other items of income of a resident of a Contracting State, wherever arising, not dealt with any other article of the 1977 OECD Model Convention confirmed the attribution of the taxing rights exclusively to the residence country[32].

[32] However, a new paragraph was included in article 21 according to which: "The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a

**1.2.3. The subsequent revisions of the OECD Model Convention – ** After the release of the 1977 OECD Model Convention, the global economy evolved considerably, with technological developments occurring at a more rapid pace than ever before. As a consequence, studies were conducted in the 1980s on whether amendments should be made to this model convention to bring it into conformity with economic reality. Since the revision of the model convention demanded ongoing attention and was a lengthy procedure, the Committee of Fiscal Affairs opted for period updates in a loose – leaf format.

Since 1977, the OECD Model Convention undergone seven revisions, before the last one in 2017; i.e. i) in 1992 (hereinafter also referred to as the "1992 OECD Model Convention"[33]); ii) in 1998 (hereinafter also referred to as the "1998 OECD Model Convention"[34]); iii) in 2000 (hereinafter also referred to as the "2000 OECD Model Convention"[35]); in 2005 (hereinafter also referred to as the "2005 OECD Model Convention"[36]); iv) in 2008 (hereinafter also referred to as the "2008 OECD Model Convention"[37]); v) in 2010 (hereinafter also referred to as the "2010

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resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply".

[33] OECD, *Income and capital model convention and commentary*, 1 September 1992, available at <www.ibfd.org>.

[34] OECD, *Income and capital model convention and commentary*, 1 June 1998, available at <www.ibfd.org>. For a comment, see D. LŰTHI, A. KOLB, C. STIEFEL, *The revision of the 1977 OECD Model Convention – An overview*, in *Intertax*, 1992 (no. 12), p. 653.

[35] OECD, *Income and capital model convention and commentary*, 29 April 2000, available at <www.ibfd.org>.

[36] OECD, *Income and capital model convention and commentary*, 15 July 2005, available at <www.ibfd.org>.

[37] OECD, *Income and capital model convention and commentary*, 15 July 2008, available at <www.ibfd.org>.

OECModel Convention”[38]) and vi) in 2014 (hereinafter also referred to as the “2014 OECD Model Convention”[39]).

I will go briefly through the aforementioned revisions focusing on those aspects which are of the most interesting for the present analysis. Firstly, looking to articles 5, 7 and 21 of the different versions of the Model Conventions, it is worth mentioning that these articles remained essentially unaltered[40]. As a result, the provision of services, irrespective of its recurrence and / or amount of profits made, should be taxed primarily at the residence state, with taxation at source dependent on the existence of a permanent establishment. This implies that the provision of services could be viewed as a permanent establishment itself, as it did not fulfil the requirements of article 5(1) and there was no exception on the matter neither in the subsequent paragraphs of the article 5 nor in other articles of the Model Convention.

In this respect, it is worth underlining that during the years one of the main focuses of the OECD in the analysis of controversial matters in the practical application of double tax treaties was the interpretation and application of the permanent establishment concept[41]. As for example, in 2013 a report[42] was issued by the OECD: the OECD perspective was in the sense that the rules in force at that time were applicable to the new forms of economic activities developed and that, therefore, no amendment of the provisions included in the OECD Model Convention was needed. However,

[38] OECD, *Income and capital model convention and commentary*, 22 July 2010, available at <www.ibfd.org>.

[39] OECD, *Income and capital model convention and commentary*, 26 July 2014, available at <www.ibfd.org>.

[40] Among the others, see A. DETWEILER, *Article 21 of the OECD Model Convention: Past, Present and Future*, in *Intertax*, 2009 (no. 37), p. 235; R. A. PAPOTTI- N. SACCARDO, *Interaction of Articles 6, 7 and 21 of the 2000 OECD Model Convention*, in *Bulletin for International Fiscal Documentation*, 2002 (no. 56), p. 516.

[41] For further details, see M. KOBETSKY, *Article 7 of the OECD Model: Defining the Personality of Permanent Establishments*, in *Bulletin*, 2006, p. 411; H. PIJL, *Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings*, in *Bulletin for international taxation*, 2011, p. 294.

[42] OECD, *Revised proposals concerning the interpretation and application of article 5 (Permanent Establishment), 19 October 2012 to 31 January 2013*, available at <www.oecd.org>; OECD, *Interpretation and application of article 5 (Permanent establishment) of the OECD model tax convention*, 12 October 2011 to 10 February 2012, available at <www.oecd.org>.

recognizing that in practice the application of the permanent establishment concept was still imprecise, the OECD analyzed proposals made by countries to alter the commentaries on the OECD Model Convention with the goal of shedding light on disputed topics. The proposals made in the permanent establishment reports were centered on how to interpret the concept in light of recent developments, e.g. the possibility of conducting work from a home office. Despite the considerable work done in the reports, the proposal for amendments to the Commentaries on the OECD Model Convention have not been discussed thoroughly. The reports have been superseded by a greater plan to combat base erosion and profit shifting, the BEPS Action Plan, on which we will focus below[43].

Unlike articles 5, 7 and 21, article 12 has been significantly modified since 1977. With reference to the 1992 revision, the definition included in paragraph 2 of article 12 has been updated[44]. More specifically, the reference to the "the use of, or the right to use, industrial, commercial or scientific equipment" included in the definition of royalties provided by article 12 of the 1977 OECD Model Convention was deleted, with the result that paragraph 2 limited the objective scope of article 12 to "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, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience". In other words, the removal of the expression "for the use of, or the right to use, industrial, commercial or scientific equipment" in article 12(2) further reduced the scope of application of article 12, submitting leasing operations to the general rule of business profits.

In this respect, the Commentary to the 1992 OECD Model Convention clarified that, given the nature of income from the leasing of industrial, commercial or scientific equipment, including the leasing of containers, the Committee on Fiscal Affairs decided to exclude income from

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[43] See below paragraph 1.2.4.

[44] See G. D. SPRAGUE – R.A. CHESLER, *Comments on the Commentary to article 12 (Royalties) of the 1992 OECD Model Convention*, in *Intertax*, 1993 (no. 6 – 7), p. 310.

such leasing from the definition of royalties and, consequently, to remove it from the application of article 12 in order to make sure that it would fall under the rules for the taxation of business profits, as defined in articles 5 and 7.

In addition to the above, concerning the commentaries on this provision, the definition of know – how by reference to the Association des Bureaux pour la Protection de la Propriété Industrielle was removed, as well as the need for these payments to refer to information that has not been patented, is non-divulged and arises from previous experience. It can be inferred that there reference have been deleted because an international tax concept of know – how already exists.

With reference to article 12 of the 1992 OECD Model Convention there were several observations and reservations on the article. Italy reserved the right: i) to tax royalties at source, even if prepared to grant favorable treatment to certain royalties (e.g. copyright royalties); ii) to subject the use of, or the right to use, software rights to a tax regime different from that provided for copyright and iii) to subject royalties and profits from the alienation of rights or property giving rise to royalties to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the rights or property in respect of which the royalties are paid is not effectively connected with such permanent establishment.

With reference to the 1998 revision, paragraph 1 of article 12 was changed. The words "royalties arising in a contracting State and *paid to* a resident of the other contracting state shall be taxable only in that other state if such resident is the beneficial owner of the royalties" has been changed into "royalties arising in a contracting state and *beneficially owned* by a resident of the other contracting state shall be taxable only in that other state" (emphasis added). In other words, the expression "paid to" was removed in favor of "beneficially owned", which was a more direct wording giving the residence state of the beneficial owner exclusive taxing rights over royalty income.

However, the substance of article 12(1) included in the 1998 version of the OECD Model Convention remained unchanged if compared to article 12(1) of the 1977 OECD Model Convention, since the exclusion of the term "paid" did not alter the scope of the paragraph: both the versions prescribed exclusive taxation in the residence state of the beneficial owner. In this respect, it is worth recalling that the wording of article 12(1) of the 1977 OECD Model Convention suggested literally that the article would be applicable only when payments were received directly by the beneficial owner. By making reference solely to the residence of the beneficial owner, the 1998 OECD Model Convention confirmed that cases in which payments were received by an intermediary who resided in the same state as the beneficial owner and the income was further transferred to the latter were also within the scope of the provision.

With reference to article 12 of the 1998 OECD Model Convention there were several observations and reservations on the article.

Going to the 2000 revision, paragraph 3 of article 12 was amended by deleting reference to article 14. Such a change was a mere consequence of the deletion of article 14 of the Model Convention related to the "independent personal services"[45]. As already mentioned, article 14 assimilated income from independent personal services to business income, subjecting taxation at source to the threshold of a fixed place of business but it did not adopt the permanent establishment concept; rather it innovated by making reference to a fixed base. This term was not defined in the model convention, but examples were given on what would constitute a fixed base. In the view of the drafters of the model convention, the uncertainty surrounding the concept would be beneficial, as the article would not be bound to a precise term such as a permanent establishment.

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[45] Italy fully confirmed the reserves made to article 12 of the 1992 OECD Model Convention also with reference to article 12 of the 1998 OECD Model Convention. See J.W.J. DE KORT, *Why Article 14 (Independent Personal Services) was Deleted from the OESO Model Tax Convention*, in *Intertax*, 2001 (Volume 29, Issue 3), p. 72; J. D. B. OLIVER, *The Future Relevance of Article 14*, in *Intertax*, 2001 (Volume 29, Issue 6-7), p. 204; E. VAN DER BRUGGEN, *Developing Countries and the Removal of Article 14 from the OECD Model*, in *Bulletin*, 2001, p. 601.

Nevertheless, the result of this vagueness was exactly the opposite, i.e. countries could not precisely assert the scope of the provision and how to apply it. With the goal of clarifying these issues, the OECD established a working group on article 14. The working group focused on certifying: i) the activities that would be subject to article 14; ii) the persons covered by the provision and iii) whether there were practical differences between taxation according to article 7 and article 14.

Concerning the material scope of the article, the working group[46] acknowledged that either there were no practical differences between the activities regulated by article 7 and article 14 or the differences did not justify a diverse treatment of the activities, so deleting article 14 would be the most logical approach. As for the personal scope, the ambiguity of whether the provision was applicable solely to individuals or also to companies, the need for coherence in the tax treatment of services, irrespective of the service provider, and the irrationality of maintaining two articles dealing with the same issue justified the deletion of article 14.

Further, regarding practical differences between article 7 and 14, the working group conceded that the threshold for taxation was lower in the case of a fixed base, i.e. the development of activities through this base was not a necessary condition for a fixed base to arise. Consequently, the deletion of article 14 and submission of its activities to the permanent establishment threshold of article 7 could indeed restrict source taxation rights. Nonetheless, as the working group did not find practical examples of fixed bases that would not be permanent establishments or vice versa, it supported, once again, the deletion of article 14.

As a result of this report, the OECD removed article 14 from its Model Convention in the year 2000; from this date on, independent personal services were subject to article 7 of the OECD model convention. The deletion of article 14 from the OECD Model Convention met with resistance from academic literature and certain countries, which insisted on the

[46] OECD – Committee on Fiscal Affairs, *Issues related to article 14 of the OECD Model Tax Convention*, Paris, 27 January 2000, available at <www.ibfd.org>.

importance of the fixed base concept for the source taxation of income from services, since it would be less strict than the permanent establishment concept, allowing for more source taxation. Further, a number of countries decided to maintain this provision in their tax treaties.

Moreover, the uncertainty of the beneficial ownership concept necessitated the addition of paragraphs to the commentaries asserting that this concept should not be applied as a means of verifying the person with ultimate control over entities or assets, e.g. the shareholder of a company, but rather as the individual or entity that has the right to use and enjoy the royalties without any contractual or legal obligation to pass the income received to another person. This obligation to forward the income needed to be dependent on the receipt of income, so obligations as a debtor or party in a financial transaction did not affect an individual's status as a beneficial owner.

1.2.4. The impact of the Base Erosion and Profit Shifting Project – Working further on the update of the Model Convention, the OECD embarked on a much broader plan to study a phenomenon that, although not novel, was happening on a much broader scale in this century, the erosion of the tax base of countries and the consequent profit shifting to low – tax states.

This issue was first addressed in a report prepared by the OECD at the beginning of 2013[47]. In this report, the OECD recognized that, despite the lack of empirical evidence supporting the actual effect of the BEPS activities on the tax base of countries, base erosion was a risk to the collection of tax revenues as well as the sovereignty and tax fairness of states, affecting non – member countries as well. Further, it was acknowledged that the technological development and greater integration between countries may lead to the inadequacy of current domestic and international rules for international taxation and the economic reality.

[47] OECD, *Addressing base erosion and profit shifting*, Paris, 2013, available at <www.keepeek.com>.

Significant focus was put on the permanent establishment concept, moving from the consideration that in the existing scenario it was possible to participate considerably in the economy of a state without having a permanent establishment therein. In order to tackle BEPS, OECD decided on developing an Action Plan to be adopted worldwide, in a coordinated manner, with the goal of realigning international tax standards to the current business environment.

One of the key objectives of the BEPS initiative was to ensure taxation where the significant economic activities take place and value is created. More specifically, the OECD project was based on the premise that: “[i]nternational tax issues have never been as high on the political agenda as they are today. The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created”[48].

This Action Plan was presented in June 2013[49] and identified fifteen actions along three key pillars: introducing coherence in the domestic rules that affect cross – border activities, reinforcing substance requirements in the existing international standards and improving transparency as well as certainty. In any case, the OECD Action Plan made it clear that its purpose was to directly address the flaws in the current system instead of developing a new system. Moreover, it was clearly stated that, although the actions may lead to more source or residence taxation, it was not within the scope of the Action Plan to amend the existing international allocation of taxing rights between states. Hence, the Action Plan was not concerned with the possible inadequacy of the standard adopted by the double treaties as regards source and residence taxation; its focus was on closing loopholes that may

[48] OECD, *Addressing base erosion and profit shifting*, cit., p. 35.

[49] OECD, *Action plan on base erosion and profit shifting*, OECD Publishing; Paris, 2013, available at <www.oecd.org>.

lead to BEPS, such as the double non – taxation of international income. In other words, according to the BEPS Project intention, an eventual increase of source or residence taxation would be a mere consequence of the fulfillment of its limited objective.

As already mentioned, the OECD identified 15 actions that should be taken to tackle base erosion and profit shifting phenomenon but this study will not delve into all actions[50]. In this respect, it must be borne in mind that the BEPS project does not view services as base erosion activities; nevertheless the taxation of services can be affected in principle by numerous BEPS actions. In light of this, I have decided to focus the present analysis only on the action which is more closely linked to the object of the present chapter[51]: Action 7 on preventing the artificial avoidance of permanent establishment status[52].

1.2.4.1. The BEPS Project: focus on Action 7 on preventing the artificial avoidance of permanent establishment status – To tackle BEPS through the artificial avoidance of the permanent establishment status, the OECD Action Plan endeavored to study potential amendments to the permanent establishment definition, with the aim to prevent the use of certain common tax avoidance strategies that were currently used to

[50] For an analysis of the overall project and its main implications, see G.S. COOPER - M. STEWART, *The Road Home? Finalizing and Implementing the BEPS Agenda*, in Bull. Intl. Taxn, 2015, p. 69; A. P. DOURADO, *The Base Erosion and Profit Shifting (BEPS) Initiative under Analysis*, in *Intertax*, 2015 (no. 43), p. 2; P. SAINT-AMANS – R. RUSSO, *The BEPS Package: Promise Kept*, in *Bulletin for International Taxation*, 2016 (Volume 70 - No. 4); B. YALTI (et al.), *Base erosion and profit shifting (BEPS) in taxation*, Beta, Istanbul, 2018. For a comment about the impacts of the BEPS Project, see G. MAISTO, *Shall international tax planning drop dramatically by virtue of BEPS? It depends*, in B. YALTI (ET AL.), *Base erosion and profit shifting (BEPS) in taxation*, Istanbul, 2018, p. 171; G. MARINO, *The "gattopardo" side of BEPS: Everything Must Change so that Everything Can Stay the Same*, in C. HOYOS JIMENEZ, C. GARCIA NOVOA, J. A. FERNANDEZ C., *New Taxation: Studies in Honor of Jacques Malherbe*, Bogotà, 2017, p. 1013.

[51] For a further analysis on Actions 8 – 10 on aligning transfer pricing outcomes with value creation, see next chapter 2; for a further analysis on Action 1 on addressing the tax challenges of the digital economy, see next chapter 3.

[52] OECD / G20 BEPS PROJECT, *Action 7 on preventing the artificial avoidance of permanent establishment status*, Paris, 2015, available at <www.oecd.org>.

circumvent the permanent establishment definition[53]. More specifically, the OECD activity focused on the following tax avoidance strategies:

i) commissionaire arrangements, through which taxpayers replace subsidiaries that traditionally acted as distributors by commissionaire arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country. More specifically, according to BEPS Action 7, "[a] commissionaire arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission)";

ii) the exemptions mentioned in article 5(4), the exploitation of which was – according to Action 7 – particularly relevant with reference to the digital economy. More specifically, moving from the consideration that, since the introduction of the exemptions in article 5(4), "there have been dramatic changes in the way that business is conducted", the report on Action 7 outlined that activities previously considered to be merely preparatory or auxiliary in nature may correspond in the context of the digitalized economy to core business activities. In order to ensure that profits derived from core

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[53] See D. AVOLIO – D. SENCAR, *La nuova "anti-fragmentation rule" in materia di stabile organizzazione*, in *Corriere Tributario*, 2016 (no. 38), p. 2927; V. DHULDHOYA, *The Future of the Permanent Establishment Concept*, in *Bulletin for International Taxation*, 2018 (Volume 72 - No. 4a/Special Issue*);* J. EISENBEISS, *BEPS Action 7: Evaluation of the Agency Permanent Establishment*, in *Intertax*, 2016 (no. 44), p. 481.; C. GARBARINO, *L'impatto del progetto BEPS sul concetto di stabile organizzazione*, in *Diritto e Pratica Tributaria*, 2019 (no. 2), p. 587; A. PLEIJSIER, *The Agency Permanent Establishment in BEPS Action 7: Treaty Abuse or Business Abuse?*, in *Intertax*, 2015 (no. 43), p. 147 ss.; Y. USLU*, An Analysis of "Google Taxes" in the Context of Action 7 of the OECD/G20 Base Erosion and Profit Shifting Initiative,* in *Bull. Intl. Taxn.*, 2018, p. 72.

activities performed in a country can be taxed in that country, Article 5(4) should be modified to ensure that each of the exceptions included therein was restricted to activities that are otherwise of a "preparatory or auxiliary" character;

iii) "fragmentation of activities", which implies an avoidance of the permanent establishment status within a multinational group by fragmenting a cohesive operating business into several small operations – each of one performed by a different company belonging to the multinational group - in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions from the permanent establishment status;

iv) the splitting up of contracts as a means to avoid having a permanent establishment at source, in order to benefit from the exception provided by art. 5(3) of the Model Convention for the construction sites.

In its initial draft report on measures to be taken regarding Action 7[54], the OECD focused on potential amendments to paragraphs 3, 4, 5 and 6 of article 5 and respective commentaries on the OECD model convention that could further combat BEPS. With reference to the commissionaire arrangements, the potential amendments concerned paragraphs 5 and 6 of article 5, with the aim to curb the use of commissionaire arrangements to erode the tax base of the source state: the debate about these two amendments was quite intense. The BEPS Action 7 Report prescribed four alternatives for amending paragraphs 5 and 6 of article 5, the wording of which was unchanged since the 1963 OECD Draft Model Convention. The crux of these proposals was the assertion that whenever the activities of an intermediary lead to the conclusion of contracts to be performed by the foreign resident and the intermediary was not acting in the course of his own business, the foreign resident should be liable for taxation at source. In such a work, the OECD focused on the terms "authority to conclude contracts in the name of", the controversy surrounding the interpretation of which is a

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[54] OECD / G20 BEPS PROJECT, *Public Discussion Draft, BEPS Action 7: Preventing the artificial avoidance of PE status*, 31 October 2014 – 9 January 2015, Paris, 2014, available at <www.oecd.org>.

deep-rooted one. Its origins lie in the differences of interpretation between civil law and common law countries. Given that the concept of “agency” is a non-tax concept and is undefined in tax treaties, reference to the domestic law of countries that have adopted these different legal systems and, therefore, have varied interpretations, is unavoidable. At the heart of the debate is the varied interpretation of the concept of an “agency”. While civil law countries recognize a difference between direct and indirect representation and, therefore, the intricacies of the principals’ liability in each of the situations, common law countries do not recognize such a difference. Under a common law system, the concept of indirect representation does not exist and the deeds of the agent, or the representative, bind the principal, i.e. the foreign enterprise, with regard to third parties. This is even the case where the third party has no knowledge of the principal. As a result, under a common law system, the agent binds the principal, even if the agent concludes contracts in its own name, with third parties, as the agent is acting for the principal as such, while, under a civil law system, the principal is not bound by contracts entered into by an agent. What follows, in simple terms, is that common law countries adopt a more economic approach in holding that, ultimately, the principal is liable to the agent, while civil law countries adopt a more legalistic approach, as the third party can only sue the agent and not the principal under the relevant contract.

The use of this indirect representation where the agent concludes contracts in its own name, which is referred to as commissionnaire arrangements, has become common, as the principal can participate in the economic life of the source state without having a dependent agent permanent establishment. This is so, as the provision on agency permanent establishments only applies where an agent concludes contracts in the name of an enterprise. The discussion surrounding the interpretation of these terms was further fueled by the insertion in the Commentary in 2003 of paragraph 32.1, which stated that: “also the phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of

the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise".

According to one interpretation, this amendment was made to clarify that the common law approach of considering the principal as legally bound, even where the contract was concluded in the name of the agent, could fall within the scope of article 5(5) of the OECD Model and, therefore, that the activities of the agent, i.e. the commissionaire, could constitute a permanent establishment for the principal in the source state. However, this was not to be interpreted as a widening of the application of article 5(5) of the OECD Model so as to adopt a more economic or substance-over-form approach in every case. Nevertheless, the debate still remained unsettled with courts in some countries adopting a legal approach, while others adopted the economic one and held that even the activities of the commissionaire could constitute a dependent agent permanent establishment for the principal.

In addition to the above, many foreign enterprises adopted a strict legal interpretation of the term "authority to conclude": they could limit the authority given to the agent, such that the agent would do all the soliciting and other groundwork in the source state, but the contract would, ultimately, be concluded by the principal. Consequently, the interpretation that was adopted had the effect that, as the agent did not have the "authority to conclude", the requirements of article 5(5) of the OECD Model were not satisfied and, therefore, there could not be an agency permanent establishment of the principal. As a result, even though an agent undertook substantial activities in the source state, a foreign enterprise would not have a permanent establishment. The OECD attempted in 2005, through amendments to the commentary, to clarify that even if an agent has not been given the formal authority to conclude, it can still be interpreted that the agent has such authority, if the agent negotiates the main elements of the contract in a way that is binding on the principal.

The draft report tried to further clarify both the points mentioned above, identifying – as already mentioned - four different options to change the model convention and the relating paragraphs of the Commentary[55].

[55] Option A read as follows: "[N]otwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts: a) In the name of the enterprise, or b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) For the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for 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".

In other words, in option A, paragraph 5 would be extended to include the provision of services as a situation leading to a permanent establishment and an agency permanent establishment would be deemed to arise whenever an intermediary engages with persons in a way that results in the conclusion of contracts. Additionally, it would be clarified in paragraph 6 that an intermediary acting exclusively or almost exclusively on behalf of an enterprise shall not be considered an independent agent.

Option B read as follows: "Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, that are a) In the name of the enterprise, or b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) For the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for 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".

In light of the above, it emerges that option B had the same concept as option A, with the difference that the former was also applicable to situations in which the contract was not concluded by the intermediary, who negotiated the material elements of the contract.

Option C read as follows: "Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for 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".

This proposal used the phrase of Proposal A, namely 'engaging with specific persons resulting in the conclusion of contracts' but added a new element. The contracts should be, by virtue of the legal relationship between that person and the enterprise, on the account and risk of the enterprise. Consequently, legal agreements between the foreign company and its intermediary could not be used, as it happens with commissionaire arrangements, to exclude source taxation of the provision of services / sales of goods by the foreign entrepreneur.

Lastly, option D read as follows: "Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting

Looking to the existing common point, all the proposals incorporated in Article 5(6) of the OECD Model convention the idea discussed in the commentaries on the article, and present in article 5(6) of the UN Model convention, that a person acting exclusively on behalf of an enterprise or associated enterprises could not be viewed as an independent agent. On the other hand, the provision did not incorporate the limitation set on the 2001 UN Model Convention that, for the agent to be considered dependent, the conditions set between him and the foreign enterprise should not be arm's length. The lack of reference to the arm's length principle made the proposed OECD paragraph more beneficial to source states than the UN Model Convention paragraph itself.

As regards the exemptions prescribed in article 5(4), the OECD suggested rephrasing Article 5(4)(f) to clarify that the activities mentioned in paragraphs (a) to (e) would not lead to a permanent establishment only if they were of a preparatory or auxiliary nature, so they would form a permanent establishment if the enterprise had one of these activities as its main activity. If countries did not agree on this amendment, the OECD proposed three alternatives: (i) the deletion of the world "delivery" in subparagraphs (a) and (b), aligning the OECD Model Convention with the UN Model Convention; (ii) the deletion of the exception for purchasing activities from subparagraph (d); (iii) or the complete deletion of subparagraph (d).

State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for 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".

Option D had a strong relation with the current agency permanent establishment definition: it was based on option B, but also incorporated the provision of option C regarding contracts that are on the account and at the risk of the foreign enterprise due to a legal relationship between the intermediary and such an enterprise.

For a critical review of the four proposals, see A. PLEIJSIER, *The Agency Permanent Establishment in BEPS Action 7: Treaty abuse or business abuse?*, in *Intertax*, 2015 (Volume 43 – Issue 2), p. 147.

Such an idea was also not new, since it has already been proposed prior to the establishment of the BEPS Action Plan. Whether the specific activities mentioned in article 5(4)(a) to (d) of the OECD Model were also subject to a “preparatory or auxiliary” requirement was indeed a question that had been widely debated and on which there were divergent opinions. The OECD’s view could be gauged from the clarification in the Commentary on Article 5 of the OECD Model, which stated that article 5(4)(e) of the OECD Model specifically stipulated that these activities had to be of a preparatory or auxiliary nature. In addition, others shared this view to the effect that the “preparatory or auxiliary” requirement was a general requirement that had to be satisfied with regard to any activity to fall within the scope of article 5(4) of the OECD Model. However, others adopted a more literal reading and were of the view that the requirement of “preparatory or auxiliary” was specifically referred to only in article 5(4)(e) and (f) of the OECD Model and, therefore, did not apply to the other specific activities noted in article 5(4)(a) to (d).[70]

In practical terms, there were many who adopted this latter view. This gave rise to concerns of base erosion and profit shifting, as it permitted multinational groups to undertake these activities, which could be core activities in certain business models and not preparatory or auxiliary in nature, in the source state without creating a taxable presence there.

With reference to the fragmentation of activities, an anti-fragmentation rule was proposed. More specifically, the OECD proposed the inclusion of a paragraph to deny the application of the exceptions to complementary activities carried on by associated enterprises when one of the enterprises has a permanent establishment in the source state or even if none of the associated enterprises has a permanent establishment in the source state.

Also in this case, it is worth mentioning that the Commentary on Article 5(4) of the OECD Model already provided some guidance with regard to the separation and fragmentation of activities and clarified that: “an enterprise cannot fragment a cohesive operating business into several small

operations in order to argue that each is merely engaged in a preparatory or auxiliary activity". By way of Action 7, the OECD intended to strengthen the fragmentation rule by introducing a devoted paragraph within the scope of article 5 of the OECD model convention, as well as to expand the cases of applicability of the fragmentation rule: the proposed anti-fragmentation rule would indeed take into consideration not only activities carried on by the same foreign enterprise at multiple different places of business, but also the activities carried on by closely related enterprises at different places or at the same place as the foreign enterprise within the source state.

The issue concerning article 5(3) was that to avoid passing the 12-month threshold and, consequently, having a permanent establishment at source, enterprises have been splitting up contracts between companies of the same group, so that no activity will be conducted by the same company in the source state for more than 12 months. Although this issue can be solved by a general anti – abuse clause, which was discussed in BEPS Action 6, the OECD also proposed a more targeted approach, the inclusion in article 5(3) of a provision stating that activities carried out by associated enterprises in the same building site or construction or installation project during different periods of time should be added up when assessing this 12 – month threshold.

It is interesting to note that also this inclusion has already been suggested in the commentaries on article 5 of the OECD Model convention, so it cannot be said that the report is actually bringing a novel idea to the discussion. Alternatively, the report also proposed to include a paragraph on the commentaries with an example of a situation in which a permanent establishment would arise, notwithstanding the fact that the 12-month threshold was not surpassed by any individual company of the same group, because the splitting up of contract was done with the principal purpose of avoiding the permanent establishment.

This public discussion draft received a considerable number of comments (more than 850 pages of comments) and, as a consequence, a

revised discussion draft was released[56]. In this revised draft, the OECD intended to clarify issues that were still unclear to commentators and amended the initial proposals in line with the comments received.

Since most of the commentators expressed their preference for option B for amending paragraphs 5(5) and 5(6), the working party of the OECD favored option B. As for the amendments on article 5(4), despite objections to all alternatives proposed by the public discussion draft, commentators and the working party of the OECD preferred to limit exceptions to the formation of a permanent establishment to situations that are preparatory or auxiliary, stating that additional guidance on the meaning of the term was necessary. Regarding the anti-fragmentation rule to be introduced in article 5(4), commentators considered that the alternatives proposed would be difficult to apply in practice, as there was uncertainty in the definition of terms, and did not favor the adoption of any of the proposals made. In spite of these remarks, the working party of the OECD confirmed the importance of an anti – fragmentation rule and – as a consequence – expressed its support for the adoption of a provision that should apply regardless of the existence of a permanent establishment at source. Concerning the potential amendment of Article 5(3) to combat the splitting up of contracts, the proposals were heavily objected, but some commentators expressed their preference for the inclusion of paragraphs in the commentaries to deal with this issue. As a consequence, the revised draft proposes the inclusion of an example in the commentaries in which the splitting up of contracts did not prevent a permanent establishment because this artificial split has been done with the main purpose of avoiding the permanent establishment threshold and, for countries that favor the inclusion of a specific paragraph on the Model Convention, the commentaries put forward the wording of an article, similar to the proposal made in the public discussion draft.

[56] OECD / G20 BEPS PROJECT, *Revised discussion draft, BEPS Action 7 on preventing the artificial avoidance of PE status*, 15 may 2014 – 12 June 2015, Paris, 2015, available at <www.oecd.org>.

The revised draft proposal was also open for comments. After considering these remarks, the conclusions reached by the OECD were presented in the Action 7 Final Report.

With reference to the artificial avoidance of permanent establishment status through commissionaire arrangements, paragraphs 5 and 6 of article 5 were replaced by the following: "5. Notwithstanding the provisions of paragraphs 1 and 2 *but subject to the provisions of paragraph 6*, where a person is acting *in a Contracting State* on behalf of an enterprise and*, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are a*) in the name of the enterprise*, or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise,* that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for 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. 6. *a)* Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of *one or more enterprises to which it is closely related*, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise. b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent

of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise" (italics added).

As it emerges, article 5(5) and 5(6) were once again amended, and the terms "or negotiates the material elements of contracts" and "of one or more enterprises to which it is connected" were replaced, respectively, with "or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" and "of one or more enterprises to which it is closely related". The definition of article 5(6)(b) was also amended to provide for the definition of closely related, as had happened with the proposed anti-fragmentation rule mentioned above. On that matter, it was added in article 5(6)(b) that the threshold of having more than 50% of the beneficial interest in an enterprise is related to direct and indirect ownership.

Consequently, the paragraphs to be included in the commentaries on article 5 have been amended correspondingly to reflect these changes.

With reference to the exceptions contained in article 5(4); the final report did not diverge from the revised draft, maintaining the wording of the article proposed. More specifically, paragraph 4 of article 5 was replaced by the following: "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; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of

collecting information, for the enterprise; *e*) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity (deleted "of a preparatory or auxiliary character"); *f*) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *a)* to *e)*, (deleted: "provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character"), *provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character*" (italics added).

However, more guidance was included in the commentaries, e.g. an example dealing with an insurance company that sets an office for the collection of information.

As for the anti-fragmentation rule, the sole significant difference in comparison to the revised draft was the substitution of the term "connected enterprises" with "closely related", amending the wording of the proposed paragraph and the corresponding commentaries. More specifically, the final wording to be included in the new paragraph 4.1 of the model convention reads as follows: "4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation".

In this Final Report, the OECD opted to reassert the idea contained in the revised draft that, to avoid the splitting up of contracts, an example

should be added in the commentaries on the principal purpose test and in the commentaries on article 5(3), substituting the term "connected enterprises" with "closely related enterprises". This proposal was not surprising, since comments on the drafts focused on the uncertainty of the terms used, such as "closely related", and questioned what the material elements of the contract would be. By referring to the role of the agent in negotiating contracts that are not significantly altered by the foreign enterprise, the deliverable looked to dismiss the issues surrounding the definition of the terms and focused on actual work developed by the agent. Hence, it could be said that the final provision was in line with the idea of attributing the taxing rights to the place where the activity is developed.

Taking the aforementioned into consideration, it remains clear that, notwithstanding the comments received on the drafts, in its final report on action 7 the OECD maintained its goal of amending article 5(4), 5(5) and 5(6) of the OECD Model Convention to prevent the avoidance of permanent establishment status through the use of the exceptions to the formation of a permanent establishment and commissionaire arrangements. As for the measure intended to combat the splitting up of contracts, the OECD dealt with this issue in its traditional manner, inserting paragraphs in the commentaries without effectively altering the wording of the respective article in the model convention[57].

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[57] Even if it goes beyond the scope of the present work, it is important – for the sake of completeness- to mention that the final report on Action 7 mandated follow-up work to develop additional guidance on the issue of attribution of profits to permanent establishments: such work was intended to provide guidance on how the rules of Article 7 should apply to permanent establishments resulting from the changes in the Report on Action 7 of the BEPS Action plan to Article 5, as well as take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital. As a consequence, a discussion draft was released on July 4, 2016 (OECD / G20 BEPS PROJECT, *Action 7: additional guidance on the attribution of profits to a permanent establishment under BEPS Action 7*, Paris, 4 July 2016 – 5 September 2016, available at <www.oecd.org>); such a discussion draft was replaced by a new discussion draft (OECD / G20 BEPS PROJECT, *Action 7: additional guidance on the attribution of profits to a permanent establishment under BEPS Action 7*, Paris, 22 June 2017 – 15 September 2017, available at <www.oecd.org>). The final report has been issued on March 22, 2018 (OECD / G20 BEPS PROJECT, *Additional guidance on the attribution of profits to permanent establishments – BEPS Action 7*, Paris, March 2018, available at <www.oecd.org>).

In light of the above, three preliminary considerations can be formulated. First, the proposed amendments to article 5(4) of the OECD Model that result from Action 7 appear to add an economic and/or substance test to the article. This is particularly evident with reference to the amendments made with reference to article 5(4) of the OECD Model: since it now specifically requires that the subparagraphs (a) to (d) be “preparatory or auxiliary” in nature, it requires furthermore that the fulfilment of these requirement is assessed on the basis of the business of the taxpayer. In summary, a business specific evaluation must be made, as what may be in the nature of “preparatory or auxiliary” for one business may be a core activity for another business.

The addition of an economic and/or substance test is further evidenced by the following proposed addition to the Commentary on Article 5 of the OECD Model that deals with article 5(4)(a) of the OECD Model and the storing, displaying and delivering of goods: “Whether the activity carried on at such a place of business has a preparatory or auxiliary character will have to be determined in light of the factors that include the overall business activity of the enterprise. Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise’s sale/distribution business and do not have, therefore, a preparatory or auxiliary character”.

Secondly, as already outlined, BEPS action plan expressly stated that the proposed measures were not “aimed at changing the existing international standards on the allocation of taxing rights on cross border income”. However, the final amendments did just the contrary, since they resulted in greater taxation in the source state than under the original provision that was drafted to benefit residence states.

In sum, BEPS Action 7 lowered the threshold at which commissionaire arrangements, auxiliary activities and building site and construction activities qualify as a permanent establishment[58].

The amendments have also been included in the updated 2017 OECD Model Convention (Article 5) and the Commentary on this article.

The BEPS outcomes – including those related to Action 7 - are intended to be implemented in countries' tax treaty networks via the multilateral convention[59]. However, the states are scarcely implementing the options provided under the Multilateral Convention on the permanent establishment concept. As outlined indeed by the BEPS itself, "[t]he various measures outlined in the final 2015 BEPS Action 7 Report are currently being implemented in a number of existing tax treaties through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI, Box 3.1), as well as in the course of bilateral tax

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[58] The BEPS outcomes – including those related to Action 7 - are intended to be implemented in countries' tax treaty networks via the multilateral convention. The relevant provisions can be found in Articles 12–15 of the multilateral convention. The multilateral convention leaves countries considerable scope to structure their tax treaty policies as they wish. It is entirely up to them, for example, whether to implement the BEPS outcomes relating to Action 7 in their tax treaties, either via the multilateral convention or otherwise.

With regard to the system to be applied, the approach adopted in the multilateral convention is that of 'yes, unless': in other words, all multilateral convention provisions are effective in every tax treaty entered into by countries that have signed the convention except those provisions that a country has stated do not apply. The MLI seeks to do this through a system of 'compatibility clauses', 'reservations' and 'notifications'.

The position differs with regard to the 'minimum standards' to which countries have committed themselves politically (i.e. treaty abuse and more effective dispute resolution through mutual agreement). Countries signing up to the multilateral convention are required to implement measures in these areas, although the multilateral convention also allows treaty partners flexibility by offering various alternative mechanisms.

In this respect, it is worth mentioning that the OECD acts as a depositary by maintaining public record of countries' accession to the multilateral instrument, their opt-in and opt-out choices and the dates on which the applicable provisions enter into force for the specific countries.

See OECD/G20 BEPS PROJECT, *Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS*, Paris, 2015, available at <www.oecd.org>. See also the text of the multilateral convention included in the document named "Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting", available at <www.oecd.org>. See A. BOSMAN, *General Aspects of the Multilateral Instrument*, in *Intertax*, 2017 (no. 45), p. 642 ss.; N. BRAVO, *The Multilateral Tax Instrument and Its Relationship with Tax Treaties*, in *World Tax J.*, 2016, 8; P.J. HATTINGH, *The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?*, in *Bull. Intl. Taxn.*, 2017, p. 71; P.J. HATTINGH, *The Impact of the BEPS Multilateral Instrument on International Tax Policies*, in *Bull. Intl. Taxn.*, 2018, p. 72.

[59] OECD, *Model tax convention on income and on capital – Condensed version*, Paris, 2017, available at <www.oecd.org>.

treaty negotiations. Based on the provisional positions of the jurisdictions that have signed the MLI, however, it is estimated that the changes recommended under Action 7 will only be implemented in a fairly limited number of bilateral treaty relationships. The latest projections are as follows: For the revised dependent agent PE definition (Article 5(5) of the OECD Model): It is estimated that, based on the positions taken so far, this revised definition would apply to around 17% of the 1 246 tax agreements currently covered by the MLI (i.e., approximately 206 bilateral tax agreements). For the revised provision defining specific-activity exemptions (Article 5(4) of the OECD Model): It is estimated that, based on the positions taken so far, this revised provision would apply to around 22% (i.e., approximately 277 bilateral tax agreements)"[60].

1.3. The treatment of cross border service fees in the current version of the OECD Model Tax Convention on Income and on capital – The tax treatment provided by the 2017 OECD Model Convention is that the profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein (as long as they are not covered by other Articles of the Convention that would allow such taxation). In other words, instead of several revisions, the same tax treatment of service fees provided by the first OECD Model Convention has been confirmed over times, even if with some amendments of the permanent establishment concept.

According to the current version of the commentary of the OECD Model Convention and in line with the previous versions of the OECD Model Convention, such a tax treatment is grounded by various policy and administrative considerations. From a theoretical point of view, it is consistent with the principle of setting the permanent establishment as the minimum threshold for attributing taxing rights to a given State. In other

[60] OECD, *Tax Challenges Arising from Digitalisation: Interim Report*, Paris, 2018, available at <www.oecd.org>.

words, until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State. The result is that the provision of services should, as a general rule subject to a few exceptions for some types of service be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services. In addition to such theoretical reasons, there are also administrative considerations, including, for example, the fact that the extension of the cases where source taxation of profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State would be allowed would increase the compliance and administrative burden of enterprises and tax administrations.

More specifically, looking to the relevant articles, Article 5 of the current OECD model – which covers the permanent establishment concept and reflects the work done at the BEPS level, as described in the preceding paragraph 1.2.4.1. – does not include any reference to the furnishing of services: such an aspect is worth underlining, since – as we will further detailed in the following paragraph 5 of this chapter – it represents one of the most important difference emerging from the comparison of the OECD Model Convention with the UN Model convention, the article 5 of which makes instead direct reference to the provision of services.

However, several paragraphs of the commentary on article 5 of the 2017 OECD Model Convention (see paragraphs 132 – 164) are entitled to the provision of services, confirming that there have been an important debate within the working parties about the tax treatment of services.

According to the Commentary to the OECD Model, two main points have been agreed by all the States. First of all, all member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. In other words, the mere fact that the payer of the consideration for services is

a resident of a State, or that such consideration is borne by a permanent establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.

The second commonly approved point is, according to the Commentary, about the amount on which tax should be levied: only profits coming from the provision of services (and not gross payments). In other words, only the profits derived from the services should be taxed. Thus, provisions that are sometimes included in bilateral conventions and that allow a State to tax the gross amount of the fees paid for certain services if the payer of the fees is a resident of that State do not seem to provide an appropriate way of taxing services. First, because these provisions are not restricted to services performed in the State of source, they have the effect of allowing a State to tax business activities that do not take place in that State. Second, these rules allow taxation of the gross payments for services as opposed to the profits therefrom.

In addition to the above two commonly accepted aspects, there were also quite different positions on the provision of services between the member states. As expressly stated in the Commentary, "some states are *reluctant* to adopt the principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated in their territory but that are performed in that territory. These States propose changes to the Article in order to preserve source taxation rights, in certain circumstances, with respect to the profits from such services" (emphasis added).

Several arguments are mentioned by such states in order to support their diverging position. The main concerns here are about those service businesses, which do not require a fixed place of business in their territory in order to carry on a substantial level of business activities: in such cases, additional taxing rights are deemed appropriate and the compliance and administrative difficulties do not justify exempting from tax the profits from such kind of services.

The result of such a debate was the inclusion of an optional provision within the Commentary: the aim of such provision is to limit the circumstances in which States that did not agree with the attribution of taxing rights on the service fees only to the residence country could tax profits from services performed in their territory by a non – resident entity, even if without a permanent establishment.

More specifically, the commentary allows the States to provide for an optional service permanent establishment provision according to which where an enterprise of a Contracting State performs services in the other Contracting State

a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or

b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless the activities performed are limited to those deemed to be not included in the permanent establishment concept.

In light of the above, it appears that the conditions for admitting taxation of service fees in the source country are: i) taxation should not extend to services performed outside the territory of a State; ii) taxation should apply only to the profits from these services (and not to the payments for them) and iii) taxation is allowed only in case of an earlier minimum level of a presence.

Article 7 of the 2017 OECD Model Convention confirms the permanent establishment as the minimum threshold for attributing taxing

rights on business income to the source country. More specifically, according to the named article, 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.

The current OECD model convention – also in this case in line with the previous versions of the model convention – does not include any specific rule for a withholding tax on services within the ambit of article 12 on royalties. Indeed, the mentioned article states that royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

The definition of royalties includes 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, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Also with reference to article 12, reference to the tax treatment of service fees is included in the current version of the Commentary to the 2017 OECD Model Convention. More specifically, in the Commentary on the OECD Model[61], attention is paid to mixed contracts that cover the supply of know-how and the provision of technical assistance services. According to the Commentary, the appropriate course to take with such contracts is that, if the services are only of an ancillary and largely unimportant character, the treatment for the supply of know-how should generally be applied to the whole amount of the consideration, including the payment for the services.

Finally, the so called catch all provision (article 21) which provides for the tax treatment on income which is not covered by other articles of the OECD Model Convention confirms the attribution of taxing rights to the residence country only.

[61] OECD Model, para 11.6.

1.4. The treatment of cross border services in the current version of the UN Model Convention between Developed and Developing Countries – After having analyzed the provisions included in the OECD Model, we will now focus on the corresponding provisions of the UN Model. However, with reference to the UN model, the analysis will be limited to the version currently in force[62], even if making reference to the revisions which have been performed by the United Nations over time and are of most interest for the present analysis.

Preliminarily, it should be noticed that the articles included in the UN Model Convention are constantly monitored and updated, as happened within the OECD. Aware of the need to undertake recurrent updates to its Model Convention and stirred by the work performed by the OECD, the UN decided indeed that, from 2005 on, the ad hoc group of the Committee of Experts on International Cooperation in Tax Matters should gather annually in Geneva in order to discuss the outstanding issues of the UN Model Convention. Looking to these meetings, it emerges that the taxation of services has been constantly addressed, with a focus whether (i) article 5 of the UN Model Convention should be amended; (ii) article 12 on royalties should be updated; (iii) article 14 on independent personal services should be deleted and (iv) changes to the OECD Model Convention should influence the UN Model Convention.

The treatment to be granted to the taxation of services was widely discussed prior to the release of the current version of the UN Model Convention. In this respect, the work done during the eight session of the Committee of Experts (Geneva, 15 – 19 October 2012)[63] is worth mentioning. In that meeting, indeed, the Committee of Experts set the requirements for source taxation of the income from services, establishing that source countries should: (i) be limited to taxing income from services performed in the source country; (ii) tax non – resident service providers

[62] UNITED NATIONS, *Model Double Taxation between Developed and Developing Countries*, New York, 2017, available at <www.un.org>.

[63] United Nations Committee of Experts on International Cooperation in tax matters, Eighth Session, Geneva, 15 – 19 October 2012, available at <www.un.org>.

only if their involvement in the economic life of the source country exceeds a minimum threshold; (iii) be entitled to tax income from services derived by non – residents if the payments are deductible by the payers against the source country's tax base; (iv) be given taxation rights over income from services only if those rights can be enforced effectively and (v) be required to tax income from services derived by non – residents on a net basis unless the expenses incurred in earning the income are not significant. Alternatively, if gross basis tax is permitted, the rate of tax should be limited, as it is with respect to dividends, interest and royalties. Taking these criteria into consideration, the Committee of Experts concluded that the tax treatment of services in the UN Model Convention was inconsistent and that the source principle was not yet fully recognized in regard to business services.

Moreover, it is worth mentioning that also the United Nations – as done by the OECD - have started a further revision procedure of their model convention, the result of which is the version currently in force.

Article 5 of the UN Model covering the permanent establishment concept makes direct reference to the provision of services. More specifically, article 5(3)(b) of the UN Model provides for the so called service permanent establishment, reading as follows: "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 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".

Within the OECD model, as already pointed out, such kind of provision represents only an option, which has been introduced by the Commentary as a result of the intense debate occurred within the OECD countries about the taxation over the service fees. Also within the UN Model,

the debate on the provision under analysis was quite intense[64]. As for article 5 of the UN Model Convention, it is striking that a discussion arose already in the first meeting of the Committee of Experts due to a remark that the article was flawed and needed to be rewritten. This assertion was questioned and, to prove that the assertion was incorrect, several experts referred to the long – standing tradition of the article in double tax conventions. Consequently, the UN Model Convention was guided by the idea that the permanent establishment concept should be maintained but that new developments in the international field should be subject to debate in the UN forum.

Later on, further significant amendments were proposed to Article 5(3)(b). It was thought that this article should be substituted by an article similar to the services permanent establishment alternative inserted in the Commentaries on the OECD Model, which has been examined in the preceding paragraph and that the threshold for taxation at source should be reduced to ninety or one hundred and twenty days. In spite of these recommendations, the sole amendment to the provision regarded the adoption of the 183 – day threshold instead of the six month threshold. This amendment, even though not substantial, brought more coherence to the UN Model Convention by assimilating the services permanent establishment to the one prescribed in Article 14(1)(b) with reference to the independent personal services. Although such modification, the two mentioned articles still presented an inconsistency: article 5(3)(b) of the 2011 UN Model Convention made direct reference to activities conducted at source for more than 183 days, while art. 14 stated that the person should be present at source for more than 183 days, irrespective of whether this person was conducting business during the whole period. Therefore, while in the case of article 5, the rendering of services for 160 days followed by a

[64] For a clear comparison of the service PE provisions provided by the OECD Commentary on the Model Tax Convention and the UN Model Tax Convention, see, among the other, S. P. GOVIND, *The International Tax Treatment of Cross-Border Services*, in *Bulletin for International Taxation*, 2011 (no. 66), p. 4.

vacation of 30 days would not create source taxation rights, this income would be taxed at source under Article 14(1)(b).

In the 2011 revision of the United Nations Model Convention, the Committee agreed to a slight change in the wording of subparagraph (b) of paragraph 3, which was amended to read: “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 twelve-month period commencing or ending in the fiscal year concerned”, rather than, “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 six months within any twelve-month period”, as it formerly read. This was seen as providing greater consistency with the approach taken in Article 14, paragraph 1, subparagraph (b).

In the 2017 revision the Committee made a further change to subparagraph (b) to remove the words in parenthesis “(for the same or a connected project)” altogether. In such occasion, the maintenance of a time threshold for the services permanent establishment was subject to intense discussions, with source states asserting once again that the attainment of profits at source did not depend on the existence of a permanent establishment and that entitlement to taxation was not subject to the time spent at source. According to some developing countries, indeed, construction, assembly and similar activities could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise; secondly, and more fundamentally, the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as it is in the case of artistes and sportspersons under Article 17). Other developing countries opposed a time limit because it could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory. However, as stressed by the United Nations, the purpose of bilateral treaties is to promote international trade, investment, and development, and the reason for the time limit is to encourage businesses to undertake preparatory or ancillary operations in another State

that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that State. Therefore, in line with the idea that the time threshold would limit taxation at source to substantial economic activities, avoiding the immediate liability of the taxpayer in case preparatory activities were conducted at source, it was decided that the threshold should be maintained.

Article 7(1)(c) of the current UN Model Convention reads as follows: “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”.

Also with reference to article 7, we can notice a deviation from the OECD Model Convention. More specifically, the UN Model Convention confirms – in line with the OECD Model Convention – the relevance of the permanent establishment threshold for taxation of business income: the taxing rights on business income are attributed to the residence state, unless the company is active in the source country through a permanent establishment. However, in addition to the above, a limited force of attraction rule is added on other business activities, which includes services. This implies that once a permanent establishment exists in the source state through which services are provided, all income from services of the same or similar kind provided in the source state may be attributed to that permanent establishment, irrespective of whether or not the services are actually provided through that permanent establishment. In this respect, the limited force of attraction represents an extension of the source state’s right to tax.

Article 12 of the 2017 UN Model Convention provides in principle for the residence taxation over royalties income: royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However, differently from the OECD model convention, taxing rights are attributed also to the source country, which is entitled to apply for a withholding tax[65]. The definition of royalties provided by art. 12 of the UN Model Convention include the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, 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.

This article represents an even bigger departure from the guidelines introduced by the OECD concerning taxation of royalties than article 5 with regard to the constitution of a permanent establishment. As extensively discussed above, since the 1946 London Draft, it is prescribed that royalties should be taxed solely at the residence of the recipient of the income. Although this provision has been questioned by a number of OECD member and non – member countries, it has been maintained in the OECD Model Conventions, being refined by the introduction of the beneficial ownership concept[66].

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[65] Art. 12(2) of the UN Model Convention states that "However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed […] per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation".

[66] The beneficial ownership concept, inserted in the 1977 OECD Model Convention, was also included in article 12 of the UN Model Convention. Nonetheless, the presence of the expression "beneficial owner" in both model conventions should not mask the fact that this concept fulfilled different roles in these conventions. In the OECD model convention, the beneficial ownership concept was used to attribute all taxation rights to the residence state, while in the UN Model Convention it restricted taxation at source to a prearranged percentage. Thus, the concept had a less restrictive function on the latter than on the former.

Even though one might think that the beneficial ownership concept benefited source states by introducing a requirement to be met before taxation at source is reduced (in all other cases there would be no limit on source taxation), it must be borne in mind that, based on state's domestic legislation, taxation at source may already be unlimited.

Article 12 of the UN Model emerged from the dissatisfaction with the OECD system: developing states argued that patents and processes should be taxed at source, meaning where the income is earned, because the patents and processes licensed to developing states were archaic and expenses connected to them had already been recovered by residence states. As a result, the UN Model Convention established a compromise in respect to the OECD Model Convention, adopting a shared competence of residence and source state on royalty income.

With reference to the royalty article, it is further worth mentioning that in the discussion maintained over the years there was no consensus on whether technical services should be viewed as royalties or business income. Previous to the last update and similarly to the position adopted by the OECD in the Commentaries on its Model Convention, the Committee of Experts argued that article 12 should only be applicable in case of intangible property, thus excluding fees for technical services from the scope of this provision. Moreover, the Committee of Experts pointed out that if source taxation of technical services were intended, countries should make use of an expanded permanent establishment concept. Moreover, the Committee of Experts pledged for a coherent rule for income from services; if countries wish to tax technical services at source, all services should receive the same treatment. Nevertheless developing countries argued that technical services fall under the scope of the royalty provision. Some of these states even provide for an equal treatment of royalties and fees for technical services on their double taxation conventions.

Such a position has prevailed within the 2017 UN Model Convention revision, resulting in a further deviation between the OECD Model Convention and the UN Model Convention. Indeed the current UN Model

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Hence, a provision of a double tax convention that states that taxation at source may be reduced whenever the beneficial owner of the income is resident in the other contracting state is not safeguarding the taxing rights of the source state. If such a provision is absent, the source state would have no restraints. It would be at its discretion to decide, in its domestic legislation, situations in which source taxation would be reduced. Therefore, the introduction of the beneficial ownership concept in article 12(2) may actually restrict source taxation when compared with domestic legislation of a state.

Convention provides for a specific article on fees from technical services (article 12A). With reference to such fees, as already mentioned for the royalties income, the UN Model Convention also includes a shared competence of residence and source state: according to the first paragraph of the mentioned article, indeed, fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However the following paragraph 2 states that fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed a given percent of the gross amount of the fees. Such percentage is not defined by the aforementioned article of the UN Model Convention but should be established through bilateral negotiations between the two involved countries.

Interesting is also the definition provided for technical services by the Model Convention: according to paragraph 3 of the mentioned article, indeed, the term "fees for technical services" means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made: (a) to an employee of the person making the payment; (b) for teaching in an educational institution or for teaching by an educational institution; or (c) by an individual for services for the personal use of an individual.

The definition provided by article 12A is exhaustive: it includes technical services involving the application by the service provider of specialized (i.e. tailored) knowledge, skill or expertise on behalf of a client and, on the opposite, does not include services of a routine nature that do not involve the application of such specialized knowledge, skill or expertise[67]. The vagueness of such definition has been criticized by several scholars, who point out that "the real question at stake is which service does

[67] See Commentary of the 2017 UN Model Tax Convention at paras. 61, 62, 90 and 91.

not actually involve the application of (at least a certain) degree of specialized knowledge, expertise or skill” [68].

In order to address the concerns – among the others – about the uncertainty associated with the definition of “fees for technical services”, the Commentary on Article 12A sets out a second alternative to article 12A of the UN Model: according to such alternative, a withholding tax applies to i) all fees for services, i.e. technical and other services, other than payments expressly excluded, provided in a contracting state, and ii) to all fees for services provided outside that state by closely related persons.

As clearly stated the commentary to the UN Model Convention, until the addition of Article 12A, income from services derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was resident unless the enterprise carried on business through a permanent establishment in the other State (the source State) or provided professional or independent personal services through a fixed base in the source State.

Within this revision, the United Nations Committee of Experts identified fees for technical services as a matter of priority to be dealt with as part of its larger project on the taxation of income from services under the United Nations Model Convention. After considerable study and debate, having due regard to all the arguments for and against the expansion of taxing rights with regards to services, the Committee decided to add a new article to the United Nations Model Convention expanding the taxing rights for States from which fees for technical services are paid.

Among the other arguments, the Commentary pointed out that, with the rapid changes in modern economies, particularly with respect to cross-border services, it is now possible for an enterprise resident in one State to

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[68] A. BÁEZ MORENO, *The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed – Yet Appropriate – Proposal for (Developing) Countries?*, in *World Tax Journal* (no. 7), 2015, p. 3. For the same position, see also M. T. MALAN, *New Article 12A of the UN Model Regarding Fees for Technical Services: Ahead of Its Time or a Step Too Far?*, in *Bulletin for International Taxation*, 2019, p. 58. See also F. SIXDORF - S. LEITSCH, *Taxation of Technical Services under the New Article 12A of the UN Model – Improved Taxation or a Step in the Wrong Direction?*, in *European Taxation* (no. 6), 2017, p. 57.

be substantially involved in another State's economy without a permanent establishment or fixed base in that State and without any substantial physical presence in that State. In particular, with the advancements in means of communication and information technology, an enterprise of one Contracting State can provide substantial services to customers in the other Contracting State and therefore maintain a significant economic presence in that State without having any fixed place of business in that State and without being present in that State for any substantial period. In this respect, it is important to notice that the United Nation mentions expressely also the OECD work, highlighting that the OECD/G20 Base Erosion and Profit Shifting Project illustrates the difficulties faced by tax policy makers and tax administrations in dealing with the new digital business models made available through the digital economy. Even if nor a withholding tax on digital transactions neither a new nexus for taxation in the form of a significant economic presence test were recommended within the BEPS Project, it was recognized that countries were free to include such provisions in their tax treaties, among other additional safeguards against BEPS.

In light of the above, it emerges that the objective of Article 12A is multiple. It intends to extend source state taxing rights in respect of fees for technical services in cases in which there is no permanent establishment or fixed base in the source state to counter base erosion in the tax base of the source state that results from the deductibility of these fees without the source state being able to tax the fee income earned by the non-resident. As no physical presence is required in the source state for that state to be allocated the taxing rights under article 12A, the introduction of the article is an attempt to reclaim source state taxing rights on fees for technical services that have been eroded due to the increase in remotely provided services and, as such, to answer to the challenges posed by the digital economy. A further objective is to provide a standard provision regarding the taxation of fees for technical services, in order to create more uniformity in respect of such provisions in tax treaties and provide certainty in

interpretation by way of an article in the UN Model, together with Commentary.

Article 14 on independent personal services is still included in the UN Model Convention: this represents another deviation of the UN Model Convention in comparison to the OECD Model Convention. More specifically, the current version of paragraph 1 of the mentioned article provides that “income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State: (a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or (b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State”. According to paragraph 2 of article 14, the term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

In this respect, it is worth mentioning that, shortly after the deletion of article 14 from the OECD Model Convention, the UN conducted studies on whether it should also exclude article 14 from its Model Convention. The arguments in favor of this deletion derived from the OECD report on article 14, and the subcommittee responsible for the study of this issue favored the exclusion. Nonetheless, recognizing that source states were keen on preserving the article in their double tax conventions, the Committee of Experts decided on the maintenance of this provision.

However accepting that states may wish to follow the guidance of the OECD Model Convention and remove article 14 from their double tax

conventions, the Committee of Experts recommended that in this case the provision of article 14(1)(b) concerning taxation due to the performance of services at source for more than 183 days, should be transposed into article 5 as article 5(3)(c). Hence, even if article 14 were taken out, countries should still recognize that the performance of services for a certain period in the source state entitles this state to tax the proceeds derived from the rendering of services. Such a position has been confirmed also in the last version of the UN Model Convention.

Lastly, the so called catch all provision (article 21 on other income) should be mentioned in order to highlight the last deviation existing between the UN Model Convention and the OECD Model Convention. Also in this case, indeed, a shared competence of residence and source state is provided. More specifically, according to paragraph 1 of the mentioned article, taxing rights over the items not dealt in any other article of the Model Convention shall be attributed only to the residence state. However, the following paragraph also attributes shared taxing rights to the source country, stating that "items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State".

1.5. The treatment of cross border service fees in the tax treaty policy of Brazil and India – Several domestic legislations provide for a withholding tax to be applied on the service fees paid by their residents to foreign entities. This is quite common for the developing countries. Looking to South America, the Peruvian legislation is worth mentioning. In general, payments for services are not subject to tax in Peru if the services are rendered abroad. On the contrary, income from services rendered in Peru by a non-resident company is considered Peruvian-source income subject to a final withholding tax at the rate of 30% on the gross amount[69].

[69] See also F. BECERRA O'PHELAN, *Tax Reform in Peru: Adopting Anti-Base Erosion and Profit Shifting Measures with a View to Membership of the OECD and More*, in *Bulletin for International Taxation*, 2017 (Volume 71 - No. 8); K. LUYO ACOSTA, *The Role of the UN Model in Peru's Tax Treaties*, in *Bulletin for International Taxation*, 2015 (Volume 69), No. 3

Two specific derogations are provided for digital services and technical assistance services. With reference to the first case mentioned, payments made to non-resident companies for digital services performed within Peru or abroad are subject to a final withholding tax at the rate of 30%, provided that the services are used in Peru. With reference to the technical assistance indeed, non-resident companies supplying technical assistance services within Peru or abroad are subject to a final withholding tax at the rate of 15%, provided that the services are used in Peru. According to Legislative Decree 1120 of 18 July 2012, the 15% withholding tax rate applies, provided that, if the consideration for the technical assistance service exceeds 140 tax units (UIT) at the moment of the conclusion of the agreement between the taxpayer and the service provider, the local user must obtain and provide to the local tax authorities a report issued by an audit company confirming that the technical assistance services were actually rendered. Both digital and technical assistance services are deemed to be used in Peru when the user carrying out business activities deducts the expense or the cost for income tax purposes.

A further example is provided by the Argentinian national law[70]: according to the Argentinian domestic law, the concept of technical assistance becomes even more crucial. In this respect, reference should be made to rules provided by the Transfer of Technology Law, as interpreted by the competent national authority (Instituto Nacional de la Propiedad Industrial, INPI) which has also issued regulations on this matter. More specifically, guidance on the concept of technology, describing the services excluded from a technology characterization has been provided by INPI with the resolution P-328/05[71]. According to Resolution P-328/05, services are only characterized as technical assistance, engineering and consulting services if the service agreements demonstrate: i) a technical knowledge applicable to the productive activity of the local company; and ii) the transfer

[70] See also A. H. FIGUEROA, *International Double Taxation: General Reflections on Jurisdictional Principles, Model Tax Conventions and Argentina's Experience*, in *Bulletin*, 2005, p. 379.

[71] See Resolution P-328/05 issued by the INPI, published in the Official Gazette of 19 October 2005.

of such knowledge to the local company or its personnel by means of training and advisory services, details of mechanisms and technical procedures, supply of plans, reports and studies. The satisfaction of these conditions must be demonstrated in the agreement in a concrete and accurate way.

On the contrary, the following services are not deemed to be included in the scope of technical assistance: i) technical assistance or consulting services, licensing of either know-how, information, knowledge or application methods in financial, commercial, legal and/or marketing and sales areas, as well as any other consideration that does not evidence in a clear and concrete manner the effective incorporation of technical knowledge directly applicable to the productive activity of the local company; ii) software licenses and their updating; and iii) repair, supervisory, maintenance and start-up services of plant or machinery which do not include the transfer of knowledge (i.e. teaching) to personnel of the local company; and iv) in general, all activities which represent the direct hire for tasks that are inherent to the regular operation of the local firm.

The withholding tax treatment is quite different, in case of technical assistance fees or not. More specifically, technical assistance fees indeed may be subject to withholding tax rates of 21%, 28%, 31.5% or 35%. If the technical assistance qualifies as “technology” under the Transfer of Technology Law, and thus the underlying contract is subject to registration, the applicable rate is: i) 21% if the contract is registered and the technical assistance is not available in Argentina; ii) 28% if the contract is registered and the technical assistance is available in Argentina; and iii) 35% if the contract is not registered but it should have been.

If the technical assistance does not qualify as “technology”, the fees are subject to the residual 31.5% rate. In all the cases mentioned above, the withholding tax is computed on the gross amount of the fees.

Looking to the Jamaican domestic legislation, any resident of Jamaica making payments of consultancy, management, and technical services fees to a non-resident must withhold tax. The withholding tax rate

is generally 33⅓% and is not a final tax, but rather a prepayment of the non-resident's income tax liability.

Not only developing countries provide for a withholding tax on service fees. In this respect, an interesting example is given by the Canadian legislation, which is quite articulated in this respect[72]. Technical assistance and service fees generally are regarded as royalties if they relate to the use or rights to use patents, inventions, trade names, secret formulae, designs or know-how. In other cases, technical assistance and service fees will be subject to tax rules governing general business income. However, specific rules are provided for the case in which the non-resident is rendering the service within the territory of Canada. Fees, commissions or other amounts paid to a non-resident for services of any nature rendered in Canada are subject to a 15% withholding tax as a source deduction (see section 153 of the ITA and section 105 of the Income Tax Act). The source deduction is then remitted to the Canadian tax authorities as a prepayment of the non-resident's ultimate income tax liability for the year.

In addition to the above, a 25% withholding tax applies on all management or administration fees paid to non-residents (see section 212(1)(a) of the Income Tax Act). An exemption applies for reasonable amounts paid or credited on account of a service performed in a non-resident's ordinary course of business provided that the non-resident and the payor deal at arm's length. An exemption also applies for payments reimbursing a non-resident (whether or not dealing at arm's length) for expenses incurred in performing a service for the benefit of the payor.

Looking to the European Union, the Greek national law is worth mentioning. Because of the crisis, the Greek law was amended[73], in order to provide for a new system of taxation on fees for technical services, management fees, fees for consulting services, as well as for any similar services (see Law 4172/2013). According to article 62 of the Greek Income

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[72] N. BOIDMAN, *Canadian Taxation of Foreign Service Providers: Treaty Issues and Court Decisions*, in *Bulletin – Tax Treaty Monitor*, 2002, p. 321.

[73] For an overview, see A. MANITARA, *Withholding Taxation and the EU Fundamental Freedoms: Greek Source Taxation of Service Fees*, in *European Taxation*, 2018 (Volume 58- No. 2/3).

Tax Code, withholding tax applied, in principle, to the mentioned payments when the service providers were either individuals – irrespective of residence jurisdiction – or legal entities that were not resident in Greece. The subjective scope of the provision was further clarified in implementing legislation[74], with the effect that it did not cover non-Greek residents that did not have a permanent establishment in the country. It may be inferred from these clarifications that withholding tax was ultimately applicable to the relevant service fees where the service provider was an individual or non-resident legal entity with a permanent establishment in Greece. In such an instance, the withholding tax paid was not definitive but would be deducted from the final tax liability of the taxpayer.

In the context of the overall system of taxation of corporate profits in Greece, this implied that Greek resident entities were taxed on such fees through the corporate income tax system. Greek permanent establishments of foreign entities were, however, taxed on the same fees by application of corporate income tax, together with withholding tax, the latter being subsequently deducted from corporate income tax[75].

Thus, interestingly, the above scenario meant a difference in treatment between (i) resident legal entities and (ii) permanent establishments of non-resident legal entities, in the sense that the procedure for the collection of tax for the permanent establishments of non – resident legal entities was different in comparison to that provided for the Greek legal entities, even if both the types of entities are in a comparable situations from a direct tax perspective, falling under the same rules for the calculation of the tax base and having the same effective tax rate and reporting requirements. More specifically, the system applicable to Greek permanent establishments, in comparison to Greek entities offering the

[74] See Circular no. 1120/2014 on withholding taxation on fees for technical services and management fees on the basis of Law no. 4172/2013 and Circular no. 1060/2015 including instructions for the application of the provisions of articles 9, 68 and 71 of Law. No. 4172/2013.

[75] The situation regarding individuals was similar to that of permanent establishments: the fees were taxed under the personal income tax system together with withholding tax, with withholding tax subsequently being deducted.

same technical and consulting services resulted in prejudice to the former's cash flow in some cases, meaning that the Greek permanent establishments had to fulfil its tax liability earlier than respective Greek entities providing the same services to the same clientele.

As a result, such legislation raised important issues of compatibility with European Union law, from the perspective of the fundamental freedoms guaranteed by the Treaty of the Functioning of the European Union, with particular reference to the freedom of establishment and the freedom to provide services. Such restrictions did not appear to be adequately justified. Because of such serious doubts regarding the compatible of the Greek legislation with the European Union law, the Greek legislation was amended in 2017[76]. As of today, no withholding tax is imposed on service fees earned by foreign entities.

The above examples of domestic legislations providing for a withholding tax on service fees paid to non-resident entities result in an interesting question for the present chapter, i.e. whether the withholding tax eventually provided by the domestic legislations are also properly taken into consideration within the treaty policy of the country, the income tax treaty of which should deviate from the OECD Model and the UN Model (in the version proceeding to the current one). In this respect, the examples of India and Brazil are of particular interest.

1.5.1. Brazil – According to the Brazilian domestic legislation, non-residents without presence in Brazil deriving fees from the provision of services are subject to withholding tax on the gross amount. In this respect, it is important to note that Brazilian domestic legislation uses the source of payment as the criterion for taxation of services, meaning it does not matter where the services were provided. As long as they are paid by Brazilian residents, Brazil is able to tax them.

[76] See art. 29 of the Law no. 4474/2017 on Income Taxation and Other Issues.

Art. 708 of the Brazilian Income Tax Regulation[77] prescribed as follows: "[I]ncome from technical services and technical administrative and similar assistance derived from Brazil and received by residents or domiciled abroad shall be subject, independently of the form of payment, and the place and date in which the operation has been contracted, the services provided or the assistance rendered, to a withholding tax of 25%".

Taxation at source was also the rule concerning royalty payments but in this case the payments were subject to a reduced tax rate, as stated in the following article 710: "Amounts paid, credited, delivered, use or sent abroad as royalties shall be subject to a withholding tax of 15%".

Even though the rate prescribed varied in accordance with the type of activity carried out, in both cases, taxation would occur on the gross amount of the payments made. In due time, the different tax rates were unified, and the taxation of technical fees also became subject to a 15% withholding tax, as stated by art. 7 of the Brazilian Ordinary Law 10.332, dated December 19, 2001. In accordance with the article mentioned, indeed, starting from January 1, 2002, the withholding tax on payments made, credited, delivered, used or sent abroad as remuneration for services of technical assistance and similar shall be reduced to 15%.

Consequently, since 2002, Brazilian domestic law has granted the same tax treatment to royalties and fees for technical services.

However, in cases involving the payment for technical services, the Brazilian paying source required to pay the contribution of intervention in the economic domain (CIDE contribution), which is imposed at a 10% rate. This results in the fact that the total burden regarding payments fees for technical services is currently equal to 25%.

Moreover, it must be borne in mind that, with reference to the CIDE contribution, the taxpayer is – in contrast with the withholding tax – the Brazilian resident that paid for the royalty or technical services, not the non – resident. This differentiation is extremely important for the application of double tax treaties as, by singling out the Brazilian resident as the taxpayer

[77] Income Tax Regulation, Decree n. 3000, March 26, 1999.

of the contribution, no juridical double taxation arises. As a result, this contribution is not within the scope of the double tax treaties[78].

In addition to the above, it is worth mentioning that, according to Law 13.315/2016, an exemption applies to payments made for i) educational, scientific or cultural purposes, ii) covering tuition fees, congress or seminar fees, and proficiency exam fees; and iii) covering medical and hospital expenses related to medical treatment abroad (including treatment of dependents) [79].

Looking to the treaty policy of Brazil, it emerges that the domestic provisions are reflected in the tax treaties adopted by Brazil. Deviating from the OECD guidance on the treatment of technical services, Brazil expressed indeed its desire to include the term in the royalties definition and has repeatedly asserted in its double tax treaties that technical services or assistance should receive the same treatment as royalty payments.

Interestingly, the assimilation of technical services to royalties was not specified in article 12 but in its protocols to the double tax treaties (as it is the case of the double tax treaty signed by Brazil with Italy; but it is a true consideration also for the double tax treaties in place between Brazil and Belgium, Denmark, Argentina, Hungary, the Netherlands, Chile, South Africa, Trinidad and Tobago and Turkey) or solely in documents issued by the Brazilian Ministry of Finance subsequent to the signing of particular double tax treaties (this is true for example for the double tax treaties in

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[78] For an in – depth analysis, see J. L. PENA – J. VAN STADEN, *The Treatment of Outbound Service Fee Payments under the Brazilian Double Tax Conventions. Part One.*, in *Intertax* (Volume 28 - Issue 10), 2000, p. 372; J. L. PENA – J. VAN STADEN, *The Treatment of Outbound Service Fee Payments under the Brazilian Double Tax Conventions. Part Two.*, in *Intertax* (Volume 28, Issue 11), 2000, p. 440.

[79] In this respect, it is worth mentioning Private Ruling 661/2017, published in the DOU of 27 February 2018, clarified that outbound payments to foreign individuals or legal entities for the services of training offered to professionals who are resident in Brazil are subject to withholding tax at the rate of 15%. These payments are qualified as outbound payments for technical services and not as outbound payments for educational or scientific purposes, which are exempt.

Private Ruling 153/2017, published in the DOU of 22 March 2017, explained that the taxable event triggering withholding tax in the case of payments of service fees to non-resident persons through “income crediting” (crédito de rendimento) occurs upon the recognition of the payment obligation in the accounting records of the paying source in Brazil, provided that the economic or juridical availability of the income is characterized.

place between Brazil and Japan, France, Sweden and Austria). The recourse to the latter documents was common in some of the initial double tax conventions signed by Brazil but since then the preference has been for the use of protocols to affirm that technical services are part of the definitions of royalties.

With reference to the exclusive use of subsequent documents to assert that technical services are part of the royalties definition, these documents could be based on the double tax treaty itself, but most of the time there was no express provision in the double tax treaty allowing for such conduct. There is no doubt that the classification of technical services as royalties is in accordance with Brazilian tax treaty policy and domestic legislation. However, considering the lack of reference to this issue in specific double tax treaties and annexed protocols, as well as Brazil's disagreement with the prescription of the OECD and UN Model Convention, which also do not assert that technical services should be viewed as royalties, it remains questionable whether these rulings issued by the Brazilian government are the proper instruments to stipulate that technical services fall within the scope of the royalty provision.

If the signatories of these treaties had questioned the Brazilian approach, Brazil might have had to amend the double tax treaties or the protocol in question in order to subject technical services to the scope of the royalty provision. Nonetheless, considering that these instruments date from the 1970s and the classification of royalties as technical services has not yet been questioned by these treaty partners, it may be concluded that these partners do not object to the approach adopted by Brazil. Moreover, article 31(3)(b) of the Vienna Convention on the Law of Treaties states that "There shall be taken into account, together with the context, b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation". In light of such a provision, the Brazilian practice of assimilating technical services to royalties must be taken into account when interpreting the tax treaties in

question, meaning the royalty provision contained in these double tax conventions is also applicable to technical services.

The fact that technical services fall within the scope of the royalty provision does not mean that there is no more controversy as regards the definition and classification of the service fees. Among the others, there is an issue as to whether all technical services should be treated as royalty payments or only those technical services that are ancillary to a technology transfer.

Initially, the Brazilian tax authorities favored the approach that only technical services ancillary to the transfer of technology could be viewed as royalties. On that matter, Declaratory Act COSIT 1/2000 dated January 5, 2000 prescribed that, in the absence of the transfer of technology, payments derived from contracts for the provision of technical services were subject to the other income article, even if the double tax treaty in question did not contain another income article. Technical services in which there was a transfer of technology would fall within the scope of article 12.

First, it is starling that the Act in question argues for the classification of the relevant income under article 21, even in double tax treaties in which this article does not exist. If the Brazilian tax authorities indeed acted in this manner, there would be situations in which they would prefer the application of a non – existent article over another one that is part of the convention.

Moreover, this attempt by the Brazilian tax authorities to classify the income under article 21, which in Brazilian double tax conventions allows for source taxation of income, led to controversies with treaty partners and taxpayers. With regard to treaty partners, when Spain questioned the Brazilian approach, Brazil issued an interpretative norm to clarify that, in the double tax treaties with Spain, all technical services are part of the royalty concept, irrespective of an actual transfer of technology and that the other income article should never be used for technical services.

Taxpayers, on the other hand, filed lawsuits questioning the treatment of technical services under article 21. Consequently, the Brazilian Superior Court of Justice decided that the Brazilian approach was not in

accordance with the applicable double tax treaties and that article 21 was not applicable to the situation. According to the Court, if the case does not fall within the scope of article 12, it is covered by article 7.

Following this decision, the tax authorities issued Normative Declaratory Act 5/2014[80], which revoked Declaratory Act COSIT 1/2000 and prescribed a new treatment for the taxation of technical services. According to the Normative Declaratory Act, irrespective of an eventual transfer of technology, the taxation of technical services is dependent on the provisions of the double tax treaties: i) if a double tax treaty or protocol assimilates technical services to royalties, technical services should be treated as royalties; ii) if that is not the case and the technical service is related to an independent personal service, article 14 is applicable and (iii) if no reference can be made to articles 12 or 14, the income will be dealt with under article 7 of the relevant double tax conventions.

Interestingly, by asserting that it is not important whether there was a transfer of technology, the Brazilian tax authorities reversed their previous position on the matter, granting the same treatment to all technical services. Such a position is questioned by the scholars, who highlights that, in line with the idea of imparting knowledge that permeates article 12, only technical services related to a technology transfer can fall within the scope of this article. However, considering that the protocols to the double tax treaties mention technical services and not only those in which there is a transfer of technology, the wording of the protocol, which is an integral part of the treaty and was accepted by the other negotiating country, should prevail.

[80] L. FREITAS DE MORAES E CASTRO – A. L. MORAES DO RÊGO MONTEIRO, *Qualification of Services Under Double Tax Treaties in Brazil: Open Issues After Iberdrola Case*, in *Intertax* (Volume 45 - Issue 1), 2017, p. 54; M.F. FURTADO, H. VERBOOM, C. LÜTTER, *No Brazilian Withholding Tax on Payments for Technical Services?*, in *Bulletin for International Taxation*, 2015, p. 558. See also V. A. FERREIRA, *Service Income under Brazilian Tax Treaties: The Possible End of the Article 7 v. Article 21 Battle, but the Start of a New Old One?*, in *Intertax* (Volume 42 - Issue 6&7), 2014, p. 427; V. A. FERREIRA, *The New Brazilian Position on Service Income under Tax Treaties: If You Can't Beat 'em, Join 'em*, in *Intertax* (Volume 43 - Issue 3), 2015, p. 255.

In light of the above, it emerges that Brazil, diverging from the OECD guidance on the matter and in line with the current version of the UN model, makes fees for technical services equal to royalty payments, widening the scope of situation in which source taxation of fees for technical services may occur by removing this activity from the scope of the business profits article.

1.5.2. India – Looking to the domestic legislation of India, it emerges that payments for services, use of equipment and after-sales services which are rendered or utilized in India and paid to a non – resident entity are subject to withholding taxes[81]. Such payments are generally categorized as fees for technical services or royalties subject to a withholding tax of 10% (effective rate of 10.2% where surcharge is 2% or 10.5% where surcharge is 5%).

Looking to the Indian treaty policy, it appears in contrast with the usual approach taken by developing countries: India has engaged in the negotiation of double tax treaties since the 1950s and has already renegotiated a large number of treaties. India is indeed extremely active in the signing of double tax treaties, having built a respectable tax treaty network.

Having said that, it is worth underlining that India takes particular attention to the taxing rights on the service fees, having negotiated a deviation from the OECD Model Convention in all its tax treaties. India successfully managed indeed to incorporate its domestic treatment of fees for technical services as a royalty – like payment into its double tax treaties, providing for a 10% withholding tax in the source country. More specifically, Indian Double Tax Treaties include fees for technical services in the body of the Double Tax Treaties, either in the same article as royalties or in a subsequent article, prescribing the same tax treatment for these types of income.

[81] See section 195 of the Income Tax Act.

In this respect, a mention should be made to article 12 of the India – United States Income Tax Treaty[82]: such a provision indeed proved to be a determinant factor in the development of the treaty position on technical services within the ambit of royalties in later tax treaties. More specifically, article 12 of the mentioned tax treaty provides for a withholding tax in the source country on the “fees for included services”, defining as “included services” those payments made for the rendering of any technical or consultancy services if such services i) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a royalty is received; or ii) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

Moreover, the mentioned article lists the following services which do not fall within the scope of article 12 of the treaty under analysis: i) services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property other than a sale described in paragraph 3(a); ii) services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic; iii) teaching services in or by educational institutions; iv) services for the personal use of the individual or individuals making the payment; or v) services to an employee of the person making the payments or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (Independent personal services).

In other words, according to the mentioned article 12 of the India - USA tax treaty, services are explicitly lined up with royalties to the extent they are of an ancillary and subsidiary character or transfer technical know – how and experience.

[82] Convention between the government of the United States of America and the Government of the Republic of India for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, September 12, 1989, available at <www.ibfd.org>.

In light of the above, since Indian double tax treaties and domestic legislation already assimilate technical services to royalties, there is no discussion of whether the former should receive the same tax treatment as the latter. The real issue in Indian case law is whether the facts of the case support source taxation due to the existence of the provision of a technical service.

When analyzing whether a technical service has been provided, Indian courts, in line with Commentaries on the OECD Model Convention, focus primarily on whether there was a transfer (i.e. imparting of knowledge). For example, there was a case regarding payments made by an Indian resident to a Canadian research organization for the evaluation of the equivalence between generic and reference medicine, with the consequent provision of a final report containing the evaluation. Here, the Indian tax authorities argued that such payments would qualify as fees for technical services, because the provision of the report would amount to a transfer of knowledge for the Indian company[83]. On the other hand, the Canadian and Indian enterprises contended that, since no technical plan or research process was shared, with the Canadian entity having solely the obligation of providing the final report to the Indian company, there was no transfer of knowledge that would allow for the activity to be qualified as a technical service and consequently to be taxed at source irrespective of the presence of a permanent establishment.

In order to resolve this situation and confirm that it was not obliged to withhold taxes on the payments made, the Indian company asked the Authority for Advance Rulings (AAR) whether the payments were subject to tax in India. In line with the taxpayers argument, the Authority for Advance Rulings judged that the provision of the final reports does not make knowledge available to Indian companies, so there should be no taxation in India. For the Authority for Advance Ruling's perspective, the payments amount to business profit.

[83] See Anapharm Inc. v. Director of Income – Tax (International Taxation), Authority for Advance Rulings, Mumbai, September 11, 2008.

This approach has recently been confirmed by the Authority for Advance Rulings in a case[84] involving the provision of supply management services by an English company to its Indian subsidiary. Moreover, in this case, the Authority for Advance Rulings stated that procurement services cannot be classified as technical or consultative in nature and that such services do not make any technical knowledge, experience or know – how available.

The need for the actual transfer of knowledge in order for a service to be viewed as a technical service has also been consistently confirmed by Indian courts. In a recent judgement, the Income Tax Appellate Tribunal of Mumbai considered that the payments made by an Indian resident to a Canadian company for the maintenance of a security platform did not constitute a fee for technical services, because there was no imparting of technical knowledge, skill or know – how. This knowledge was not made available to the contracting party[85].

Even though case law has predominantly prescribed the need for the service to make technical knowledge, know-how and skills available to the customer in order to be qualified as a technical services, as there can still be disagreements as regards whether services provided indeed allow for the customer to perform the activities itself in the future.

In this respect, the Chennai Bench of the Income Tax Appellate Tribunal analyzed a case[86] in which this discussion was crucial for the resolution of the case. A French company provided technical and engineering services to an Indian company through a permanent establishment established in India. In order to guarantee the qualify of the service provided, the French company hired a US company to review its

[84] See Cummins Ltd, Authority for Advance Rulings 1152, of 2011, New Delhi, January 12, 2016.

[85] See Dominion Diamond (India) Pvt. Ltd. V. DCIT, Income Tax Appellate Tribunal, Mumba Bench, January 6, 2016. See also, in the same sense, Gujarat Pivavv Port Ltd. V. ITO, Income Tax Appellate Tribunal, Mumbai Bench, March 23, 2016; McKinsey & Company Inc Italy v. Asst. DIT, Income Tax Appellate Tribunal, Bench Mumbai, June 19, 2015.

[86] Foster Wheeler France S.A. v, DDIT, Income Tax Appellare Tribunal, Chennai Bench, February 5, 2016.

work, receiving from the US company forms, specifications and written procedures on best practices. According to the French company, the sharing of these procedures did not amount to a transfer of knowledge, because it could not apply the procedures in the future. Nonetheless, the court decided that, as the French company had expertise in the field of technical and engineering services, it could understand the advice from the US company and apply in the future. Consequently, payments made to US company by the permanent establishment were to be taxed in India.

Despite the difference in qualifications that may emerge from the facts of the case, there is no doubt that a payment will only be classified as a fee for technical service in Indian double tax treaties if it is considered that the services allow the payer to further execute the activity itself in the future if the knowledge concerning the activity is transferred to the payer.

Another issue commonly discussed in Indian courts is whether the place in which the services were provided can affect India's taxing rights source state. According to the Indian Ishikawajima – Harima case law[87], indeed, if services were provided abroad, India would not have any taxing rights. However, Indian Parliament has approved an amendment to the Tax Code, with retroactive effect from June 1, 1976, to assert that services provided abroad could also be taxed in India.

In a case involving a non – resident enterprise providing design and engineering services to an Indian enterprise outside of India[88], it was questioned whether this income should be taxed in India. According to the non – resident enterprise, since the payments amounted to business profits connected to the supply of equipment and the services were provided from abroad and were not related to a permanent establishment in India, there

[87] See Ishikawajima – Harima Heavy Industries Ltd. V. Director of Income Tax. For a comment, see S. LAKHANI – R. RAWAL, *Taxation of Services and Cross-Border Withholding Issues*, in *Bulletin for International Taxation*, 2014, p. 218; M. KUMAR SINGH, *Conflict of Source versus Residence-Based Taxation in India with Reference to Fees for Technical Service*, in *Intertax* (Volume 44 - Issue 6 & 7), 2016, p. 525.

[88] See Posco Engineering & Construction company Ltd. V. ADIT, Income Tax Appellate Tribunal, Delhi Bench, February 26, 2014.

should be no taxation in India. To support its argument, the non – resident enterprise made reference to the Ishikawajima – Harima judgment.

The tax authorities considered, nonetheless, that based on the facts of the case, the drawings were customized for the needs of the Indian company, so they had the nature of fees for technical services. As for the reference to Ishikawajima – Harima, it was pointed out that, after this judgement, the Income Tax Act was amended retroactively and the judgement was nullified, so the fact that services were not provided in India was not sufficient to exclude taxation in India. Since payments were made by an Indian resident company that would use the drawings to earn income in India, the payments were liable to taxation in India.

In another case, the High Court of Delhi further delineated the situation, expressing its judgment that taxation of offshore services at source will depend on the relation of these services to the supply of offshore equipment. If the services are inextricably linked to the manufacture of the equipment, they would not be viewed as fees for technical services and would not be taxed in India. If, on the other hand, they are not inextricably linked to the manufacture of the equipment, they would not be viewed as fees for technical services and would not be taxed in India. If, on the other hand, they are not inextricably linked to the equipment, the Ishikawajima – Harima case law is no longer applicable and India has taxing rights over these payments as technical services. Taking into consideration the amendment of the Income Tax Act after Ishikawajima – Harima, the court confirmed that fees for technical services paid by an Indian resident are taxable in India, unless the services are utilized in businesses carried out outside India.

In this respect, another case[89] is worth mentioning: an Indian company active in the manufacturing of sugar hired a Brazilian enterprise to advise on the acquisition of sugar hired a Brazilian enterprise do advise on the acquisition of sugar mills / distilleries in Brazil. The tax authorities

[89] Bajiaj Hindustand Ltd. V. ITO, Income Tax Appellate Tribunal, Mumbai Bench, August 12, 2011.

considered that the Indian company should have deducted taxes at source when paying the Brazilian entity, because the payments would be characterized as fees for technical services.

The taxpayer, on the other hand, argued that the acquisition would be made by a business incorporated in Brazil and the payments related to the performance of business and earning of income outside India, so such income was not subject to taxation in India. After hearing both arguments, the court agreed with the taxpayer and stated that, since it is clear that the payments are related to the earning of income outside India, India has no taxing rights over the income.

In contrast to these decisions, the Income Tax Appellate Tribunal of Delhi has decided[90] that double tax treaties signed by India are not affected by the retroactive amendment of the Income Tax Act.

Therefore, it is still uncertain whether the retroactive amendment of the Income Tax Act will cause a shift in Indian case law regarding the taxation of offshore services. If such a shift indeed occurs, it will further distance India from the guidance of the OECD on this matter, enhancing the application of India of the source of payment concept and approximating it to the position of Brazil, since, as a general rule, source taxation would be prescribed whenever payments were made by residents.

[90] Bharti Airtel Ltd. V. ITO, Income Tax Appellate Tribunal, Delhi Bench, March 17, 2016.

CHAPTER 2
TREATMENT OF CROSS BORDER INTRA – GROUP SERVICES

Summary: 2.1. Some preliminary remarks – 2.2. The benefit test – 2.2.1. Centralized services and "on – call" services – 2.2.2. The shareholder activities – 2.2.3. The duplicative activities and the activities which provide only incidental benefits – 2.3. Determining an arm's length charge: focus on the allocation key – 2.3.1. Determining an arm's length charge: focus on the mark - up – 2.3.2. Determining an arm's length charge: focus on the pass-through costs – 2.4. Safe harbors – 2.4.1. Safe harbor for low value – adding services: conditions for the applicability of the safe harbor – 2.4.2. Safe harbor for low value – adding services: the simplified approach – 2.4.3. Safe harbor for low value – adding services: documentation requirements and some open points – 2.5. Transfer pricing aspects of financial services – 2.6. The European Union framework: the EU fundamental freedoms – 2.6.1. The European Union framework: the State aid law – 2.7. The domestic framework – 2.7.1. The domestic framework – The Netherlands – 2.7.2. The domestic framework – India – 2.7.3. The domestic framework – Brazil – 2.7.4. The domestic framework – The United States of America

2.1. Some preliminary remarks – A preliminary question arises with reference to the object of this second chapter, which is entitled to the treatment of cross border intra – group services: how / why is the topic under analysis (i.e. the taxation of services) relevant within a multinational group?

As it normally happens in case of an independent company, also a company belonging to a multinational group typically needs different kinds of services, e.g. administrative, technical, financial and commercial services. In this case, the member of a multinational group in need of a service has different possibilities: i) it may decide to perform the service for itself (the same possibility is available also to an independent company), ii) it may decide to acquire the service from third party service providers (the same possibility is available also to an independent company) and iii) it may decide to acquire the service from a company belonging to its multinational group (such a possibility is clearly not available to an independent company). In this latter case, the service provider can be the parent company itself, one or more specially designated group members ("a group service centre"), or other group members. The third possibility mentioned is often the best solution for a company belonging to a multinational group

because the service provider has already a knowledge of the group and can achieve some synergies and, therefore, allows a cost saving at a group level.

Before going into the analysis, two further preliminary considerations are worth mentioning. First of all, both the perspective of the service-provider and the perspective of the associated enterprise receiving the services are relevant. Tax authorities may view the provision of intra-group services from either the perspective of a service provider or of a recipient of services. The tax authority of the service provider would seek to ensure that if chargeable intra-group services have been provided, the associated enterprise benefitting from the service is paying an arm's length price for such services. The tax authority of the service-provider would be concerned if there were no payments for the intra-group cross-border services or if the charges for such services were below arm's length prices. It would also be concerned if the service provider incurred costs for the benefit of foreign associated enterprises without reimbursement or arm's length consideration if the benefits test has been satisfied.

On the other hand, the tax authority of the recipient would be seeking to ensure that the services in question satisfy the benefit test and that the recipient was being charged arm's length prices for the intra-group services. A tax authority of the service recipient would consider making an adjustment if it considered that the services provided a benefit to the recipient but that the service charges were excessive. Given the scale of business operations of an MNE group, incurred service costs and service charges may reflect significant amounts and any misallocation of service costs or charges within an MNE will affect the profit or loss allocations among group members.

Secondly, it should be noted that the requirement that chargeable services be paid for on an arm's length basis is distinct from the question whether such arm's length payments are deductible under the domestic law of the associated enterprise receiving the service. Transfer pricing rules require the payment of arm's length transfer prices for chargeable services. Principles of domestic law are then applied to determine if such payments

may be deducted by the associated enterprise making the payment in determining its taxable income. In some countries, although an expense may satisfy the arm's length principle, the deduction may be denied, in full or in part, by domestic rules restricting deductions.

2.2. The benefit test – As already anticipated in the preceding paragraph, according to the OECD Transfer Pricing Guidelines, as well as to the 2017 UN Manual on Transfer Pricing, there are two main issues in the analysis of transfer pricing for intragroup services.

One issue is whether intra-group services have in fact been provided (the so called benefit test). The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle. In other words, looking to the intercompany services, the transfer pricing rules and the arm's length principle do not rely only on prices but rely also on the preceding step, i.e. if the services have been effectively rendered.

Looking deeper to the preceding step, the question whether an intragroup service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance or maintain its business position. In other words, this can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.

In this respect, the 2017 UN Manual on Transfer Pricing points out some further useful considerations for such analysis. The economic or commercial value we should have in mind for performing the mentioned

analysis is both the actual commercial position, as well as the expected commercial position.

Moreover, the requirement is met if the service effectively provides such value but also if the service is expected to provide such value[91].

Such a consideration further implies that, whether or not the benefit test is satisfied does not depend on the level of risk that the expected benefit will or will not be achieved. Some intra-group services, such as research and development, may involve a higher level of risk than other services, such as accounting or bookkeeping services. Notwithstanding the risk involved, intra-group research and development services are chargeable if an independent party would have been expected to pay another independent party for the research and development services in the same or similar circumstances or it would have performed this activity itself. Provided the recipient associated enterprise expects a potential economic benefit from the research and development, the benefit test is satisfied and a chargeable service has been provided, even though the activity may not always actually result in benefits.

In other words, the general principle provided by the OECD Guidelines, as well as by the UN Manual on Transfer Pricing is that in order to consider that the intra-group service has been rendered, it is necessary to analyze whether an independent third party would have been willing to pay for such service and it is not possible in the abstract to set forth categorically the activities that do or do not constitute the rendering of intra-group services[92].

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[91] In this respect, a meaningful example is provided by the UN Manual on Transfer Pricing: a marketing programme may be designed by one member of an MNE group to be used by associated enterprises operating as fully fledged distributors with the expectation that all designated associated enterprises will benefit in each of their markets. Although the marketing strategy is a success in most countries, it may fail to deliver all of the expected benefits in some jurisdictions. As long as each associated enterprise within the multinational group taking up this marketing strategy has legitimately expected a benefit, they have received a benefit for the purpose of the benefit test, despite the fact that some of these enterprises do not fully achieve the expected results.

[92] In this respect, it is interesting to mention that many of the comments made in the context of the public consultation opened by the OECD within the BEPS project highlighted that some intra-group services may be difficult to prove its effective render under this basis, due to the fact that some services that are rendered between related parties may be unique and no independent party will be willing to perform them in-house

In this respect, an important indicator is the fact that the services provided within the group meet an identified need of the service recipient.

In this respect, the example mentioned by the OECD Transfer Pricing Guidelines is the case in which an associated enterprise repairs equipment used in manufacturing by another member of the MNE group one or more specific members of the group.

Also the examples made by the UN Manual on Transfer Pricing are quite interesting. First example is related to the IT services: an associated enterprise which is part of a multinational group involved in telecommunications may suffer reputational damage and a potential loss of business if information technology (IT) problems prevent customers from using its telecommunications system. If an IT problem arises and direct assistance is provided promptly to the associated enterprise by another member of the MNE group specializing in the provision of IT services, the service would satisfy the benefit test as the associated enterprise has received an economic benefit to maintain its business operations.

Second example is related to the marketing services: if an associated enterprise seeks assistance in the design of a targeted marketing campaign from a related party which specializes in marketing strategies and practices, the associated enterprise providing the marketing strategy advice is providing a service designed to meet the specific needs of the recipient. The benefit test would generally be satisfied in such a circumstance because the associated enterprise expects a commercial benefit from the service, and an independent enterprise in the same or similar circumstances would be willing to pay for the provision of such services.

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or by having evidence that a third party is performing them. Therefore, it was suggested to clearly establish in the document that the tax administrations must presume, except if there is proof on the contrary, (i) that the service or activity has effectively been rendered and (ii) that said activity or service that has been paid for, provides economic or commercial value to enhance or maintain its commercial position in a general and broad sense. However, such a suggestion has not been accepted. In this respect, see OECD, *Comments received on public discussion draft BEPS Action 10: Proposed modifications to chapter VII of the Transfer Pricing Guidelines relating to low value – adding intra – group services*, available from <www.oecd.org>.

With reference to the remuneration, instead, the absence of payments or contractual agreements does not automatically lead to the conclusion that the intra-group services do not pass the benefit test. At the same time, the fact that a payment was made to an associated enterprise for purported services do not automatically imply that those intra – group services have passed the benefit test.

In case of payments for intra – group services, the form of such payment could also be important. In some buying or procurement services a commission element may be incorporated in the price of the product or services procured, and a separate service fee may not be appropriate. Similarly, in respect of financial services such as loans, foreign exchange and hedging, all of the remuneration may be built into the spread and it would not be appropriate to expect a further service fee to be charged if such were the case.

The analysis described above quite clearly depends on the actual facts and circumstances, and it is not possible in the abstract to set forth categorically the activities that do or do not constitute the rendering of intragroup services. However, the OECD Transfer Pricing Guidelines, as well as the UN Manual on Transfer Pricing provide for some examples of common intragroup services and establish if they pass or not the benefit test.

2.2.1. Centralized services and "on – call" services – With the expression "centralized services", we make reference to those activities that may relate to the group as a whole, are centralized in the parent company or one or more group service centers (such as a regional headquarters company) and are made available to the group (or multiple members thereof).

The activities that are centralized depend on the kind of business and on the organizational structure of the group, but in general they may include administrative services such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services;

financial services such as supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks, and refinancing; assistance in the fields of production, buying, distribution and marketing; and services in staff matters such as recruitment and training. Group service centers also often carry out order management, customer service and call centers, research and development or administer and protect intangible property for all or part of the multinational group[93].

There are numerous reasons for a multinational group to provide intra-group services on a centralized basis. The main reason is the certainty that the intra-group services will be available when required and that the quality of the services will be consistent within the multinational group.

Second common reason is the costs reduction. Services may be provided by an associated enterprise for the rest of the group in order to minimize costs through economies of scale. This may allow the multinational group to increase its profits or improve its competitive position by being able to reduce the prices charged to customers.

Quite common reason is also the need for a specialization: centralizing services may allow for specialization within multinational group which may also involve the creation of centers of excellence. Some multinational groups may centralize services in a regional management company for associated enterprises in a particular geographic region in order to align functional and management responsibilities. In some cases

[93] The UN Manual on Transfer Pricing include the following service as an example of centralized service which would pass the benefit test. An MNE group carries on an airline business in 5 countries (Countries A, B, C, D and E) with the parent of the group being located in Country A. Customers of the airline in these countries are provided with the option of calling staff by telephone to book travel and receive advice where necessary. The MNE group decides to create a centralized call centre for the MNE group to exploit economies of scale. The low cost of telecommunications and the ability to share business information among group members allows for the centralized call centre to be located in any country in which the MNE group operates. The call centre can operate on a 24 hour basis in providing call services to all time zones in which the MNE group carries on business. The MNE group concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advantage of both economies of scale and low costs. The call centre services provided by the subsidiary in Country E to the parent company and other group members satisfy the benefit test. Without the call centre the group members would either have to establish their own call centres or engage an independent party to provide call centre services on their behalf.

an associated enterprise may not have the skills or resources locally in-house for the service it requires and may rely on specialists that are responsible for providing the same type of services across a wider geographic or functional grouping of entities.

These types of activities normally pass the benefit test: the economic benefit is indeed apparent if an associated enterprise would otherwise have to perform the activity itself or engage an external service provider.

Such an approach is confirmed by both the OECD Transfer Pricing Guidelines, as well as by the UN Manual on Transfer Pricing.

More complex is the case of the services provided "on call". With the expression "on call services", we make reference to those cases in which an associated enterprise agrees to provide a particular type of service immediately or within a short period of time (the "on call" services are also referred to as "off contracts' or 'stand by contracts'). These services may be available on call and they may vary in amount and importance from year to year.

As for example, a parent company or one or more group service centres may be on hand to provide services such as financial, managerial, technical, legal or tax advice and assistance to members of the group at any time. In that case, a service may be rendered to associated enterprises by having staff, equipment, etc., available.

The crucial question here is whether the availability of such services is itself a separate service for which an arm's length charge (in addition to any charge for services actually rendered) should be determined. In order to provide the on – call services, indeed, the service provider must maintain the staff necessary to provide such services promptly as requested, even though some staff members may not be fully utilized by the multinational group at all times.

The approach suggested by the OECD Transfer Pricing Guidelines does not match to that included in the UN Manual on Transfer Pricing. Both the mentioned documents confirm the aforementioned general rule, moving from the consideration that intragroup service would exist to the extent that

it would be reasonable to expect an independent enterprise in comparable circumstances to incur "standby" charges to ensure the availability of the services when the need for them arises. In third party situations it is commonplace that arrangements will be made to make use of a service as and when required. It is not unknown, for example, for an independent enterprise to pay an annual "retainer" fee to a firm of lawyers to ensure entitlement to legal advice and representation if litigation is brought.

Both the mentioned documents confirm that a case – by – case analysis is needed.

The OECD Transfer Pricing Guidelines takes as indicator the frequency on which the on call services have been effectively called, moving from the consideration that it is unlikely that an independent enterprise would incur stand-by charges where the potential need for the service was remote, where the advantage of having services on-call was negligible, or where the on-call services could be obtained promptly and readily from other sources without the need for stand-by arrangements.

In other words, according to the OECD transfer pricing guidelines, the benefit conferred on a group company by the on-call arrangements should be considered by looking at the extent to which the services have been used over a period of several years rather than solely for the year in which a charge is to be made.

On the contrary, in accordance with the UN Manual on Transfer Pricing, the expected economic benefit to the recipient of being able to call on such services without delay when needed may be a sufficient business advantage to satisfy the benefit test, even if the contingency requiring the service never arises and actual services are never or infrequently provided. An associated enterprise that is a potential recipient of such on-call services would therefore be expected to pay the service provider for maintaining the necessary staff to provide the service, even during times when the potential recipient does not call on the associated enterprise to provide the service.

With reference to the on-call services, also the position taken by the EU Joint TP Forum is worth mentioning: a case-by-case analysis is strongly

recommended since the fee depends more on the perceived risk by the provider and the user's appetite for risk on a year on year basis.

The EU Joint TP Forum indeed points out that, in some cases it may be reasonable that a charge is made to cover the infrastructure costs and a mark up. Equally, in other cases it may be reasonable that a user pays a charge for potential access to that infrastructure but no additional fee when the agreed on call service provision is activated. That can be contrasted to the situation where a specific service is requested over and above the standard on call service. In that instance a separate additional fee is appropriate and a direct charge made.

A member of the group may not require an on call service in any one year but that fact does not necessarily mean they will not buy into the service the next year. Nor does it automatically mean they will be entitled to a reduction in the annual fee because in one year it was not used.

2.2.2. The shareholder activities – Shareholder activities do not pass the benefit test and thus do not justify a charge to other group members. Instead, the costs associated with this type of activity should be borne and allocated at the level of the shareholder.

In this respect, the definition of the shareholder activities becomes particularly important. Shareholder activities are those that a group member (usually the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder[94]. Moreover, such definition is distinguished by that of stewardship activities: the latter – included in the 1979 OECD Transfer Pricing Guidelines – is broader and include both shareholder activities and genuine intra-group services such as planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases assistance in day-today management.

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[94] The definition of shareholder activities should be distinguished from that of stewardship activities: the latter – included in the 1979 OECD Transfer Pricing Guidelines – is broader and include both shareholder activities and genuine intra-group services such as planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases assistance in day-today management.

In light of the above definition, it should be highlighted that determining which costs should be considered as shareholder costs is not a straightforward issue; it is necessary to perform a case-by-case analysis in order to reach to a conclusion on whether the costs incurred (i) benefit the whole group, (ii) benefit only the parent company or (iii) benefit certain subsidiaries and, consequently, a service is being rendered.

However, in order to give some more guidance on the concept of shareholder activities, the current version of the OECD Transfer Pricing Guidelines provide for the following examples.

i) Costs relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company, stock exchange listing of the parent company and costs of the supervisory board;

ii) Costs relating to reporting requirements (including financial reporting and audit) of the parent company including the consolidation of reports, costs relating to the parent company's audit of the subsidiary's accounts carried out exclusively in the interest of the parent company, and costs relating to the preparation of consolidated financial statements of the group (however, in practice costs incurred locally by the subsidiaries may not need to be passed on to the parent or holding company where it is disproportionately onerous to identify and isolate those costs).

The key notion here is "carried out exclusively in the interest of the parent company": it should be emphasized that only the exclusivity of the parent company interest leads to the qualification of shareholder costs.

iii) Costs of raising funds for the acquisition of its participations and costs relating to the parent company's investor relations such as communication strategy with shareholders of the parent company, financial analysts, funds and other stakeholders in the parent company;

iv) Costs relating to compliance of the parent company with the relevant tax laws. It emerges here the question if suck kind of costs include those relating to the Country – By – Country reporting;

v) Costs which are ancillary to the corporate governance of the group as a whole.

In this respect, it is worth mentioning that the current version of the OECD Transfer Pricing Guidelines provides for some more examples on the concept of shareholder activities, if compared to the 2010 OECD Transfer Pricing Guidelines. Such additional examples were the outcome of the public consultation opened within the BEPS project and have been welcomed since they help to reduce the number of existing grey areas and avoid disputes.

On the other hand, however, some of the examples given appear to be too generic and, as such, fail to reach the goal.

The most illustrative example in this respect is given by the "costs which are ancillary to the corporate governance of the group as a whole". Undefined "corporate governance" activities were also referred to in the documents issued by the EU Joint Transfer Pricing Forum as an example of shareholder cost. However, a more precise definition of such concept would be more appropriate. Indeed, a number of significant intercompany service activities (e.g. legal assistance for undertaking a business restructuring or costs associated with the management of the group accounting) may prove to be relevant for generating value for group companies, and (in)directly have an impact on the group's "corporate governance". Looking to the OECD public communications[95], one definition of corporate governance which may be found and endorsed is the following: "Procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making". As such, corporate governance appears to be a very broad and vague term, which may be understood to include group-level strategic

[95] OECD, *Glossary of Statistical Terms, Original Source: European Central Bank*, 2004, Annual Report: 2004, ECB, Frankfurt, Glossary.

decision functions which go beyond the scope of what is usually understood by the shareholder activities.

Moreover, even if the examples mentioned are borrowed from the table provided in the annex 2 of the EU Commission Communication, the list provided by the OECD does not include some of the examples given by the EU joint TP Forum[96], i.e.

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[96] Some differences exist also between the OECD Transfer Pricing Guidelines and the Dutch Decree of 14 Nov. 2013 no. IFZ 2013/184M issued by the Deputy Minister of Finance (hereinafter, also referred to as the “Dutch Decree”; for a deeper analysis, see below paragraph no. 2.7.1).

According to the mentioned document, under the arm’ s length principle, a group service has been rendered if an activity is performed for a group member that adds economic or commercial value to the group member and for which that group member would ordinarily be willing to pay.

This does not relate to activities performed in a shareholder capacity. A not exhaustive list of activities which meet the definition of shareholder activities is provided. This implies that activities not appearing on the list will have to be assessed on an individual basis to determine whether they are a group service or an activity performed in a shareholder capacity. The list includes the activities mentioned below.

i) Activities relating to the legal structure of the company itself: such kind of activities consists in implementing the conditions of Book 2 Dutch Civil Code (i.e. organizing, preparing and holding the shareholders’ meeting, activities involved with the preparation and approval of the annual financial statements and their filing with the Chamber of Commerce, activities performed by the Supervisory Board, insofar as they involve the implementation of statutory supervisory duties, the activities of the Works Council) and implementation of the General Taxes Act, to the extent that this relates to the tax obligations of the company itself (i.e. keeping accounting records, meeting the retention requirement, filing tax returns and meeting the information obligation).

ii) Activities concerning the flotation/issuance/split of shares in the company itself, or similar securities, on the capital market, and activities related to requesting/maintaining the company’ s listing on domestic and foreign stock exchanges. The Dutch Decree mentions as further examples of this category meeting stock market admission requirements, activities connected with stock exchange listings, for example, completing the forms to be provided to the American SEC in respect of the listing, making the annual financial statements available (free of charge), the annual report, etc.; membership in associations and other bodies representing stock exchanges.

iii) Activities associated with the implementation and enforcement of the legal rules in respect of share transactions. As further examples, the Dutch Decree mentions implementing and maintaining a registration system pursuant to the Dutch Financial Supervision Act and the reporting of share transactions by staff of the company subject to this legislation.

iv) Activities associated with the implementation and fulfilment of legal corporate governance rules and corporate governance codes of conduct at the company itself or the group as a whole. As further examples, the Dutch Decree mentions the implementation of corporate governance monitoring as required by law, including a paragraph thereon in the annual report and reporting on implemented/to be implemented environmental policy, social policy and policy on corporate responsibility.

v) Activities associated with preparing reports on the company itself or the group as a whole for circulation to various interested parties. The examples provided in this respect by the Dutch Decree include press conferences and other communication costs in respect of communications to shareholders and other interested parties, such as financial

i) all Presidential costs, including costs of the President's Cabinet;

ii) costs related to the study and implementation of the capitalization structure of the subsidiaries;

iii) costs for the increase of the share capital of the subsidiary;

iv) costs of supervision, managerial and control (monitoring) activities related to the management and protection of the investments in participations;

v) costs of internal audit activities within the group as long as the conclusions derived from the activities are primarily reported to the parent and not to the subsidiary/ies audited;

vi) costs to reorganize the group, to acquire new members or to terminate a division, when the objective aimed is to benefit the group as a whole (increase its financial ratios, reduce costs, etc.) and it does not directly benefit one or several subsidiaries;

vii) activities relating to the establishment of group policies (financial policies,

viii) tax policies, human resources policies, insurance policies, etc.);

ix) activities related to the definition, measurement and promotion of the strategic principles in terms of the group's reputation.

Another difference existing between the OECD Transfer Pricing Guidelines and the document issued on the same topic by the European Commission is related to the so called mixed activities, i.e. those services that provide benefit partly to the shareholder and partly to the subsidiary[97].

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analysts, insofar as the communication relates to external reports, the financial performance of, and expectations for, the company itself and the group as a whole.

[97] The Dutch Decree takes also into consideration the mixed activities. According to the mentioned Decree, indeed, classifying the activities as group services or shareholder activities may give rise to 'mixed' activities. Mixed activities refer to activities performed by a department or other group of individuals operating within the group, which partly qualify as group services and partly as shareholder activities. Examples of group activities are consolidation activities, merger and acquisition (M&A) activities, activities associated with the implementation and fulfilment of legal corporate governance rules and corporate governance codes of conduct, and activities of the board of directors. The classification of the activities as group services or shareholder activities may be based on any method that leads to an outcome in line with the arm' s length principle.

In this respect, the Dutch decree mentions as first example the consolidation activities. A group uses a management information system that includes the results of all the group companies. This information is used for budget decisions, the management and

As examples of mixed activities, we can mention the parent company's audit of the accounts of the subsidiary, the drafting and auditing of the financial statement of the subsidiary in accordance with the accounting principles of the states of the parent, information technology and the general review of the affiliates' performance if not connected to the provisions of consulting services to the subsidiaries.

In this respect, the OECD Transfer Pricing guidelines do not recognize mixed activities and do not provide specific guidance on how to

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evaluation of the respective group companies, as well as for the preparation of the quarterly, half-yearly and annual consolidation reports that form the basis for the annual financial statements. Setting up and maintaining the management information system and processing the information that is relevant to the management of the group companies involves a group service. The preparation of the regular consolidation figures for the holding company/ intermediate holding company, which are prepared on the basis of the information supplied by the management information system, is a shareholder activity.

The other examples are related to the merger and acquisition activities. The first mentioned example is related to an European head office of a group that has a mergers and acquisitions Department. The group needs an additional production facility in Europe. It is the task of the department to analyze which businesses in the various European countries are candidates for a potential acquisition that will be carried out by the European head office. The analysis carried out by the Mergers and Acquisitions Department is an activity performed in a shareholder capacity and therefore the group companies cannot be expected to pay for this activity.

In the second example, the already mentioned mergers and acquisitions department analyses which businesses on continent X (not Europe) are candidates for a potential acquisition geared to expanding the market share on that continent. On the basis of the analysis, a business on continent X is acquired by the regional office. The regional head office on continent X was the recipient of a group service. The fee to be charged for this activity must be at arm' s length.

The third example refers to a group that has a department that deals with mergers and acquisitions. This department assists an acquired business with the legal implementation of the acquisition (for example delisting the shares), with making changes to the system and house style of the group, and preparing and implementing the staff guidelines. This assistance adds economic and/or commercial value to the acquired group company for which an independent third party in comparable circumstances would be willing to pay. A group service has been provided to the particular group company. The fee to be charged for this activity must be at arm' s length.

The OECD Guidelines do not recognize mixed activities, which is in line with the notion that the subsidiary does not receive a service for which it would not have been willing to pay an independent company. It is irrelevant that certain departments or groups of individuals both perform shareholder activities and provide intra-group services. Intragroup services can only be distinguished based on general OECD principles. The above-cited examples given in the Decree ignore this. In the example of the management reporting system, phrases are used such as "exercise control" and "set budgets", which, in the author's opinion, are completely irrelevant. The OECD criterion is whether or not the service provides economic or commercial value to a company for which the latter, were it independent, would have been willing to pay. This must be determined on a case-by-case basis. The same applies to the example of the M&A department.

apportion costs related to shareholder activities and to recognize the use of subjective allocation keys (e.g. a time-spent allocation key).

Such an approach appears to be explained by the fact that the subsidiary does not receive a service for which it would not have been willing to pay an independent company. It is irrelevant that certain departments or groups of individuals both perform shareholder activities and provide intra-group services. Intragroup services can only be distinguished based on general OECD criterion whether or not the service provides economic or commercial value to a company for which the latter, were it independent, would have been willing to pay. This must be determined on a case-by-case basis.

The illustrative list of shareholder activities provided by the OECD Transfer Pricing Guidelines includes some deviations also from the list included in the UN Manual on Transfer Pricing, which appears to be more generic. The latter document indeed classifies, as shareholder activities, the preparation and filing of reports required to meet the juridical structure of the parent company, the appointment and remuneration of parent company directors, the meetings of the parent company's board of directors and of the parent company's shareholders, the parent company's preparation and filing of consolidated financial reports, reports for regulatory purposes, and tax returns, the activities[98] of the parent company for raising funds used to acquire share capital in subsidiary companies and the activities of the parent company to protect its capital investment in subsidiary companies.

[98] In this respect, a further example is provided in order to make clearer the activities deemed to be shareholder activities: obtaining financing by the parent of an MNE group to acquire a company is a shareholder activity since it fails to provide an immediate benefit to the acquired entity. If a parent company raises funds from an independent lender on behalf of an associated enterprise that is a regional headquarter company to acquire a new company, this activity can be a chargeable financial service. It would satisfy the benefit test if an independent party would have been willing to pay for the financial services in comparable circumstances. In this situation a service charge from the parent company to the associated enterprise on behalf of which the funds are raised would be appropriate, as the parent company has provided services in the form of being the associated enterprise's agent to raise finance.

2.2.3. The duplicative activities and the activities which provide only incidental benefits – With the term "duplicative activities", we make reference to those cases in which a service is provided by an associated enterprise, as well as it is performed by the service recipient itself / by a third party service provider. Duplicative activities do not usually pass the benefit test; however some exceptions are admitted, with the consequence that a case-by-case analysis is needed.

Any consideration of possible duplication of services needs to identify the nature of the services in detail, and the reason why the company appears to be duplicating costs contrary to efficient practices. There are some circumstances indeed in which duplication may provide an associated enterprise with a benefit if an independent party would have been willing to pay for the duplicated services in similar circumstances[99].

The most common example is given by those services that are performed at different levels (i.e. group, regional or local level) and therefore do not involve duplication. These functions may be carried out at group, regional or local level. This is quite common for the marketing services: strategic marketing functions are performed at group level as they are for

[99] In order to clarify such aspect, two examples – both related to the treasury activities – should be mentioned. Example A: Subsidiary Co, a company resident in Country A, is part of an MNE group (the group). The group's business is growing primary produce and distributing it in local markets. The parent company is Parent Co in Country B. Parent Co oversees treasury functions for the group. Parent Co's treasury function ensures that there is adequate finance for the group and monitors the debt and equity levels on its books and those of its subsidiaries. Subsidiary Co maintains its own treasury function and manages its finances on an independent basis. It manages its treasury operations and ensures that it has finance available either in-house or externally. A functional analysis indicates that Subsidiary Co carries on its own treasury functions in order to ensure that it has adequate debt capital to finance its operations. In this situation duplication arises as Subsidiary Co is performing treasury functions necessary for its operations and Parent Co is performing the same treasury functions for Subsidiary Co. Accordingly, Parent Co's treasury activities are duplicated activities that fail the benefit test. Under the arm's length principle, Parent Co cannot charge a service fee to Subsidiary Co for Parent Co's treasury functions.

Example B: a multinational group has its Parent Company in Country A. Parent Company performs treasury functions for itself and its subsidiaries. The treasury functions include raising capital, obtaining financing and cash management. Subsidiary Company is an associated enterprise in Country B and does not perform any treasury functions itself. In this situation there is no duplication as Subsidiary Company does not perform treasury functions. In this case, Subsidiary Company is considered to obtain a benefit from the functions performed by Parent Company.

the benefit of the entire group, while at the local level a subsidiary engages in marketing analysis of the local market conditions[100].

A further example is given by those situations that may arise if an associated enterprise receives in-house advice on an issue but chooses to get a second opinion to minimize the risk of mistakes. In other words, the benefit test is passed in those cases in which the duplication is undertaken to reduce the risk of a wrong business decision (e.g. by getting a second legal opinion on a subject).

A further exception could be represented by those cases in which the duplication of services is only temporary (for example where a multinational group is reorganizing to centralize its management functions)[101].

Activities which provide only incidental benefits do not ordinarily pass the benefit test: activities producing the incidental benefits would indeed not be ones for which an independent enterprise ordinarily would be willing to pay.

Such a situation could be quite common in all those cases where a service performed by a group member benefits or is expected to benefit only certain group members, but incidentally provides benefits to other group members. Examples could be analyzing the question of whether to reorganize the group, to make a study for a specific market[102], to acquire

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[100] Another exception could be represented by the marketing services: the fact that a company performs, for example, marketing services in-house and also is charged for marketing services from a group company does not of itself determine duplication, since marketing is a broad term covering many levels of activity. Such an example has an important impact for the multinational group: there are often instances whereby a multinational group may maintain personnel at local offices and at a central office who work jointly on the same activities to ensure smooth operations. For example, marketing personnel at a central office may work with marketing personnel at local offices to jointly create and customize marketing materials such as brochures or direct mailings for the local market. In this example, the activities performed by the central office provide an added benefit to the operations of the local offices even though the activities are very similar to those executed by the local office.

[101] For example, an MNE group may decide to centralize its human resources function for the group and this alteration would require the closure of each associated enterprise's human resources department after the necessary data has been provided to the centralized human resources database. This process is likely to involve a period of overlap and acceptable duplication during the transition phase. In this situation an independent entity would have a period of duplication if it were in the process of outsourcing its human resources function to an independent service provider.

[102] The example provided by the UN Manual on Transfer Pricing appears to be very meaningful in this respect. Motorcycle manufacturing MNE X has an associated enterprise

new members or to terminate a division. These activities could constitute intra-group services to the particular group members involved, for example, those members who will make the acquisition or terminate one of their divisions, but they also may produce economic benefit for other group members not involved in the decision by increasing efficiencies, economies of scale or other synergies. Such kind of incidental benefits ordinarily would not pass the benefit test.

In this respect, the example provided by the UN Manual on Transfer Pricing with reference to the marketing services appears to be very meaningful. Motorcycle manufacturing MNE X has an associated enterprise that serves as a distribution company in Country A, which is incurring losses. The parent company's marketing department is asked for assistance and advice as to how to make the associated enterprise in Country A profitable. After studying the Country A consumer market and comparing that market with other markets where MNE X motorcycles are sold, the parent company's marketing department develops a marketing campaign for Country A where specifically adorned and highly decorated motorcycle helmets are given away for free together with motorcycles sold in Country A. There is no law requiring the use of motorcycle helmets in country A. The marketing campaign is a success and sales in Country A increase over the

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next year. The helmets are actually quite popular due to their specific designs and adornments. In the following year, an independent study shows that motorcycles of MNE X are less likely to be involved in deadly accidents. This study boosts the sales of MNE X's motorcycles in Country A. The associated enterprise in Country A is allocated the cost of the marketing campaign developed for it by Parent company. As a result of the independent study on motorcycle safety, however, the sales of MNE X motorcycles go up in countries B, C and D as well. These countries also have no laws that require the use of motorcycle helmets when riding a motorcycle. The issue is whether the marketing campaign cost incurred by the Parent company's marketing department perhaps ought to be allocated to associated enterprises in Countries B, C and D as well. The increased sales in Countries B, C, and D appear to be incidental benefits of the marketing campaign developed for Country A specifically[103].

[103] However, the question whether and in which cases the marketing activities pass the benefit test appears to be quite disputable at country level. In this respect, the case law involving the Microsoft Group in Denmark is worth mentioning: the Eastern High Court of Denmark on 28 March 2018 decided a transfer pricing case regarding Microsoft Denmark ApS, which is a Danish subsidiary of the US software company Microsoft Corporation. An appeal against the decision was filed with the National Tax Tribunal (Landsskatteretten). The Tribunal (by a majority decision) held that Microsoft Denmark had been correctly remunerated.

The key question in the case was whether – as argued by the Danish tax authorities – marketing activities performed by Microsoft Denmark on behalf of an Irish sister company provided a compensable benefit to a US group company, which should be adequately remunerated.

The substantive aspect of the decision is important in view of the fact that the Danish tax authorities often attempt to expand the Danish tax base by creating controlled transactions and imposing transfer pricing adjustments on those transactions. In several pending cases, the tax authorities are arguing that the mere existence of a subsidiary in Denmark constitutes a separate compensable service to the foreign multinational group in addition to the sale of goods or services in Denmark.

For example, if a multinational group is active in the service industry, the tax authorities may claim that the existence of a loss-making Danish subsidiary constitutes a compensable service to a foreign group company if the group applies a strategy of being present on the Danish market in order to satisfy the needs of multinational clients (margin market argument). The outcome of the Microsoft case is in line with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations that incidental benefits do not amount to a compensable service transaction.

For further details, see J. WITTENDORF, *Microsoft Denmark: Incidental benefit did not qualify as a service transaction*, in *International Transfer Pricing Journal*, July – August 2018, p. 297; J. WITTENDORF, *Supreme Court decides that marketing activities did not constitute compensable services*, in *International Transfer Pricing Journal*, May – June 2019, p. 201.

Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed: such benefits are indeed attributable to the entity's passive association with the multinational group. In other words, the benefits of association with a multinational group are not a chargeable service for members of the multinational group.

The key feature of this type of incidental benefit is indeed that it is passive and cannot be attributed to an overt action taken by another member of the multinational group.

The most common example is given by those cases in which independent enterprises transacting with an enterprise that is a member of a multinational group may be willing to provide goods or services to it at prices that are below the prices charged to independent buyers. These discounts may be provided because the independent supplier hopes that it will be able to generate future sales to other group members if it provides favourable pricing and good service. Moreover, the associated enterprise may be viewed by the independent supplier as a low risk customer that is unlikely to default on any trade credit.

Another example in this respect is given by the credit rating: the passive association of an associated enterprise with its multinational group may improve the associated enterprise's credit rating. There are circumstances where an associated enterprise that is part of a multinational group may be able to receive a credit rating from lenders on the basis of its membership in the multinational group higher than it would if it were unaffiliated. Under these circumstances, the associated enterprise's membership of the multinational group does not result in a chargeable service being provided to the associated enterprise by the multinational group.

Totally different is the situation in which the parent company provides a lender with a formal guarantee for a loan made to an associated enterprise, the parent would be actively seeking the advantage ofa lower

finance charge for the associated enterprise: in such a case, the guarantee would qualify as a chargeable service for transfer pricing purposes requiring the payment of an arm's length guarantee fee.

2.3. Determining an arm's length charge: focus on the allocation key – Once it is determined that an intra-group service passes the benefit test, it is necessary, as for all the types of intra-group transfers, to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. This means – as for all the types of intra-group transfers – that charges for the services should reflect the charges that would be paid by independent entities in the same or similar circumstances.

Moreover, the arm's length price for services should be considered from both the perspective of the service provider and the perspective of the service recipient. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances (given the extent of the benefit it expects to receive from the service), as well as the costs to the service provider.

Also in this case, the nature of the transaction involves some specific steps, in order to check the compliance of the remuneration with the arm's length principle:

i) first of all, the allocation key has to be identified. The use of allocation keys provides an effective proxy for estimating the proportional share in the expected benefits from the activities, and accordingly, for allocating the costs or value of services within a multinational group, once the benefit test has been satisfied. An allocation key should be determined consistently for all associated enterprises concerned and should reasonably reflect each associated enterprise's share in the expected benefits from the intra-group services.

In some case, the multinational group uses a direct-charge method, i.e. where the associated enterprises are charged for specific services. The direct charging method requires that for specific services provided the

beneficiary of the services and the price for those services must be identified.

A direct charge method is ordinarily available in all those cases in which the employees of a given company work for the benefit of another company belonging to the same multinational group and the time spent as well as the costs related to the employees can be clearly identified. For example, an overseas subsidiary may be directly charged for a 2-day visit of a software engineer who is employed by the parent company and who may have visited the overseas subsidiary's site at the latter's request to render certain consultancy services or advisory services. In such a case the parent company can charge the specific costs for these consulting services with or without a mark-up (as the case may be) directly to the foreign subsidiary.

A direct charge is possible also in those cases in which specific services are provided not only to associated enterprises but also to independent enterprises in a comparable manner and as a significant part of its business: in such cases, indeed, it could be presumed that the group has the ability to demonstrate a separate basis for the charge (e.g. by recording the work done, the fee basis, or costs expended in fulfilling its third party contracts).

Alternatively, an indirect – charge method has to be adopted.

In some cases, an indirect-charge method may be necessary due to the nature of the service being provided. One example is where the proportion of the value of the services rendered to the various relevant entities cannot be quantified except on an approximate or estimated basis. This problem may occur, for example, where sales promotion activities carried on centrally (e.g. at international fairs, in the international press, or through other centralised advertising campaigns) may affect the quantity of goods manufactured or sold by a number of affiliates.

Another case is where a separate recording and analysis of the relevant services for each beneficiary would involve a burden of administrative work that would be disproportionately heavy in relation to the

activities themselves. In such cases, the charge could be determined by reference to an allocation among all potential beneficiaries of the costs that cannot be allocated directly, i.e. costs that cannot be specifically assigned to the actual beneficiaries of the various services.

If the indirect – charge method is adopted[104], the allocation key should meet the following requirements:

i) measurable;

ii) relevant to the type of services, i.e. provide a reasonable proxy for measuring the parties' proportional share in the expected benefits from the services at hand;

iii) determined consistently within a multinational group;

iv) documented.

To chose the most proper allocation key, a case – by – case analysis is required: when selecting an allocation key, the taxpayer should indeed consider the nature of the services and the use to which the services are put.

From a compliance perspective, there is a trade-off between precision and simplicity. A complex allocation key may place an excessive compliance burden on multinational groups with negligible improvements in allocating expenses within a multinational group. Any allocation will benefit from having supporting evidence to justify that it allocates expenses within a multinational group on an appropriate basis. Determining whether an allocation key is appropriate requires an analysis of a multinational group's facts and circumstances.

On one hand, the chosen allocation key should be able to reflect the relative benefit that each associated enterprise is expected to receive from the provision of intra-group services. This means that the allocation key

[104] The mentioned requirements are those provided by the UN Manual on Transfer Pricing. However, the same requirements are confirmed also by the OECD Transfer Pricing Guidelines, which require that the allocation keys should be sensitive to the commercial features of the individual case (e.g. the allocation key makes sense under the circumstances), contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.

should be based on an appropriate measure of the usage. For example, if the services relate to human resource activities, the proportionate number of employees may be an appropriate measure of the respective benefit to each group member. On the contrary, the allocation of the stand-by costs of priority computer back-up could be allocated in proportion to relative expenditure on computer equipment by the group members.

On the other hand, the chosen allocation key should be also easy to verify. Commonly accepted allocation keys are: sales, gross or net profit, units produced or sold, number of employees or full time equivalents, salaries and wages, number of information technology users, office spaces or factor space, capital, operating expenses, the number of personal computers and the activity based allocation keys such as the orders processed.

In light of the above, with reference to all those cases in which the proportion of services rendered to each beneficiary might not be easily identifiable with reference to the exact quantum of benefit attained or expected (for instance, in cases involving a centralized advertisement campaign), it is admitted that the allocation key is an approximate value (e.g. proportional net sales of all the beneficiaries to allocate the cost incurred to implement the centralized advertising campaign mentioned above).

In this respect, it is worth mentioning that the EU JTPF Guidelines include a non-exhaustive list of allocation keys that are commonly used by the multinational groups for certain types of services. Such list is mentioned as a reference also by the UN Model on Transfer Pricing (differently from the OECD Transfer Pricing Guidelines). More specifically, the list includes the following services:

i) information technology: number of personal computers:

ii) business management software: number of licences;

iii) human resources / health and safety / staff training: number of employees;

iv) tax and accounting: sales or size of balance sheet;

v) marketing services: sales to independent customers;

vi) vehicle fleet management: number of cars.

2.3.1. Determining an arm's length charge: focus on the mark - up – After identifying the proper allocation key, the arm's length consideration should be determined: the matter should be considered both from the perspective of the service provider and from the perspective of the recipient of the service. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

With reference to the transfer pricing method, the transfer pricing methods generally provided for the testing of all the intragroup transactions should be used to test also the provision of intra – group services.

With reference to the services, the commonly used transfer pricing methods are: i) the comparable uncontrolled price method or ii) a cost-based method (cost plus method or cost-based transactional net margin method) for pricing intra-group services.

The comparable uncontrolled price method requires a high degree of comparability between controlled and uncontrolled transactions: this means that an analysis of the types of services provided in controlled and uncontrolled transactions is required. For such an analysis, details on the services rendered, functions performed, assets used, the risks borne, the intangible assets used and the contractual terms may be needed.

While comparable service transactions between independent parties may take place, it is unlikely that the critical information on these transactions (such as the prices charged, functions performed, assets used and risks borne by the parties) will be available for comparison. This type of information on uncontrolled transactions is often confidential and unlikely to be publicly available: in light of this, the external comparable uncontrolled price method is more difficult to be applied.

There are three common situations in which the comparable uncontrolled method appears to be applicable[105], i.e.:

i) if an multinational group's service provider renders the same services in comparable circumstances to independent entities as it provides to associated enterprises (in these cases indeed, the service-provider has a charging system in place);

ii) similarly, if an associated entity receives the same or similar services from both an associated enterprise and from independent service providers, that entity may be able to use these as internal comparables for the comparable uncontrolled price method;

iii) if the service provider only provides centralized services to intra-group members, external comparable uncontrolled price method may in some cases be available. An external comparable uncontrolled price method may be used provided it is comparable to the intra-group services.

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[105] In this respect, the example provided by the UN Manual on Transfer Pricing appears quite interesting: Grain Co and Shipper Co are associated enterprises. Grain Co is resident in Country A and produces wheat for export.

Shipper Co is resident in Country B and carries on a business of providing grain shipping services. Shipper Co provides grain shipping services to four independent enterprises and approximately 60% of its business is made up of performing shipping services to these independent customers and 40% of its business is performing shipping services for Grain Co. In this situation it is likely that Shipper Co would be able to use the CUP method as it has internal comparables to use in setting its transfer prices for Grain Co. The reliability of the comparables depends on a comparability analysis. Assume that there is a high comparability in terms of the type of service provided, the volume of transactions, the contractual terms and the economic conditions. In this case, Shipper would be able to use the internal comparables in setting its transfer prices for shipping services provided to Grain Co.

Assume the same facts as Example 10, except that 90% of Shipper Co's business is providing shipping services for Grain Co. The remaining 10% of its business is providing shipping services on an ad hoc basis to independent customers. Assume further that the independent customers only use Shipper Co in times of acute shortage of shipping capacity by other independent shipping enterprises. In these situations, shipping services may be more costly than when there is no shortage. In this situation, the comparability analysis is likely to lead to the conclusion that the comparables need to be adjusted for the significant differences between the controlled and uncontrolled transactions which would affect the shipping charges.

The main differences on the facts are the volume of business (90% of volume originated by Grain Co and 10% by independent entities) and the regularity of providing grain transporting services that must be taken into account as they would be expected to have a material effect on the transportation charges. If reasonably accurate adjustments for material differences between the controlled and uncontrolled transactions cannot be made, the reliability of the CUP method will be reduced, and the CUP method may not be the most appropriate method.

A cost based method would likely be the most appropriate method in the absence of a comparable uncontrolled price method where the nature of the activities involved, assets used, and risks assumed are comparable to those undertaken by independent enterprises. The Cost Plus Method is less dependent on similarity between the controlled and uncontrolled service transactions than the comparable uncontrolled price method. The aim of the Cost Plus Method is to set the appropriate cost plus mark-up on cost base so that the gross profit in a controlled services transaction is appropriate in the light of the functions performed, risks assumed, assets used and market conditions.

Total services costs means all costs in calculating the operating income. The items that would be expected to be included in the direct cost base are: salaries of the staff providing services; bonuses; travel expenses; materials used in providing services; and communication expenses attributable to the provision of services. Indirect expenses may include the following items: depreciation of equipment and buildings; rent for leased items or immovable property; property taxes; occupancy and other overhead costs; maintenance costs; insurance; personnel costs, accounting and payroll expenses; and other general, administrative and managerial expenses. Total services costs do not include interest expenses, foreign income taxes or domestic income taxes[106].

If the cost plus method is inapplicable (because reliable information on gross profit margins is unavailable for comparable service providers or because the cost base used for controlled and uncontrolled transactions is different), the TNMM may be used. The TNMM may be based on internal comparables, such as those from uncontrolled transactions that the

[106] It is assumed that these intra – group charges are based on actual cost but this is not expressively mentioned neither in OECD TP Guidelines nor in the UN Manual on Transfer Pricing. In practice, this implies that the group companies have to wait until each month's closing is completed before there are able to analyze the actual cost occurred and, if necessary, to perform the allocation key calculation and to come up with the appropriate amount and markup to issue the invoice to other group companies. Remarkably, this issue applies for direct as well as indirect charge methods.

The industry practice shows that many multinational groups also charge budget amounts e.g. monthly 1/12 of the annual budget during the year and try to apply a true up in December to reflect actual cost.

associated enterprise enters into. Alternatively, the profit margins may be obtained from transactions by independent parties.

The profit level indicator that may be appropriate for intra-group services provided by an associated enterprise would be the ratio of the operating profit to the cost base of providing the services[107].

The Profit Split Method may in certain circumstances be used for services: more specifically, the Profit Split Method may be used when both sides to controlled transactions contribute significant intangible property. Under the Profit Split Method the profit derived from controlled transactions is allocated between the associated enterprises on the basis of each associated enterprise's relative contributions. The relative contributions would be determined on the basis of functions performed, risks assumed and assets used by each associated enterprise[108].

With reference to the most appropriate TP method, the OECD Guidelines provide also for some meaningful examples. One example

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[107] Service Provider Co in Country A is a member of an MNE group and it provides marketing services for the group. Service Provider is requested by an associated enterprise Seller Co in Country B to design a marketing program for a new product. Following research, Service Provider has concluded that the CUP and Cost Plus Methods are inapplicable. In applying the TNMM to Service Provider, the costs of providing services and operating expenses are known. The unknown variable is the arm's length charge for the intra-group service. A comparability analysis is then carried out to determine the appropriate arm's length net profit margin for Service Provider. If we assume that the cost of providing the service is $80,000 and the operating expenses are $20,000, the total direct and indirect costs of providing the services are $100,000. Assume that Service Provider makes a net profit to costs of 5%. A search of comparable independent marketing enterprises has revealed they are making a net profit to costs of providing services of 3%-8%. Country A accepts the range of indicative comparables. The comparables are marketing enterprises which are listed on the stock exchange in Country A and provide similar marketing services to those provided by Service Provider. In this situation, Service Provider's net profit of 5% is within the arm's length range of the net profit to the cost of providing the services. The service provider is treated as making a net profit of $5,000 from providing intra-group services to an associated enterprise.

[108] Air Express is engaged in the business of a logistics service provider offering a comprehensive portfolio of international, domestic and specified freight handling services. The group of entities is generally involved in international transactions involving freight services provided by associated enterprises. The business activities involve entering into contracts with third parties for moving their cargo from its source to destinations abroad. The execution of the job involves lifting cargo from the location of the customer in one country, sending it to the country of destination, collecting it from a port or airport and then supplying it to the ultimate buyer. All such activities are carried out by associated enterprises in various countries. The total expenses incurred in all countries are combined and then deducted from gross receipts and the residual amount is shared in the ratio of 50:50 between the entity of the origin country and the entity of the destination country, based on a Profit Split Method.

involves debt-factoring activities, where a multinational group decides to centralize the activities for economic reasons. For example, it may be prudent to centralize the debt-factoring activities to better manage liquidity, currency and debt risks and to provide administrative efficiencies. A debt-factoring center that takes on this responsibility is performing intragroup services for which an arm's length charge should be made. In principle, it is confirmed that it might be possible to use a CUP, but presumably this is predicated on the availability of market data on debt factoring rates. In practice – even if it is not acknowledged by the OECD - this can be difficult to source reliably.

The second example is related to the manufacturing activities. The activities can take a variety of forms including what is commonly referred to as contract manufacturing. In some cases of contract manufacturing the producer may operate under extensive instruction from the counterparty about what to produce, in what quantity and of what quality. In some cases, raw materials or components may be made available to the producer by the counterparty. The production company may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a low-risk service to the counterparty, and the cost-plus method could be the most appropriate transfer pricing method.

Research is similarly an example of an activity that may involve intra-group services. The terms of the activity can be set out in a detailed contract with the party commissioning the service, commonly known as contract research. The activity can involve highly skilled personnel and vary considerably both in its nature and in its importance to the success of the group. The actual arrangements can take a variety of forms from the undertaking of detailed programs laid down by the principal party, extending to agreements where the research company has discretion to work within broadly defined categories. In the latter instance, the additional functions of identifying commercially valuable areas and assessing the risk of unsuccessful research can be a critical factor in the performance of the

group as a whole. It is therefore crucial to undertake a detailed functional analysis and to obtain a clear understanding of the precise nature of the research, and of how the activities are being carried out by the company, prior to consideration of the appropriate transfer pricing methodology. The consideration of options realistically available to the party commissioning the research may also prove useful in selecting the most appropriate transfer pricing method.

2.3.2. Determining an arm’s length charge: focus on the pass-through costs – The last aspect to be mentioned is related to those cases in which no mark-up is applied.

On this aspect, the OECD Transfer Pricing guidelines, as well as the UN Manual on Transfer Pricing move from the consideration that an independent enterprise normally would seek to charge for services in such a way as to generate profit, rather than providing the services merely at cost. However, there are circumstances in which an independent enterprise may not realize a profit from the performance of services alone: therefore, it need not always be the case that an arm’s length price will result in a profit for an associated enterprise that is performing an intra-group service.

In this respect, the most common example is given by those cases in which a multinational group may decide to outsource some services to an independent entity (e.g. advisory services, travel costs, IT expenses) and to use an associated enterprise to act as an agent for the group to pay the accounts and to then allocate the charges to its associated enterprises on an objective basis. As an agent, its only role may be to pay the independent service provider and to then allocate the total cost of services among group members on an objective basis. In such a case, it may not be appropriate to determine arm’s length pricing as a mark-up on the cost of the outsourced services: those expenditures include indeed a profit element at the level of the service provider.

In other words, it is acknowledged that in the case of mere agency or intermediation in respect of externally incurred costs that would otherwise

be incurred directly by the beneficiary as well (hence, without the alteration of the externally provided services or own value added), it may be appropriate to pass on these costs to the group recipients without a mark-up.

In such cases, only the agency function should be adequately remunerated: this implies that a mark-up should apply only on the costs (if any) incurred for the agency or intermediary function.

These costs are in practice often referred to as pass-through costs or disbursements[109].

In this respect, the example mentioned by the UN Manual on Transfer Pricing is quite interesting in this respect: a multinational group has a parent company, Controller Company, in Country A and has an associated enterprise; Subsidiary Company in Country B. Controller Co has ten subsidiaries in total around the world. The multinational group has reviewed its operations and has decided to keep in-house the activities in which it has a comparative advantage and to outsource activities that independent enterprises can provide at a lower cost. The multinational group has decided to outsource its human resources activities to an independent enterprise, Independent Company, in Country B for the whole group.

A multinational group has decided to outsource the work through Subsidiary Company as it is located in the same jurisdiction as the service provider. The role of Subsidiary Company is to pay the independent enterprise and to recharge the costs it incurs in doing so to group members. In this situation Subsidiary Company is operating as an agent. Subsidiary Company passes on the service costs charged by Independent Company to group members on the basis of full time employee equivalents in the group. The charge is on a pass-through basis as Subsidiary Company is not

[109] There are other cases in which there could be no mark-up. A first example is represented by those cases in which a supplier's costs exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities.

A second example is given by those cases in which the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the multinational group. In such cases, indeed, the market value of intragroup services is not greater than the costs incurred by the service provider.

adding value and is merely used for convenience to distribute the human resource costs of outsourcing to Independent Company without a profit mark-up. In addition, Subsidiary Company may provide a service in paying Independent Company and allocating the cost to group members[110].

2.4. Safe harbors – it is often burdensome and costly to determine arm's length prices if an associated enterprise provides a range of intra-group services. A practical alternative for a tax authority is to provide taxpayers with the option of using a safe harbor for certain low value-adding services, provided it results in an outcome that broadly complies with the arm's length principle. The safe harbor rates may be based on acceptable mark-up rates for services.

Several countries provide a safe harbor option for certain services. The advantages of a safe harbor are: i) reducing the compliance effort of meeting the benefits test and in demonstrating arm's length charges; ii) providing greater certainty for multinational groups that the price charged for the qualifying activities will be accepted by the tax administrations that have adopted the simplified approach when the conditions for the simplified approach have been met; and iii) providing tax administrations with targeted documentation enabling efficient review of compliance risks. With reference to the latter point, any additional tax revenue that a tax authority may receive from a transfer pricing adjustment of such services may be outweighed by the administrative costs of applying the arm's length principle to such services. Accordingly, providing a safe-harbor enables tax authorities to use their resources to concentrate on transfer pricing reviews in which the tax revenue at stake is more significant.

[110] In this respect, the Dutch Decree is also worth mentioning. According to the Dutch Decree, indeed, Pass-through costs do not have to be included in the cost base. Pass-through costs refer to costs initially paid by the contracting party providing the service; these include administrative charges, court costs and service costs. In general, they should be charged separately to the principal. Although these costs are related to the services provided by the contracting party and are recharged, they do not warrant a separate reimbursement payment. Whether such costs should be regarded as pass-through costs depends on whether an unassociated contracting party would recharge these costs without markup, in accordance with the 2017 OECD Guidelines.

The downside of a unilateral safe harbor is that the service-provider's country may not provide for a safe harbor and insist on a higher mark-up than the safe harbor mark-up and this may result in double taxation. If a bilateral or multilateral safe harbor is available, this is to be preferred as it reduces the risk of double taxation.

The most commonly accepted safe harbor is that related to the low-value services which are unconnected to an associated enterprise's main business activity. More specifically, section D of the OECD Transfer Pricing Guidelines provides specific guidance relating to a particular category of intra-group services referred to as low value-adding intra-group services; for such kind of services, a simplified approach for transfer pricing analysis is admitted. The mentioned section has been introduced in 2017 as a result of the BEPS Project: action 10 of the mentioned project indeed was entitled to the low value-adding intra-group services[111]. Also the UN Manual on Transfer Pricing provides for the safe harbor for Low-value services that are unconnected to an associated enterprise's main business activity (see section B.4.5.3). Such simplified approach was already approved by the EUJTP Guidelines.

In addition to the mentioned safe harbor for low value – adding services, the UN Manual on Transfer Pricing provides for a further safe harbor for minor expenses. These are for situations in which the costs of services provided or received are relatively low, so the tax authority may agree to not adjust the transfer prices provided they fall within the acceptable range. The rationale for this safe harbor is that the cost of a tax authority making adjustments is not commensurate with the tax revenue at

[111] See OECD / G20 BEPS PROJECT, *Action 10: Proposed modifications to Chapter VII of the transfer pricing guidelines relating to low value – adding intra – group services*, November 2014, available at <www.oecd.org>. After the publication of the mentioned document, a public consultation was opened: the results of such consultation are included in the document issued by the OECD in January 2015 (see OECD, *Comments received on public discussion draft BEPS Action 10: Proposed modifications to chapter VII of the Transfer Pricing Guidelines relating to low value – adding intra – group services*, 2015, available at <www.oecd.org>). The final report was issued in October 2015: see OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, 2015, available at <www.oecd.org>.

stake and therefore the taxpayer cannot be expected to incur compliance costs to determine more precise arm's length prices.

In order to determine the intra – group services to which the minor expense safe harbor option applies, a threshold has to be set on the basis of the costs related to the services. Once determined, a fixed profit mark margin is used for calculating the arm's length remuneration.

The minor safe harbor may contain the following requirements: i) a restriction on the relative value of the service expense (e.g. less than X% of total expenses of the associated enterprise receiving the services); ii) a fixed profit margin; iii) the requirement that the same profit margin is used in the other country, and iv) the documentation requirements that are expected. An important requirement is that the same fixed profit margin should be used for in-bound and out-bound intra-group services for a country[112].

The UN Manual on Transfer Pricing provides for an interesting example in this respect. We can assume that Subsidiary Co is resident in Country A and receives marketing services from its parent company, Parent Co which is resident in Country B. The total direct and indirect cost of providing the services is $500,000. Subsidiary Co decides to use the safe harbor option, as the costs of preparing a comprehensive transfer pricing analysis for such services and determining the arm's length margin would be excessive given that the services are low value-adding services. Subsidiary Co does not acquire other services from associated enterprises and its total deductible expenses are $10 million. The total charge for services of $537,500 is below the $750,000 threshold and the expense is 5.37% of its total deductible expenses and thus below the 15% threshold.

[112] An example of a minor expense safe harbour for services could set out as follows. For inbound intra-group services: i) the total cost of the services provided is less than X% of the total deductions of the associated enterprises in a jurisdiction for a tax year; ii) the transfer price is a fixed profit mark-up on total costs of the services (direct and indirect expenses); and iii) documentation is prepared to establish that the safe harbor requirements have been satisfied.

For outbound intra-group services: i) the cost of providing the services is not more than X% of the taxable income of the associated enterprise providing the services; ii) the transfer price charged is based on a fixed profit mark-up on the total costs of the services (direct and indirect expenses); iii) the same profit margin is used in the other country, and iv) documentation is created to establish that these safe harbour requirements have been satisfied.

Accordingly, the maximum transfer price Subsidiary Co can deduct for the services rendered by Parent Co under the safe harbor option is $537,500. A transfer price up to this amount will be deductible by Subsidiary Co provided the documentation requirements are satisfied.

Safe harbors may have unintended consequences and should be carefully considered before they are implemented. If in the above example, a full transfer pricing analysis concluded that the arm's length cost plus margin is 5%, the service charge would have been $525,000. By using the safe harbor, Subsidiary Co has been able to claim $537,500 as a deductible expense in Country A for intra-group services without incurring the costs of a full transfer pricing analysis (which may have exceeded $12,500).

On the other hand, if the tax authorities in Country B are not aware of the safe harbor, they would require arm's length services income of $525,000 to be reported, which is $12,500 less than the amount claimed as a deductible expense at the level of Country A. To avoid this result, it is material that safe harbor requirements consider this possibility and a matching of income and costs is required.

2.4.1. Safe harbor for low value – adding services: conditions for the applicability of the safe harbor – In order to apply the mentioned simplified approach for low value – adding services, three different conditions have to be met:

i) the service should fall within the definition of low – value adding service provided by the OECD Transfer Pricing Guidelines themselves;

ii) the comparable uncontrolled price method should not be available;

iii) an "all – in approach" is needed, i.e. a multinational group electing to adopt this simplified method would as far as practicable apply it on a consistent, group wide basis in all countries in which it operates.

First of all, with reference to the definition provided by the OECD Transfer Pricing Guidelines, low value-adding intra-group services for the purposes of the simplified approach are defined as the services performed by one member or more than one member of a multinational group on behalf

of one or more other group members which meet the requirements mentioned below. In this respect, on a preliminary basis, it is worth mentioning that some terms and expression which constitute the rules for identifying the low value services are not clearly defined within the OECD Transfer Pricing Guidelines. On the contrary, they are defined by domestic legislation or administrative practices of some countries either for income tax purposes or VAT purposes. The result is that this domestic law meaning may influence the interpretation of the terms and expression as used by the report.

First of all, looking to the functions performed by the service provider, it is clearly stated that:

i) the low – value adding services should have a supportive nature. The concept of "supportive" is not defined within the OECD Transfer Pricing Guidelines. Under VAT EU Regulation 282/2011, "administrative support" is partly defined by stating that "where the resources of the fixed establishment are only used for administrative support tasks such as accounting, invoicing and collection of debt-claims, they shall not be regarded as being used for the fulfillment of the supply of goods or services".

ii) the low – value adding services should not be part of the core business of the multinational enterprises. The second characteristic requires the activities not to be part of the core business of the multinational group.

The definition of "core business" requires some clarification too. To assess the satisfaction of this characteristic, it may be helpful to consider the activities of an "auxiliary and preparatory character" covered by article 5(4) of the OECD Model Convention. The provision excludes a fixed place of business through which the enterprise solely exercises an activity which has a preparatory or auxiliary character for the enterprise from the definition of permanent establishment: these activities are listed expressly by article 5(4) of the OECD Model Convention. The rationale for this provision lies with the fact that the activity of the fixed place of business in itself does not form an essential and significant part of the activity of the enterprise as a

whole. The Commentary to the provision also states that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question.

The Report describes activities not constituting the core business of the multinational group as "activities" not creating the profit – earning activities or contributing to economically significant activities of the multinational group". One example may better clarify the interaction between the scope of low value services under the OECD Transfer Pricing Guidelines and preparatory and auxiliary activities under article 5(4) of the OECD Model Convention. "Purchasing activities relating to raw material or other material that are used in the manufacturing or processing process" are excluded from low services activities. Article 5(4)(d) of the OECD Model Convention includes purchasing goods or merchandise in the scope of preparatory or auxiliary activities. Evidently, the transfer pricing guidelines take the view that purchase of raw material carries greater value than the one derived from the purchase of goods or merchandise which is consistent with the wording of article 5(4)(d) of the OECD Model Convention.

Another consistency between the Report and the activities excluded by article 5(4) of the OECD model convention may be found by the parallel exclusion of "warehousing" from low value – adding services in the report on Action 8 – 10 and from the list of auxiliary and preparatory activities under article 5(4) as advocated by the Report on action 7.

Reference is made to the multinational group as a whole and not to the service provider which is a departure from the old OECD Guidelines which look at the stand – alone affiliate. This aspect is made clear by the OECD Transfer Pricing guidelines, according to which the definition of low value-adding intra-group services refers to the supportive nature of such services, which are not part of the core business of the multinational group. The provision of low value-adding intra-group services may, in fact, be the principal business activity of the legal entity providing the service, e.g. a

shared service center, provided these services do not relate to the core business of the group.

As an example, the OECD Transfer Pricing Guidelines assume that a multinational group is engaged in the development, production, sale and marketing of dairy products worldwide. The group established a shared services company, the only activity of which is to act as a global IT support service center. From the perspective of the IT support service provider, the rendering of the IT services is the company's principal business activity. However, as clearly stated by the OECD Guidelines, the service is not a core business activity both from the perspective of the service recipients and from the perspective of the multinational group as a whole: therefore, it may qualify as a low value-adding intra-group service.

Secondly, looking to the assets used by the service provider, it is stated that the low – value adding services should not require the use of unique and valuable intangibles, as well as should not lead to the creation of intangibles.

Furthermore, with reference to the risks assumed by the service provider, it is provided that the low – value adding services do not involve assumption or control of substantial risk by the service provider and do not give rise to the creation of significant risk for the service provider.

After having generally defined the concept of low – value adding services, the 2017 OECD Transfer Pricing Guidelines provide for some further guidance. On one hand, a non – exhaustive list of services which should in principle fall within the definition of low – value adding services is provided. The list of included services – unlike the list of excluded services which we will examine below – is an illustrative list (these are mentioned as services which are "likely" to fall under the scope): in this respect, scholars have outlined that the entire rationale of the simplified approach is to improve certainty and limit disputes and non – efficient use of resources by tax administrations during tax audits. It would therefore have been desirable for the transfer pricing guidelines to establish quite clearly that all of the services listed by the transfer pricing guidelines have to be regarded as low

value services or that, alternatively, burden of proof would lie on the tax administration to document that the services fall outside the simplified approach. Moreover – as we will point out also with reference to the excluded services – the list of included services lacks clarity by reason of the uncertainty of the meaning of the terms. Such a list includes the following activities:

i) accounting and auditing, for example gathering and reviewing information for use in financial statements, maintenance of accounting records, preparation of financial statements, preparation or assistance in operational and financial audits, verifying authenticity and reliability of accounting records, and assistance in the preparation of budgets through compilation of data and information gathering;

ii) processing and management of accounts receivable and accounts payable, for example compilation of customer or client billing information, and credit control checking and processing;

iii) human resources activities[113]. Among the other human resources activities, the OECD transfer pricing guidelines mention the training and employee development, for example evaluation of training needs, creation of internal training and development programs, creation of management skills and career development programs. In this respect, it is worth mentioning that this kind of activities might be to create and transfer know –

[113] The 2017 OECD Transfer Pricing Guidelines provide further guidance on human resources activities: more specifically, it mentions as examples of low – value adding services: i) staffing and recruitment, for example hiring procedures, assistance in evaluation of applicants and selection and appointment of personnel, on-boarding new employees, performance evaluation and assistance in defining careers, assistance in procedures to dismiss personnel, assistance in programs for redundant personnel; ii) training and employee development, for example evaluation of training needs, creation of internal training and development programs, creation of management skills and career development programs; iii) remuneration services, for example, providing advice and determining policies for employee compensation and benefits such as healthcare and life insurance, stock option plans, and pension schemes; verification of attendance and timekeeping, payroll services including processing and tax compliance; iv) developing and monitoring of staff health procedures, safety and environmental standards relating to employment matters.

how which is a point made by the Base Erosion and Profit Shifting Report on Intangibles[114];

iv) monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business;

v) information technology services where they are not part of the principal activity of the group, for example installing, maintaining and updating IT systems used in the business; information system support (which may include the information system used in connection with accounting, production, client relations, human resources and payroll, and email systems); training on the use or application of information systems as well as on the associated equipment employed to collect, process and present information; developing IT guidelines, providing telecommunications services, organizing an IT helpdesk, implementing and maintaining of IT security systems; supporting, maintaining and supervising of IT networks (local area network, wide area network, internet);

vi) internal and external communications and public relations support (but excluding specific advertising or marketing activities as well as development of underlying strategies);

vii) internal and external communications and public relations support (but excluding specific advertising or marketing activities as well as development of underlying strategies);

viii) legal services[115];

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[114] According to paragraph 1.155 of the Base Erosion and Profit Shifting Action 8 on intangibles, indeed, "It should be noted, however, that the transfer or secondment of one or more employees may, in some situation depending on the facts and circumstances, result in the transfer of valuable know – how or other intangibles from one associated enterprise to another. For example, an employee of Company A seconded to Company B may have knowledge of a secret formula owned by Company A and may make that secret formula available to Company B for use in its commercial operations. Similarly, employees of Company A seconded to Company B to assist with a factory start – up may make Company A manufacturing know – how available to Company B for use in its commercial operations. Where such a provision of know – how or other intangibles results from the transfer or secondment of employees, it should be separately analyzed under the provisions of chapter VI and an appropriate price should be paid for the right to use the intangibles"

[115] The definition of legal services is further clarified: as examples, the 2017 OECD Transfer Pricing Guidelines mention general legal services performed by inhouse legal counsel such as drafting and reviewing contracts, agreements and other legal documents, legal consultation and opinions, representation of the company (judicial litigation, arbitration

ix) activities with regard to tax obligations, for example information gathering and preparation of tax returns (income tax, sales tax, VAT, property tax, customs and excise), making tax payments, responding to tax administrations' audits, and giving advice on tax matters;

x) general services of an administrative or clerical nature.

The EU JTPF Guidelines include a number of deviation from the list provided by the OECD Transfer Pricing guidelines. Scrolling down the lists of activities, the first main difference between the EU and the OECD is that the latter expressly excludes marketing and R&D services from the definition of low value while the EU does not. This change of approach might be considered in light of the related works on Action 8 ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation. Indeed, the Report (paragraph 6.56) states that, in considering the arm's length compensation for functional contributions of various members of the multinational group, some "important functions" (including marketing and R&D activities) will have, in appropriate circumstances, "special significance" because they usually make a significant contribution to intangible value.

Moreover, differently from the EU Joint TP Forum, the OECD does not mention warehousing activities. This is probably due to the possible interaction with paragraphs 11 et seq. of the BEPS Action 7 "Preventing the Artificial Avoidance of Permanent Establishment Status" stating that "where, for example, an enterprise of State R maintains in state S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in state S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise's sale

panels, administrative procedures), legal research and legal as well as administrative work for the registration and protection of intangible property.

/ distribution business and do not have, therefore, a preparatory or auxiliary character. The inclusion of warehousing in the list of activities that would likely meet the definition of low value – adding services would have been inconsistent with the proposition made under BEPS Action 7 under which warehousing can no longer be regarded as ancillary and preparatory (contributing minimally to the creation of income).

On the other hand, a non - exhaustive list of services which do not fall expressly within the definition of low – value adding services is also provided. The list of excluded services – unlike the list of included services – is conclusive and, in its literal wording, does not appear to permit the multinational group to document a contrary characterization under the circumstances. Moreover, scholars have outlined that the list of excluded services lacks clarity by reason of the uncertainty of the meaning of the terms. The list includes the activities mentioned below.

i) Services constituting the core business of the multinational group.

ii) Research and development services (including software development unless falling within the scope of the aforementioned definition of information technology services qualified as low – value adding services).

iii) Manufacturing and production services. Some criticism was raised as to the exclusion as well as the lack of guidance on the characterization of contract / toll manufacturing activities. The parallel between the low – value adding services and the auxiliary and preparatory activities under article 5(4) of the OECD model convention indicates that processing activities are not included within auxiliary or preparatory activities which would exclude the existence of a permanent establishment. Letter c of paragraph 4 makes it clear that the exclusion is confined to storage for processing by another enterprise[116].

[116] Recently, the Italian Supreme Court – Criminal Section stated that business of toll manufacturers is outside the scope of permanent establishment concept (Supreme Court, Criminal Section, 18 Apr. 2014, No. 17299). The Italian judiciary has given relevance to the absence of decision power and risks at the level of the Italian company. The reasoning of the Italian Supreme Court could lead to the conclusion that toll manufacturer services should be considered low value service as they do “not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider”. For a comment on the decision of the

iv) Purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process.

v) Sales, marketing and distribution activities. In this respect, it is worth mentioning that marketing services are excluded while "internal and external communications and public relations support" – which might fall within the meaning of marketing – are included among low value services. It is worth noting that the Joint Transfer Pricing Forum includes marketing service within the scope of low value services. Comments made in the context of the public consultation have extensively criticized the general exclusion of marketing services from the scope of low value services. Indeed, depending on business – specific circumstances, marketing activities can be considered an intangible generating activity (e.g. in the case of consumer brands), a mid – to – high value service (e.g. creating advertising copy) or a low value – adding service (e.g. printing marketing brochures).

vi) Financial transactions: the category appears to be too broad and might well include low value services.

vii) Extraction, exploration, or processing of natural resources.

viii) Insurance and reinsurance: the same consideration done for the category of the financial transactions is valid for insurance and reinsurance activities. Indeed, also the category of the "insurance and reinsurance activities" appears to be too broad, since insurance and reinsurance activities may be a routine function for certain businesses.

ix) Services of corporate senior management (other than management supervision of services that qualify as low value-adding intra-group services under the definition provided above). The expression "corporate senior management" has also been criticized in the comments made in the context of the public consultation. Indeed "corporate senior managers" can also be involved in the performance of low value – adding activities. Focus should be on the nature and type of service and not on who

Supreme Court, see P. PISTONE, *Italy: No permanent establishment for toll manufacturing without participation in strategic decision making*, in *Tax Treaty Case Law Around the Globe*, 2015, p. 115.

provides the services. In practice, it may be wondered the extent to which activities rendered by senior management are enveloped into services taking into account that their responsibilities frequently cover several functions of the group without a clear – cut distinction.

Moreover, the expression "corporate senior management" has no legal meaning and may be interpreted differently within a multinational group. For instance, in the US, the expression "senior executive" means the chief executive officer, chief operating officer, chief financial officer or anyone in charge of a principal business unit or function (Model Business Corporation Act which is a model set of law prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association and is followed by twenty – four states).

The second condition in order to grant the applicability of the simplified approach is that the infra – group transaction cannot be tested through the comparable uncontrolled price method; in other words, the transfer pricing guidelines confirm that the comparable uncontrolled method should be always applied if it is available. More specifically, according to the paragraph 7.46 of the OECD Transfer Pricing Guidelines, the simplified approach is not applicable to services that would ordinarily qualify as low value-adding intra-group services where such services are rendered to unrelated customers of the members of the multinational group. In such cases it can be expected that reliable internal comparables exist and can be used for determining the arm's length price for the intra-group services. It is noteworthy that para 7.46 of the OECD Transfer Pricing Guidelines mention expressly only the internal CUP: this seems to imply that only the availability of internal comparables restricts the application of the simplified approach. However, a more careful reading of the Final Report leads to a different conclusion. Indeed, paragraph 7.31 provides that "[a] cost-based method would likely to be the most appropriate method in the absence of a CUP. Reference is generally made to the CUP method without distinguishing between internal and external. Therefore, the simplified

approach should also not be enforced in the case of applicability of the external CUP.

As a third condition for the applicability of the simplified transfer pricing method, an “all – in approach” is needed, i.e. a multinational group electing to adopt this simplified method would as far as practicable apply it on a consistent, group wide basis in all countries in which it operates.

In any case, such a rule has two further specifications with reference to the cases in which a tax jurisdiction has not adopted the simplified approach and the multinational group is organized through regional hubs. In the first case mentioned, where a tax administration has not adopted the simplified approach, and, as a consequence, the multinational group complies with the local requirements in that jurisdiction, such compliance would not disqualify the multinational group from the application of the simplified approach to other jurisdictions.

With reference to the second case mentioned, moving from the consideration that not all multinational groups are vertically integrated and may instead have regional or divisional sub-groups with their own management and support structures, the OECD Transfer Pricing Guidelines admits that the multinational groups may elect to adopt the simplified method at the level of a sub-holding company and apply it on a consistent basis across all subsidiaries of that sub-holding company.

The provision will be surely of practical importance since it is true that the multinational groups are often organized through regional hubs. However, the possibility to apply the sub – holding limited application of the election should be clarified as the meaning of sub – holding is neither defined nor available in domestic laws of OECD countries.

2.4.2. Safe harbor for low value – adding services: the simplified approach – If the three conditions mentioned above are met, the provision of the services deemed to be low – value adding services can be tested through the simplified approach. More specifically, both the two steps which form the transfer pricing analysis (i.e. whether intra-group services have in

fact been provided and what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle) have been simplified.

More specifically, looking to the first step – whether intra-group services have in fact been provided – the paragraphs related to the simplified approach confirms the general assumption according to which the activity must provide the group member expected to pay for the service with economic or commercial value to enhance or maintain its commercial position, which in turn is determined by evaluating whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself.

However, with reference to the low – value adding services, the transfer pricing guidelines further points out that, because of the nature of the low value-adding intra-group services, the application of the benefit test may be difficult or may require greater effort than the amount of the charge warrants. In light of the above, the burden of proof of the tax payer has been lightened: where the multinational group has followed the guidance of the simplified approach the documentation and reporting discussed in the section related to the low – value adding services and mentioned below, it should provide indeed sufficient evidence that the benefits test is met given the nature of low value-adding intra-group services. Tax administrations should therefore generally refrain from reviewing or challenging the benefits test when the simplified approach has been applied under the conditions and circumstances discussed in this section and in particular in conformity with the documentation and reporting requirements provided in the discussed section.

Moreover, the OECD Transfer Pricing Guidelines clearly state that the taxpayers need only to demonstrate that assistance was provided with reference to the different categories of services and not on a specific charge basis. Thus, the taxpayer need only demonstrate that assistance was provided with, for example, payroll processing, rather than being required to

specify individual acts undertaken that give rise to the costs charged. Provided that the mentioned documentation and reporting requirements are met and that the relevant documentation is made available to the tax administration, a single annual invoice describing a category of services should suffice to support the charge, and correspondence or other evidence of individual acts should not be required. In other words, in evaluating the benefits test, tax administrations should consider benefits only by categories of services and not on a specific charge basis.

After having passed the benefit test – in the simplified way mentioned above –, the intra-group charge for the low value adding services should be determined in accordance with the arm's length principle. Such a phase consists of the following steps.

i) Determination of costs: at this stage in the calculation, the multinational group has to identify a pool of costs associated with categories of low value-adding services which are provided to multiple members of the multinational group.

The costs should be pooled according to category of services and should identify the accounting cost centers used in creating the pool.

According to the OECD Transfer Pricing Guidelines, the costs to be pooled should:

- include direct and indirect costs of rendering the service as well as, where relevant, the appropriate part of operating expenses (e.g. supervisory, general and administrative);

- include pass-through costs;

- exclude costs that are attributable to an in-house activity that benefits solely the company performing the activity;

- exclude costs that are attributable to the shareholder activities performed by the shareholding company;

- exclude those costs that are attributable to services performed by one group member solely on behalf of one other group member.

In addition to the above – even if no expressly mentioned in the OECD Transfer Pricing Guidelines – two further aspects should be taken into consideration.

Because of the mentioned “all – in” or “all – out” approach, a multinational group that elects for the simplified approach should – as an initial step – create one global cost pool for all costs incurred by all members of the group in performing any low value – adding intragroup services. Applying such an approach across different countries may create problems for example because some countries may allow a charge of costs without a markup for certain activities (e.g. Netherlands and the United States of America). Moreover, the “all – in” or “all – out” approach will likely create issues for low value services which are included in the cost of goods or services charged to other affiliates, in which case segregation might become difficult.

In addition to the above, at this stage, the multinational group should identify those costs that should be allocated among members of the group. In this regard, taxpayers should consider that compensation for services rendered to an associated enterprise may be included in the price for other transfers. For instance, the price for licensing a patent or know – how may include a payment for training services performed for the licensee. Even though such services are closely linked and continuous that they cannot be evaluated adequately on a separate basis, the costs of such services should not be carved out from the price for the rights to use intangible property or transfer of goods.

ii) Allocation of the costs: The second step in this simplified charge method for low value adding intra-group service costs is to allocate – on the basis of one or more allocation keys – among members of the group the costs in the cost pool that benefit multiple members of the group.

The appropriate allocation key or keys will depend on the nature of the services. However, some guidance is provided in this respect by the OECD Transfer Pricing Guidelines. The same allocation key or keys must be used on a consistent basis for all allocations of costs relating to the same

category of services. At the same time, once defined, the same reasonable key has to be used from year to year unless there is a justified reason to change.

By way of examples, the allocation key for services related to people might employ each company's share of total group headcount, IT services might employ the share of total users, fleet management services might employ the share of total vehicles, accounting support services might employ the share of total relevant transactions or the share of total assets. In many cases, the share of total turnover may be a relevant key.

iii) Application of the 5% profit mark – up: paragraph 7.61 of the OECD Transfer Pricing Guidelines provides for a profit markup equal to 5% to be applied to all pool costs. In other words, in determining the arm's length charge for low value-adding intragroup services, the provider of services shall apply a profit mark-up to all costs in the pool with the exception of the pass-through costs. The mark-up under the simplified approach does not need to be justified by a benchmarking study.

It is doubtful if one margin for all cost pools will properly reflect the arm's length remuneration. Accounting services may carry profit margins which are different from markups on monitoring safety and environmental matters. Furthermore, the flat markup disregards the location of the cost center and the different labor cost levels which may be found in different countries. Group synergies leading to cost efficiency are also not taken into account (knowledge of business models within the group may result in lower cost compared to an arm's length situation).

Moreover, certain industries carry a profit margin which is less than 5%. Indeed, data provided by the EUJTPF analysis of margins for intragroup services shows that the profitability of certain service providers is lower than the 5% indicated by the Report (i.e. land transport services 2,8%; air transport 2,5%; warehousing / storage 3,3%; HR 3,6%; travel services 1,6% and administration / business support 3,8%).

It is clear that it would be odd to obtain remuneration on low value services which are greater than the margins which are derived from the conduct of its core activities.

For these reasons, the fixed margin set out by the 2017 OECD Transfer Pricing Guidelines raised criticism. However, the lack of precision in identifying the proper margin for each class of services is a downside which is rewarded by the simplified approach adopted by the OECD Transfer Pricing Guidelines. Furthermore, the lack of precision in identifying the proper markup may lead to very negligible profit shifting issues if one considers that a 1% discrepancy between arm's length margin and the 5% fixed margin weighs EUR 10 million taxable income on an aggregated low value cost of EUR 1 billion. The exposure would be even more limited if one considers the overall effect of inbound and outbound services (e.g. in situations in which the 5% markup is too generous or it would generate more deductions for the recipient company and more income for the service provider). This is not conclusive as some countries may have an unbalanced ratio between inbound and outbound services such as developing countries which may be essentially inbound with the exception of a few emerging countries which host general service centers of a multinational group.

The risk of profit shifting is thus very limited and offset by the reduction of cost derived by tax administrations through auditing activities.

It may be wondered if a multinational group which elects for the simplified approach and so meets the documentation requirements may do so to protect itself from adjustments in excess of 5% for low value services and, nevertheless, maintain the ability to establish a lower than 5% markup. It is worth noting that the JTPF Report on low value – adding intragroup services does not provide for a fixed markup as it generally refers to experience showing a markup range between 3% and 8% or “often around 5%”.

It may be discussed at length if a range of marks-up could have been a better alternative to be adopted by the OECD Transfer Pricing Guidelines

(this was indeed the alternative chosen in the preliminary draft report). It is notable that the simplified approach relies on coordination between countries and requires a consistent approach, a target which could hardly be satisfied by a range of margins.

Finally, it may be wondered the extent to which the fixed profit markup may be consistently applied to purely domestic situations which, in some countries, might require legislative changes.

In addition to the above, it is worth mentioning that the 2017 OECD Transfer Pricing Guidelines recognize to the tax administrations the possibility to set a threshold: where such a threshold is adopted, the tax administration would not be obliged to accept the simplified approach if the level of low-value adding intra-group service fees exceeds the threshold and may require a full functional analysis and comparability analysis including the application of the benefits test to specific service charges.

The aim of such a threshold is to reduce the risk of shifting income and tax planning techniques.

Indeed, the risk of tax arbitrage exists insofar as the modeling of services may drive low value services compared to ad hoc services which would not fall under the 5% markup simplified approach. This approach enveloping ad hoc services into low value general services, however, may have drawbacks for the multinational group insofar as – as mentioned earlier – the increase of the overall amount of low value services may exceed the threshold which would rule out the eligibility for the simplified approach.

As mentioned earlier, the simplified approach can be ruled out when the aggregate of costs incurred for low value services exceeds certain amounts determined on the basis of a certain ratio (paragraph 7.63 of the OECD Transfer Pricing Guidelines considers on an illustrative basis proportion of such cost versus total costs or turnover).

It would be desirable for tax administrations to establish more than one ratio to be selected by the multinational group in order to permit taxpayers to pick the most suitable ratio which may adequately reflect the

peculiarities of the business segment and of the multinational group itself (e.g. less efficient multinational group which incurs labor costs above average and which may be documented by cost cutting programs).

The difficulty raised by the threshold is the need of coordination between countries as to qualitative and quantitative features of the threshold. This would avoid situations whereby the country of residence of the service provider accepts the 5% simplified approach and the country of residence of the recipient rules out the 5% simplified approach based on its autonomous rule on thresholds.

The selection of the threshold is quite broad as the report makes reference to different key (e.g., turnover or cost) amounts (percentage of the relevant ratio) and entities to which the ratio would apply (e.g. the recipient party versus the group).

Finally, the 2017 OECD Transfer Pricing Guidelines provide for the documentation and reporting requirements that the multinational group should fulfill in order to apply the simplified approach. This is a crucial aspect since the simplified approach – introduced by BEPS Action 9 - is based on a greater transparency granted by the tax payers towards the tax administration.

2.4.3. Safe harbor for low value – adding services: documentation requirements and some open points – Once a multinational group has opted for the simplified approach, the information and documentation mentioned below should be prepared and made available upon request to the tax administration of any entity within the group either making or receiving a payment for low value-adding intra-group services.

i) A description of the categories of low value-adding intra-group services provided; the identity of the beneficiaries; the reasons justifying that each category of services constitute low value-adding intra-group services within the definition included in the OECD Transfer Pricing Guidelines; the rationale for the provision of services within the context of the business of

the multinational group; a description of the benefits or expected benefits of each category of services; a description of the selected allocation keys and the reasons justifying that such allocation keys produce outcomes that reasonably reflect the benefits received, and confirmation of the mark-up applied;

ii) Written contracts or agreements for the provision of services and any modifications to those contracts and agreements reflecting the agreement of the various members of the group to be bound by the allocation rules of this section;

iii) Documentation and calculations showing the determination of the cost pool and of the mark-up applied thereon, in particular a detailed listing of all categories and amounts of relevant costs, including costs of any services provided solely to one group member;

iv) Calculations showing the application of the specified allocation keys.

Finally, some considerations about the effects of the elective simplified approach and its legal form should be developed. The effects of the simplified approach raise indeed some questions and, where the lack of clarity arises, this may reflect the resistance of some countries to surrender their power to assess or disqualify the resident affiliate when the election has so been made by the multinational group. The BEPS Action 9 – which has introduced the simplified approach for the low – value adding services – indicates that the system is a “safe harbor”.

The revised section E on safe harbors in Chapter IV of the OECD Transfer Pricing Guidelines includes, in the definition of safe harbor, situations in which eligible taxpayers are relieved from certain obligations otherwise imposed by a country’s general transfer pricing rules or are exempted from the application of all or part of these rules. The low value services simplified approach falls within the first class of safe harbors insofar as taxpayers electing for such a regime are not entirely excluded from the application of the rules for the class of eligible transactions.

Indeed, the coverage of the simplified approach does not seem to extend to the benefit test (paragraph 7.54 states that “tax administrations should generally refrain from reviewing or challenging the benefit test when the simplified approach has been applied” and that multinational group “should provide sufficient evidence that the benefits test is met”).

As the Report makes reference to the multinational group’s election, it is not clear which legal entity must apply for the simplified approach (the parent company or the sub – holding or each single affiliate).

Also the legal form of the election is not clear: it could be questioned indeed if it: i) should take the form of a specific request to be filed with the tax return, or ii) should be included in the transfer pricing documentation or iii) should be included in the reporting obligation regarding the compliance with documentation requirements.

The subject falls within the competence of domestic laws and administrative practice of each state. However, guidance is required insofar as the simplified approach relies on a coordination between more than one State (the cost plus 5% must be simultaneously applied to the country of residence of the recipient of the service as well as to the country of residence of the service provider).

The taxable years covered by the simplified approach are also not addressed in the OECD Transfer Pricing Guidelines. Should such timing rules be different, the simplified approach would have different coverage in the countries involved. For instance, one country might apply the simplified approach from the taxable period in which the election is filed while other countries might apply the simplified approach from the tax period for which the tax return is filed. Furthermore, affiliates may have different financial periods so that an election made simultaneously in the several states might apply to different time intervals. Finally, an entity might join a group in a taxable period for which the deadline for the election has expired so that the simplified approach is no longer available for that taxable period. This might require domestic law or administrative practice to consider retrospective application of the simplified approach under such circumstances.

In case of no possibility to apply the simplified, the service should be tested according to the general rules. In this respect, paragraph 7.48 of the OECD Transfer Pricing Guidelines further clarifies that the fact that an activity does not qualify for the simplified approach, as defined under paragraph 7.45, should not be interpreted to mean that that activity generates high returns. The activity could still add low value. However, as it came out from the comments made in the context of the public consultation, there is the risk that the tax authorities make the simplistic syllogism: excluded services are high value.

2.5. Transfer pricing aspects of financial services – Over the past decade, focus on transfer pricing aspects of cross-border related party financial transactions[117] such as intercompany loans[118], financial guarantees[119] and cash pooling arrangements[120] has been increased. Within the BEPS Project, Actions 8 – 10 provided that further guidance should have been provided on the economically relevant characteristics for determining the arm's length conditions for financial transactions. In light of this mandate, a discussion draft has been published in September 2018[121].

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[117] A. BAKKER, *Transfer Pricing and Intra Group Financing: Low-Hanging Fruit?*, 15(2) in *Derivatives & Financial Instruments*, 2013, p. 27; D. LEDURE ET AL., *Financial Transactions in Today's World. Observations from a Transfer Pricing Perspective*, in *Intertax*, 2010, (no. 38 -6/7), p. 350.

[118] V. CHAND, *Transfer Pricing Aspects of Intra - Group Loans in Light of the Base Erosion and Profit Shifting Action Plan*, Intertax (Volume 44 – Issue 12), 2016, p. 885; M. HELMINEN, *Determining the Arm's Length Interest Rate of an Intra-Group Loan,* in *European Taxation*, 2011, p. 153.

[119] V. AVERYANOVA - J. SAMPAT, *Transfer pricing aspects of Intra – Group Financial Guarantees in Light of the BEPS Action Plan*, in *International Transfer Pricing Journal*, 2015, p. 361; J. BUNDGAARD, *Tax Law on Intra-Group and Shareholder Security from a Transfer Pricing Perspective*, in *International Transfer Pricing Journal*, 2006 (March / April), p. 79; G. DESHPANDE, *The transfer pricing aspects of Cross – Border Performance Guarantees*, in *Bulletin for International Taxation*, 2017.

[120] V. CHAND, *Transfer Pricing Aspects of Cash Pooling Arrangements in Light of the BEPS Action Plan*, in *International Transfer Pricing Journal*, 2016 (23 – 1), p. 38; A. HALLER - V. CHAND, *Application of the Arm's Length Principle to Physical Cash Pooling Arrangements in Light of the OECD Discussion Draft on Financial Transactions*, in *Intertax* (Volume 47 – Issue 4), 2019, p. 349.

[121] OECD / G20 BEPS PROJECT, *Actions 8 – 10. Financial transactions, 3 July – 7 September 2018*, available at <www.oecd.org>. The final document has not been issued yet. For a comment, see P. BONARELLI, *Il Discussion Draft BEPS sull'applicazione del principio di libera concorrenza alle transazioni finanziarie*, in *Fiscalità e Commercio Internazionale*, 2018 (no. 18), p. 5.

The analysis described above in order to check if the provision of an intra – group service (i.e. the benefit test and the set up of an arm's length charge) is compliant with the transfer pricing rules should be adjusted for the financial services.

Looking to the benefit test of intercompany loans, it should be firstly checked if the loan arrangement can be re-characterized or disregarded in the borrowers State under the arm's length principle.

In other words, when dealing with intercompany loans, as an initial step it needs to be ascertained as to whether the funding arrangement qualifies as debt or equity. The OECD is indeed of the view that Article 9(1) 'is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital'[122].

The first part of the discussion draft provides guidance on the application of the principles contained in Section D.1 of Chapter I of the Transfer Pricing Guidelines to financial transactions. More specifically, the discussion draft clarifies that the guidance included in this section does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation. Section B.2 outlines the economically relevant characteristics that inform the analysis of the terms and conditions of financial transactions.

The second part of the discussion draft, contained in sections C, D and E, addresses specific issues related to the pricing of financial transactions such as treasury function, intra-group loans, cash pooling, hedging, guarantees and captive insurance.

[122] See para. 3(b) of the OECD Model - Commentary on Article 9. Please note that this position has been criticized by some scholars (see J. WITTENDORFF, *The Transactional Ghost of Article 9(1) of the OECD Model*, 63(3) in *Bulletin for International Taxation*, 2009 (63 – 3), p. 115; see also F. HOSSON - M. MICHIELSE, *Treaty Aspects of the 'thin capitalization' Issue – A Review of the OECD Report*, in *Intertax*, 1989 (17 – 11), p. 480).

It is stated that Article 9(1) can only be used to determine whether the interest rate charged on loans between associated enterprises is at arm's length or not and cannot be used to recharacterize debt to equity. The view is based mainly on a literal reading of Article 9(1) which provides that adjustments can be made for 'conditions […] made or imposed […] between the two enterprises in their commercial or financial relations'. It is argued that an examination of the contracted terms which have already been made or imposed needs to be undertaken for the purpose of Article 9(1) rather than the entire contract itself. Put differently, the term 'conditions […] made or imposed' only refers to the terms of the contract (such as interest rate) and not to the existing financial relations between the associated enterprises. Thus, Article 9(1) would not permit a re-characterization of debt to equity.

On the contrary, other commentators suggest that the view proposed against such re-characterization is extremely narrow as Article 9(1) is broad and indeed covers situations where debt can be re-characterized as equity. This is because the word 'imposed' in relation to the word 'conditions' indicates that not only the contractual terms but also other terms i.e. the overall financial relations of the associated enterprises are to be taken into consideration (see L. DE BROE, *International Tax Planning and Prevention of Abuse*,

Secondly, the related party transaction can be disregarded and replaced with another arrangement if the related party arrangement differs from those which would have been adopted by independent enterprises behaving in 'a commercially rational manner' thereby preventing the determination of a price that would be acceptable to both parties taking into account their respective perspectives and their realistically available options.

The analysis, which is seen from the borrowers' perspective, addresses the following question[123]: would the borrowing entity actually borrow a similar amount at arm's length given the performance of its business? Specifically, the analysis focuses on under what conditions a borrower would have borrowed at arm's length taking into consideration (including but not limited to) features such as (1) its financial situation, (2) the amount of debt and whether taking that amount leaves room to absorb cyclical or seasonal variations, unforeseen events or a fluctuation in interest rates or profits, (3) its costs of borrowing, (4) its debt servicing ability and the possibility to have sufficient cash to operate as a profitable organization, and (5) whether the borrower would have taken the loan at all.

If all the facts and circumstances, after undertaking the analysis, indicate that the borrower would have entered into the transaction then the loan should be respected. On the contrary, if all the facts and circumstances indicate that the borrower would not enter into the transaction then the loan may be re-characterized.

Once the benefit test is met (as described above), a two-step process needs to be undertaken, in order to set up the arm's length remuneration. More specifically, a credit rating evaluation of the borrowing entity is required to be done (first step); an arm's length interest rate needs to be determined (second step).

Amsterdam, 2008, see page 505; V. CHAND, *Transfer Pricing Aspects of Intra – Group Loans in Light of the Base Erosion and Profit Shifting Action Plan*, in *Intertax* (Volume 44 – Issue 12), 2016, p. 87).

[123] In this respect, see A. RUSSO - O. MOERER, *Introduction*, in A. BAKKER – M.M. LEVEY, *Transfer Pricing and Intra Group Financing*, Amsterdam, 2012, p. 15.

With reference to the first step (i.e. credit rating evaluation), credit ratings can serve as a useful measure of creditworthiness and so help to identify potential comparables. Credit ratings can be assigned to the overall creditworthiness of a company or in relation to a specific issuance of debt. In general, a lower credit rating will indicate a greater risk of default and be expected to be compensated by a higher rate of return[124].

Furthermore, the question arises as to whether the credit rating of a borrower needs to be adjusted for implicit support. In pricing an intra-group loan, the borrower is viewed as an independent enterprise. This does not mean that the presence of the rest of the group is necessarily ignored. Therefore, the potential impact of passive association on creditworthiness and other terms is taken into account. In particular, the external funding policies and practices of group management will assist in informing the conditions under which the subsidiary would have borrowed from an independent lender, including all economically relevant characteristics such as the type of loan, its term, currency, security, covenants, and so forth.

In other words, an independent lender would usually take into account the possibility of implicit support from elsewhere in the multinational group when considering the terms and conditions of any loan to a multinational group. Implicit support is the benefit that may arise from passive association when, for example, a multinational group attains a better credit rating and correspondingly reduced interest rate from an independent lender due to its membership of the multinational group of

[124] Information about the credit ratings is readily available in many lending markets on the different rates of interest charged for differently rated enterprises and such information may usefully contribute to benchmarking studies for interest rates charged by associated enterprises.

The estimation of the credit rating may be particularly challenging for start-up companies, special purpose vehicles, or those which have recently been part of a merger or demerger. In circumstances such as these, an independent lender would usually conduct a due diligence process that includes examining cash-flow and earnings projections for the business, preferably for the entire period covered by the funding.

In addition to ratings prepared for an entity, commercial tools are also available which are designed to rate a specific debt borrowing, particularly where no issuer credit rating is available.

which it is a part and where there is no contractual obligation of any group member to provide support[125].

The arm's length interest rate, fixed or floating, consists of a base rate (risk free rate) that is determined on the basis of currency and maturity and a credit spread that is determined on the basis of the risks undertaken by the lender with respect to the transaction. In this respect, as already pointed out above, the OECD Guidelines provide that 'in respect of financial services such as loans remuneration would generally be built into the

[125] The revised OECD guidance discusses the following example. S is an entity with a Baa rating on a standalone basis. With this rating, S is able to obtain loans at an interest rate of 9%. However, as S is a member of a multinational group, an independent lender lends to S at an interest rate of 7% – the rate that the lender would charge to borrowers with a credit rating of A. At the same time, S obtains a loan from a related party lender viz., T at rates applicable to borrowers with an A rating i.e. at an interest rate of 7% (all loan terms and conditions being similar).

The question arises as to whether the interest rate charged by T to S is at arm's length? The revised OECD guidance answers the question in the affirmative because the rate charged by T to S is the same as the rate charged by an independent lender to S. Moreover, it is stated that payment or comparability adjustments need not be undertaken for the incidental (synergistic) benefit that S enjoys from being a part of the multinational group, that is, its ability to obtain a loan from an independent lender at lower interest rates. Accordingly, the act of raising S's credit rating of few notches upwards by including the synergistic benefit is justified.

Likewise, in the context of analyzing the question of whether the provision of a guarantee amounts to an intra-group service, the revised OECD guidance provides that an intra-group service is provided when the provision of formal guarantee (a deliberate concerted action by the parent) enhances the credit rating of the subsidiary (for instance from A to AAA) that thereby enables it to obtain a loan at a lower rate (for instance at an interest rate of 5% – the rate applicable to borrowers with a AAA rating).

On the contrary, if the subsidiary has a higher credit rating (for instance – A) due to its group membership than the credit rating it could achieve on an individual basis (for instance – Baa) then no service is provided by the parent to the subsidiary as the latter company only receives an incidental benefit by being associated with the group. In the former situation, guarantee fee is justified whereas in the latter it is not. It is clearly stated that the guarantee fee shall reflect the benefit of raising the subsidiaries credit rating from A to AAA. On the contrary, the uplift from Baa to A is attributable to a synergistic benefit. Once again, in this example, the standalone credit rating of the taxpayer is adjusted a few notches upwards to take into account implicit support.

It could be argued that, at arm's length, an independent lender would look into the standalone credit rating of the borrower. Accordingly, taking into consideration the parental affiliation to notch up the credit rating does not comply with the arm's length principle. However, it should be noted that associated enterprises enjoy benefits which are not available to market participants in uncontrolled transactions. Therefore, it makes perfect sense to adjust for implicit support.

In light of the above, it could well be possible that the credit rating of the borrower is notched up (for example Baa to A) due to parental affiliation. The arm's length interest rate will then be determined using the A rating.

spread and it would not be appropriate to expect a further service fee to be charged'[126].

There are different approaches to pricing intra-group loans. The most common approach is the external comparable uncontrolled price method[127]: the widespread existence of markets for borrowing and lending money and the frequency of such transactions between independent borrowers and lenders, coupled with the widespread availability of information and analysis of loan markets may indeed make it easier to apply the external comparable uncontrolled price method to financial transactions than may be the case for other types of transactions.

This implies that the arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors.

As an alternative, the cost plus method can be applied: if this is the case, the loan would be priced based on the cost of funds incurred by the lender in raising the funds to lend, plus the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan and a profit margin.

In this respect, it is worth mentioning that the cost of funds approach may be used to price loans where capital is borrowed from an unrelated party which passes from the original borrower through one or more associated intermediary companies, as a series of loans, until it reaches the ultimate borrower. In such cases – as noted above for all the intercompany transactions – where only agency or intermediary functions are being performed, "it may not be appropriate to determine the arm's length pricing

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[126] See the OECD Transfer Pricing Guidelines, para. 7.15.

[127] The internal comparable uncontrolled price method can also often be applicable. Whereas it is unlikely that a multinational group's average interest rate paid on its external debt meets the comparability requirements to be considered as an internal comparable uncontrolled price method, it may be possible to identify potential comparable loans within the borrower's or its multinational group's financing with an independent lender as the counterparty.

as a mark-up on the costs of the services but rather on the costs of the agency function itself."

2.6. The European Union framework: the EU fundamental freedoms – The arm's length principle has become accepted both internationally and within the European Union. Art.9 of the OECD Model Double Tax Convention and Art. 9 of the UN Model Treaty subscribe to it[128]. Moreover, they provide for an obligation of the other involved state to make a countervailing adjustment in order to avoid double taxation of the same profit.

At European level, the arm's length principle is included in Article 4 No. 1 of the EU Arbitration Convention of 1990[129]. Furthermore, the convention prescribes a binding arbitration procedure in case two Member States disagree on the recognition and necessary adjustments of the contractual terms among related parties within the European Union. In its 2001 report on company taxation, the European Commission considered the arm's length principle as a 'coherent and sound concept for establishing the correct attribution of company profits between countries'[130].

There are two main aspects based on which the compatibility of the arm's length principle with the European Union law should be assessed: i) the EU fundamental freedoms and ii) the State aid legislation. With reference to both the mentioned aspects, the leading cases come from the intercompany financial services.

Looking to the first aspect mentioned (i.e. the compatibility of the arm's length principle with the EU fundamental freedoms), several fundamental freedoms could in principle be relevant: intra-group sales,

[128] "Dealing at arm's length" was the starting point for the model treaties elaborated under the auspices of the League of Nations since the days of the Carroll Report of 1933. In this respect, for an historical analysis see: RICHARD J. VANN, *Taxing International Business Income: Hard-Boiled Wonderland or the End of the World*, in *World Tax Journal*, 2010 (2), p. 291.

[129] *Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises*, 23 Jul. 1990, 90/436/EEC, OJ 1990 L 225, 10.

[130] EUROPEAN COMMISSION, *Company Taxation in the Internal Market*, 23 Oct. 2001, SEC (2001) 1681, p. 255.

services and license agreements seem indeed to be covered by the free movement of goods and services while intra-group loans seem to fall under the scope of the free movement of capital.

However, according to the traditional jurisprudence of the European Court of Justice, the freedom of establishment as laid out in Art. 49 et seq. TFEU is usually deemed to be relevant and therefore examined with reference to cases of related party transactions TFEU.

According to paragraph 1 of art 49 TFEU, indeed, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Moreover, according to the same paragraph, such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

As Art.49 par.1 s.2, Art.55 TFEU explicitly extends the scope of this freedom both to the creation of a permanent establishment (a “branch office”) and to the setting-up of a subsidiary by a corporate taxpayer.

In light of the above, the European Court of Justice has often confirmed that the cross-border formation of a corporate group falls squarely within the boundaries of the freedom of establishment, stating that “national legislation intended to apply only to those shareholdings which enable the holder to exert a definite influence on a company’s decisions and to determine its activities fall within the scope of the freedom of establishment”[131].

Looking therefore to the freedom of establishment, it prohibits the Member State of origin from hindering the establishment in another Member State of a company incorporated under its legislation, in particular through a subsidiary. Freedom of establishment is hindered if, under a Member State’s tax system, a resident company having a subsidiary in another Member State suffers a disadvantageous difference in treatment for tax

[131] Moreover, the controlling shareholder exercises a “definite influence” on the related entities, which leads to the result that the freedom of capital (which applies to portfolio shares) is superseded by the freedom of establishment.

purposes compared with a resident company having a subsidiary in the first Member State .

In light of the above, it appears that the arm's length principle itself is coherent and does not lead to distortion of competition. However, if transfer pricing rules are applied only to cross-border transactions they constitute distortion of competition between market players acting cross-border and market players acting domestically, since the former bear an additional financial and administrative burden. A transfer pricing adjustment leads to an add-back of a company's profits and, thus, leads in principle to a higher tax burden of that company. In addition, the company has to determine the transfer price and has to provide certain documentation to the tax authorities. Accordingly, national transfer pricing rules which solely apply to cross-border transactions, constitute discrimination[132].

Having said that, the European Court of Justice had to deal with the question whether the discriminatory Belgian transfer pricing rule could be justified by overriding reasons of public interest. The Court found that to permit resident companies to transfer their profits in the form of unusual or gratuitous advantages to associated enterprises that are resident in another Member State may undermine the balanced allocation of taxing rights and the preservation of tax avoidance, because such habit avoids the tax that is normally due in a Member State's territory.

Therefore, national transfer pricing legislation could be justified by the objective of preserving the balanced allocation of the power to tax between the Member States, taken together with the objective of preventing tax avoidance.

However, two requirements have to be met by discriminatory transfer pricing rules in order to be proportionate: i) firstly, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer [must be] given an opportunity, without being subject to undue administrative constraints, to provide evidence of any

[132] For being more precise, the European Court of Justice use the term 'restriction'.

commercial justification that there may have been for that transaction; ii) secondly, profit adjustments have to comply with the arm's length principle and may not exceed what would have been agreed between independent parties.

The above-mentioned principles have been confirmed by the European Court of Justice in all the cases (not many) that the latter has examined with reference to transfer pricing cases, which all concern the provision of financial services between related companies[133].

The present analysis will focus on the most recent case Hornbach-Baumarkt. Hornbach-Baumarkt AG is a corporation with its registered head offices in Germany. The Hornbach group owns a chain of do-it-yourself and construction materials stores in Germany and other EU Member States.

In 2003, Hornbach-Baumarkt AG indirectly held 100% of the equity of two companies domiciled in the Netherlands. The two Dutch group companies showed negative equity in their balance sheets such that an unrelated bank was not willing to provide further bank loans to these entities

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[133] We are making reference to: i) European Court of Justice, Judgment of 12 December 2002, Case C-324/00 (Lankhorst-Hohorst); ii) European Court of Justice, Judgment of 13th March 2007, Case C-524/04 (Test Claimants in the Thin Cap Group Litigation) ECR I – 2107; iii) European Court of Justice, Judgment of 21st January 2010, Case C-311/08 (Société de Gestion Industrielle) and iv) European Court of Justice, Judgement of 31 May 2018, Case C-382/16 (Hornbach-Baumarkt AG).

For a general comment on the topic, see M. GLAHE, *Transfer Pricing and EU Fundamental Freedoms*, in *EC Tax Review*, 2013 (5), p. 222; W. SCHÖN, *Transfer Pricing, the Arm's Length Standard and European Union Law*, Max Planck Institute for Tax Law and Public Finance Working Paper 2011 – 08, September 2011, available at <http://ssrn.com>.

In literature the Société de Gestion Industrielle case is widely understood as a leading case, endorsing the arm's length principle. See the annotations by P. BAKER, *Transfer Pricing and Community Law: The SGI Case*, in *Intertax*, 2010 (38), p.194; P. BOONE – A.J. CASLEY – J.V.D. GUCHT – M. CHATAR, *SGI Case: The Impact of the Decision of the European Court of Justice from a European Perspective*, in *International Transfer Pricing Journal*, 2010, p.183; A. M. JIMENEZ, *Transfer Pricing and EU Law Following the ECJ Judgement in SGI: Some Thoughts on Controversial Issues*, in *Bulletin for International Taxation*, 2010, p. 271; G. T. K. MEUSSEN, *The SGI Case: ECJ Approves Belgian System of Selective Group Corrections in Relation to Foreign Group Companies*, in *European Taxation*, 2010, p. 245.

For a comment of the Hornbach-Baumarkt case, see X. DITZ – C. QUILITZSCH, *German Transfer Pricing Rules Incompatible with EU Law – A Critical Assessment of the ECJ's (Case C-382/16) Hornbach-Baumarkt Decision*, in *European Taxation*, 2019, p. 181; B. HEIDECKE - M. KIRCHER – J. SUSSICK, *German Tax Authorities' First Reaction after the ECJ's Hornbach Decision – An Attempt to Limit the Damage?*, in *International Transfer Pricing Journal*, March / April 2019, p. 82; G. SCIFONI, *Lo status di socio riconosciuto quale possibile esimente ai fini del transfer pricing*, in *Corriere Tributario*, 2018 (no. 29), p. 2252.

without an explicit guarantee (in the form of comfort letters) from the ultimate parent company in Germany.

Hornbach-Baumarkt AG therefore issued the requested comfort letters to the bank. According to the information included in the sentence issued by the Court of Justice, “in those comfort letters, Hornbach-Baumarkt AG undertook vis-à-vis the financing bank to refrain from divesting of or changing its shareholding in Hornbach Holding BV and, in addition, undertook to ensure that Hornbach Holding BV would likewise refrain from divesting of or changing its shareholding in the foreign group companies without giving the bank written notice thereof at least three weeks prior to such divestment or change.

Furthermore, Hornbach-Baumarkt AG irrevocably and unconditionally undertook to fund the foreign group companies in such a way as to enable them to meet all of their liabilities. Accordingly, it had to make available those companies, as necessary, the requisite funds to enable them to satisfy their liabilities towards the funding bank. In addition, Hornbach-Baumarkt AG had to ensure that such funds would be used to settle any liabilities towards the funding bank”.

The German tax authorities took the view that unrelated third parties, under the same or similar circumstances, would have agreed on remuneration in exchange for granting the guarantees. Therefore, the presumed amount of the remuneration for the guarantees should have been subject to tax.

The European Court of Justice confirmed all the principles mentioned above. However, on that occasion, some further guidance was given by the European Court of Justice with reference to the concept of “commercial reasons”, the meaning of which is quite unclear, resulting therefore in uncertainty both for the tax payers as well as for the tax administrations.

More specifically, according to the sentence, “[i]n the present case, it is clear from the order for reference that the foreign group companies had negative equity capital and the financing bank made the granting of the loans required for the continuation and expansion of business operations

contingent on the provision of comfort letters by Hornbach-Baumarkt AG. In a situation where the expansion of the business operations of a subsidiary requires additional capital due to the fact that it lacks sufficient equity capital, there may be commercial reasons for a parent company to agree to provide capital on non-arm's-length terms. Furthermore, it should be noted that, in the present case, no argument relating to the risk of tax avoidance has been advanced. The German Government has neither identified a wholly artificial arrangement, within the meaning of the Court's case-law, nor a desire on the part of the applicant in the main proceedings to reduce its taxable profit in Germany. Accordingly, there may be a commercial justification by virtue of the fact that Hornbach-Baumarkt AG is a shareholder in the foreign group companies, which would justify the conclusion of the transaction at issue in the main proceedings under terms that deviated from arm's-length terms. Since the continuation and expansion of the business operations of those foreign companies was contingent, due to a lack of sufficient equity capital, upon a provision of capital, the gratuitous granting of comfort letters containing a guarantee statement, even though companies independent from one another would have agreed on remuneration for such guarantees, could be explained by the economic interest of Hornbach-Baumarkt AG itself in the financial success of the foreign group companies, in which it participates through the distribution of profits, as well as by a certain responsibility of the applicant in the main proceedings, as a shareholder, in the financing of those companies".

In light of the above, the European Court of Justice referred the case to the national court, recommending to check whether Hornbach-Baumarkt AG was in a position, without being subject to undue administrative constraints, to put forward elements attesting to a possible commercial justification for the transactions at issue in the main proceedings, "without it being precluded that economic reasons resulting from its position as a shareholder of the non-resident company might be taken into account in that regard".

In other words, in the view of the European Court of Justice, the parent in Germany has an economic self-interest in the business success of its non-resident subsidiary because it participates in the subsidiary's success through profit distributions and therefore bears responsibility for the subsidiary's financing.

This is particularly significant because the German government had argued that commercial grounds and shareholder grounds in connection with the arm's length principle are mutually exclusive. More specifically, according to the German Government, the concept of 'commercial justification' should have been interpreted in the light of the principle of free competition which, by its nature, rules out acceptance of economic reasons resulting from the position of the shareholder. For the purposes of assessing the proportionality of legislation such as that at issue in the main proceedings, it is necessary, moreover, to distinguish between, on the one hand, the possibility of relying on the reasons why advantages were granted gratuitously between companies in the same group, and, on the other hand, the assessment of the substance of those advantages. Hornbach-Baumarkt AG had the opportunity to present the reasons for its decision but could not show that those reasons corresponded to economic reasons.

The European Court of Justice clearly disagrees with the mentioned approach.

The sentence has been criticized by the scholars[134], who pointed out that a parent always has a commercial interest in the sustained – and sustainable – business success of its subsidiaries. With that in mind, almost every non-arm's length intragroup transaction could be justified on grounds arising from a parent's status as a shareholder: in other words, the opinion of the European Court of Justice – if literally interpreted – could significantly restrict the scope of arm's length principle.

Probably, the opinion of the Court should be interpreted in strict connection with the facts subject to the scrutiny of the Court: the commercial

[134] See the literature mentioned above in note 42.

reason justifying the inapplicability of the arm's length principle is represented indeed by the need to save the economic existence of the group of companies as such or of the entity affiliated to the taxpayer. In other words, the attempt to rescue an associated enterprise that is in financial trouble might be the only commercial purpose justifying non-arm's length transactions.

Such an interpretation appears to be confirmed also by the German tax authorities, which have issued a circular letter in the attempt of aligning the German tax system to the principles issued by the Court. According to the mentioned Circular Letter, restructurings that are required to prevent bankruptcies represent a case of valid commercial reasons which enables to tax payer to disapply the arm's length principle. More specifically, according to the mentioned circular letter, "[i]n its ruling of 31 May 2018 in Case C-382/16 "Hornbach-Baumarkt", the European Court of Justice ruled that a provision such as the one in section 1 of the AStG must allow a resident taxpayer to prove that conditions have been agreed upon for economic reasons resulting from its position as shareholder of the non-resident company. In the present case, a subsidiary was reliant on the injection of capital to expand its business activities. In such a case, economic reasons could justify the granting of capital by the parent company under non-arm's length conditions. Accordingly, an income adjustment based on section 1, paragraph 1 of the AStG cannot be imposed if the taxpayer can prove factual, economic reasons which require conditions deviating from the arm's length principle in order to secure the otherwise threatened economic existence of the group of companies as such or the entity affiliated to the taxpayer ("financial recovery measure"). Restructuring measures are aimed at avoiding over-indebtedness or insolvency and ensuring the going concern of the related party or group of companies. The taxpayer must provide [firstly] evidence of the requirement for a financial recovery measure [Sanierungsbedürfigkeit], in particular the need for a financial recovery and [secondly] the possibility of a successful financial recovery [Sanierungsfähigkeit] with regard to the affiliated entity or

group of companies. In its decision, the ECJ refers to the freedom of establishment, hence its decision does not apply to cases involving non-EU countries”[135].

2.6.1. The European Union framework: the State aid law – As already pointed out, member states are obliged to respect the prohibition of State aid for a proper functioning of the internal market.

More specifically, limiting the analysis to those aspects that are more strictly connected to the current analysis, it is worth mentioning that the object of the European Commission assessment includes the tax rulings: the grant of a tax ruling must respect the State aid rules.

As clearly stated by the European Commission indeed[136], the function of a tax ruling is to establish in advance – for reasons of legal certainty and predictability on the application of tax rules – the application of the ordinary tax system to a particular case in view of its specific facts and circumstances. Among the other cases, this may be done to establish in advance how ‘arm's-length profits’ will be set for related party transactions where uncertainty justifies an advance ruling to ascertain whether certain intra-group transactions are priced at arm's length.

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[135] See the two-page circular letter issued on 6 December 2018 by the Germany’s Federal Ministry of Finance. A partial translation is available in: B. HEIDECKE – M. KIRCHER –J. SUSSICK, *German Tax Authorities’ First Reaction after the ECJ’s Hornbach Decision – An Attempt to Limit the Damage?*, in *International Transfer Pricing Journal*, March / April 2019, page 85.

As pointed out by the mentioned authors, “[w]ith the guidance in the Circular, the Ministry of Finance tries to provide a practical interpretation of the implications of the ECJ decision without mentioning any of the potentially most far-reaching consequences. It imposes a set of minimum requirements that need to be met in order to justify a deviation from the arm’s length principle: (1) in the given situation, the supported entity is in need of a financial recovery measure (requirement for a financial recovery measure, Sanierungsbedürftigkeit); (2) in the given situation, it is theoretically possible to successfully recover the supported entity financially (Sanierungsfähigkeit); (3) the burden of proof for the two aforementioned aspects lies with the taxpayer; and (4) the transaction needs to be a cross-border transaction within the European Union”.

[136] See EUROPEAN COMMISSION, *DG Competition Working Paper on state aid and tax rulings*, 2016, available at < ec.europa.eu>; see also EUROPEAN COMMISSION, *Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01)*, 2016, available at <https://eur-lex.europa.eu>.

Moreover, as clearly state by the European Commission, the grant of a tax ruling must, however, respect the State aid rules. This means that, where a tax ruling endorses a result that does not reflect in a reliable manner what would result from a normal application of the ordinary tax system, that ruling may confer a selective advantage upon the addressee, in so far as that selective treatment results in a lowering of that addressee's tax liability in the Member State as compared to companies in a similar factual and legal situation.

In its past State aid practice, the European Commission has taken negative decisions on national schemes that applied to some cases related to the application of the arm's length principle by the multinational groups[137]. Looking to the only two joint cases that have reached the European Court of Justice so far[138], the European Court of Justice held that – in order to

[137] See Commission Decision 2003/81/EC of 22 August 2002 on the aid scheme implemented by Spain in favour of coordination centres in Vizcaya; Commission Decision of 5 September 2002 on the aid scheme implemented by Germany for control and coordination centres; Commission Decision of 16 October 2002 on the State aid scheme – Coordination Centres – implemented by Luxembourg and Commission Decision of 17 February 2003 on the aid scheme implemented by Belgium for coordination centres established in Belgium. For a comment of these cases, see, inter alia, E. SPORKEN & Y. CATTEL, *Investigations by European Commission into Transfer Pricing Underlying Certain Tax Rulings in the European Union*, in *International Transfer Pricing Journal*, 2015 (3); A. GUNN - J. LUTS, *Tax Rulings, APAs and State Aid: Legal issues*, in *EC Tax Review*, 2015 (24 – 2), p. 119; A. TAFERNER - J. WOUDA KUIPERS, *Tax Rulings: In Line with OECD Transfer Pricing Guidelines, but Contrary to EU State Aid Rules?*, in *European Taxation*, 2016 (56 – 4), p. 134.

[138] See ECJ, 22 June 2006, Joined Cases C-182/03 R and C-217/03 R, Belgium and Forum 187 ASBL. In that judgment on the Belgian tax regime for coordination centers, the Court of Justice assessed a challenge to a Commission decision (Commission Decision 2003/757/EC of 17 February 2003 on the aid scheme implemented by Belgium for coordination centers established in Belgium (OJ L 282, 30.10.2003, p. 25)) which concluded, inter alia, that the method for determining taxable income under that regime conferred a selective advantage on those centers. Under that regime, taxable profit was established at a flat-rate amount which represented a percentage of the full amount of operating costs and expenses, from which staff costs and financial charges were excluded. According to the Court, 'in order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centers confers an advantage on them, it is necessary, […], to compare that regime with the ordinary tax system, based on the difference between profit and outgoings of an undertaking carrying on its activities in conditions of free competition.' The Court then held that 'the effect of the exclusion of [staff costs and the financial costs] from the expenditure which serves to determine the taxable income of the centers is that the transfer prices do not resemble those which would be charged in conditions of free competition', which the Court found to '[confer] an advantage on the coordination centers' (paragraphs 96 and 97).

For further details on the tax regime provided by the Belgian law for the coordination centers, see I. VERLINDEN - P. BOONE - AMANDINE VAN DEN BUSSCHE, *Recent*

assess the compatibility of the Belgian regime provided for the coordination centres with the state aid law, the determination of the taxable profits of a group company must be based on transfer prices that shall be "charged in conditions of free competition". More specifically, according to the Court, "in order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centers confers an advantage on them, it is necessary, as the Commission suggests at point 95 of the contested decision, to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on *its activities in conditions of free competition*" (*emphasis added*).

In its subsequent transfer pricing cases[139], the European Commission has regularly referred back to this judgment as a precedent for

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Developments on the Coordination Centre Front: Every Cloud Has a Silver Lining, in *International Bureau of Fiscal Documentation*, 2002, p. 201.

[139] See, among the others, the final decisions issued for:

- Amazon (Commission Decision (EU) 2018/859 of 4 October 2017 on State Aid SA.38944 (2014/C ex 2014/ NN) implemented by Luxembourg to Amazon);
- Apple (Commission Decision of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple);
- Belgian Excess Profit Scheme (Commission Decision (EU) 2016/1699 of 11 January 2016 on the excess profit exemption State aid scheme 2016 SA.3766 (2015/C) (ex 2015/NN) implemented by Belgium);
- Starbucks (Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks);
- and Fiat (Commission Decision (EU) 2016/2326 of 21 Oct. 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat).

The European Commission's decisions have been appealed before the Court of Justice of the European Union (ECJ) and it remains to be seen whether the Court of Justice of the European Union will share the European Commission's view. Concerning the Netherlands, those would be cases T-760/15 (OJ C 59, 15 Feb. 2016, pp. 50-51) and T-636/16 (OJ C 462, 12 Dec. 2016, p. 25); for Luxembourg, cases T-755/15 (OJ C 59, 15 Feb. 2016, pp. 48-49) and T-759/15 (OJ C 59, 15 Feb 2016, pp. 49-50); and for Ireland, cases T-778/16 (OJ C 38, 6 Feb. 2017, pp. 35-36) and T-892/16 (OJ C 53, 20 Feb. 2017, pp. 37-39).

At the time of writing the present thesis, the General Court has issued a decision on the Belgian Excess Profit Scheme cases and has annulled the Commission decision on procedural grounds. However, it has not addressed the material issues concerning the selectivity and the arm's length principle. For the decision, see BE: ECJ, 14 Feb. 2019, Joined Cases T-131/16 and T-263/16, Magnetrol International.

For a comment, see F. CACHIA, *Analysing the European Commission's Final Decisions on Apple, Starbucks, Amazon and Fiat Finance & Trade*, in EC Tax Review 2017 (1), p. 23; A. MILADINOVIC – R. PETRUZZI, *The Recent Decisions of the European Commission on Fiscal State Aid: An Analysis from a Transfer Pricing Perspective*, in International Transfer Pricing Journal, 2019; P. PISTONE - Y. BRAUNER, *The European Union*

contending that the arm's length principle constitutes the benchmark against which a ruling must be measured. Such an approach is also clearly confirmed by the internal working paper prepared by the EU Commission[140], according to which "[i]n 2006, the European Court of Justice endorsed the arm's length principle for determining whether a fiscal measure prescribing a method for an integrated group company to determine its taxable profit gives rise to a selective advantage for the purposes of Article 107(1) TFEU. Accordingly, a fiscal measure that endorses a method for determining an integrated group company's taxable profit in a manner that does not result in a reliable approximation of a market-based outcome in line with the arm's length principle can confer a selective advantage upon its recipient. That would be the case where such a fiscal measure results in a reduced taxable profit, and thus reduced corporate income tax liability" [141].

In light of the above, the decisive element within the European Commission's assessment is the arm's length principle and its proper application: profits deriving from transactions between related parties should not deviate from the profits that would have been realized if the transactions were agreed upon between unrelated parties in comparable circumstances. If transactions between related parties are not assessed in line with the arm's length principle and this leads to a reduction of (taxable) profits for one of the related parties compared to those of unrelated parties,

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and the United States: The Good Old Tax "Frenemies" in the Shadows of Reforms, in *Bulletin for International Taxation*, 2017, p. 61.

For a more general comment, see also P. ROSSI – MACCANICO, *Fiscal State Aids, Tax Base Erosion and Profit Shifting*, in *EC Tax Review*, 2015 (2), p. 63.

[140] See EUROPEAN COMMISSION, *DG Competition Working Paper on state aid and tax rulings*, 2016, available at < ec.europa.eu>. Such document further clarifies that the investigations of the European Commission are not targeting the instrument of tax rulings as such and recognizes the importance of advance rulings as a tool to provide legal certainty to taxpayers. In other words, according to the European Commission view, tax rulings do not raise issues under EU State aid law provided they do not grant a selective advantage to specific economic operators.

The same approach is confirmed also by the document named "Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union" issued in 2016 by the European Commission (Document no. 2016/C 262/01) and available at <https://eur-lex.europa.eu>.

[141] For a more critical view on taking this decision as a precedent, see J. DE COCK, *Is Belgium and Forum 187 v. Commission a suitable legal source for an EU 'At Arm's Length Principle'?*, in *EStAL*, 2017 (17 - 4), p. 615.

from a tax perspective, the former will be favored over the latter. Therefore, when tax authorities agree on transactions that are not in line with the arm's length principle by way of rulings, they might grant to the beneficiary of the ruling a selective advantage. This constitutes State aid, unless it can be justified.

Moreover, according to the internal working paper prepared by the EU Commission, the EU Commission focuses on cases in which there is a manifest breach of the arm's length principle. More specifically, according to the mentioned document, a considerable number of the rulings relate to transfer pricing arrangements that appear to reflect a reliable approximation of a market based outcome in line with the arm's length principle. In general, rulings that cover intra-group transactions between two different Member States, where both companies carry out genuine economic activities on which they are taxed, have been found to be unproblematic. However, some transfer pricing arrangements do not seem to reflect the arm's length principle when the outcome manifestly deviates from a reliable approximation of a market based outcome.

In this respect, it is worth mentioning that the European Commission emphasizes that the arm's length principle it applies is not derived from article 9 of the OECD Model Tax Convention (OECD Model) but from art. 107(1) Treaty on the Functioning of the European Union. This implies that the arm's length principle "necessarily forms part of the European Commission's assessment under Article 107(1) TFEU of tax measures granted to group companies, independently of whether a Member State has incorporated this principle explicitly into its national legal system"[142]. In other words, as stated by the Notice issued on the matter by the European Commission[143], "the arm's length principle the Commission applies in

[142] See Fiat Final Decision Fiat (Commission Decision (EU) 2016/2326 of 21 Oct. 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat), para. 228.

[143] The same approach is confirmed also by the document named Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union" issued in 2016 by the European Commission (Document no. 2016/C 262/01) and available at <https://eur-lex.europa.eu> (see para. 172).

assessing transfer pricing rulings under the State aid rules is therefore an application of Article 107(1) of the Treaty, which prohibits unequal treatment in taxation of undertakings in a similar factual and legal situation. This principle binds the Member States and the national tax rules are not excluded from its scope".

Regarding the interpretation of the arm's length principle that is inherent in article 107(1) of the TFEU, the European Commission states that it is applying a universal principle according to which transactions between related parties shall be assessed as if they were concluded between unrelated economic operators on terms that are at arm's length. A national tax system subjecting income from corporations to taxation is consistent only if it treats both group companies and independent companies equally on the basis of the arm's length principle. The European Commission applies the ordinary corporate income tax system in each Member State's national law as a benchmark to determine whether a ruling confers a selective advantage on the recipient.

The OECD Guidelines represent the main tool taken into consideration by the European Commission for the interpretation and implementation of the arm's length principle. Indeed, as outlined in the notice issued by the European Commission on the matter[144], "when examining whether a transfer pricing ruling complies with the arm's length principle inherent in Article 107(1) of the Treaty, the Commission may have regard to the guidance provided by the Organization for Economic Cooperation and Development ('OECD'), in particular the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'. Those guidelines do not deal with matters of State aid per se, but they capture the international consensus on transfer pricing and provide useful guidance to tax administrations and multinational enterprises on how to ensure that a transfer pricing methodology produces an outcome in line with market conditions. Consequently, if a transfer pricing arrangement complies

[144] See EUROPEAN COMMISSION, *Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union* (2016/C 262/01), 2016, available at <https://eur-lex.europa.eu> (see para. 173).

with the guidance provided by the OECD Transfer Pricing Guidelines, including the guidance on the choice of the most appropriate method and leading to a reliable approximation of a market-based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State aid"[145].

For the aim of the present analysis, I have decided to focus on the Fiat case[146] since it concerns financial services and therefore is able to provide useful considerations for the present analysis.

The Fiat case concerned a ruling issued by the tax authorities of Luxembourg to Fiat Finance and Trade, a company of the Fiat group resident in Luxembourg. Fiat Finance and Trade, based in Luxembourg, provides financial services, such as intra-group loans, to other Fiat group car companies (mainly in Europe). More specifically, as clearly shown in the image here below[147]:

- Fiat Finance and Trade provided financing and treasury services. The way of working can be summarized as follows: Fiat Finance and Trade raised funds from the market, especially from bank loans and the issuance of bonds, and obtained financing from other treasury companies of the Fiat group, which was subsequently lent to the operating group companies;

[145] Such an approach has been criticized by some scholars. See, for example, A. MILADINOVIC – R. PETRUZZI, *The Recent Decisions of the European Commission on Fiscal State Aid: An Analysis from a Transfer Pricing Perspective*, in *International Transfer Pricing Journal*, 2019. According to the authors, "the European Commission's most recent decisions have led to a high level of uncertainty for taxpayers, as well as for the EU Member States. Thus, even though the European Commission has provided some guidance on how it is applying the ALP under article 107 of the TFEU, it is not yet entirely clear whether taxpayers are safe to rely on the OECD Guidelines. Moreover, it has not yet been clarified as to which version of the OECD Guidelines should be applied, nor as to whether decisions made in the past on the basis of older versions of the OECD Guidelines comply with today's application and understanding of the ALP under the State aid rules. To this end, taxpayers should review (also retrospectively) their tax planning structures and transfer pricing policies in light of the conclusions reached by the European Commission and comply with them as far as possible, as well as with the new transfer pricing developments around the world".

[146] See Fiat Final Decision (Commission Decision (EU) 2016/2326 of 21 Oct. 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat). Please note that the analysis is based on the published version of the decision, in which some information has been omitted, pursuant to articles 30 and 31 of Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union, concerning non-disclosure of information covered by professional secrecy.

[147] http://europa.eu/rapid/press-release_IP-15-5880_en.htm?locale=en

- in addition to the above, Fiat Finance and Trade performed other financial transactions such as, for example, liquidity investments, cash pooling, as well as foreign exchange and interest rate risk management.

In such a scenario, Fiat Finance and Trade bears the market risk, credit risk, counterparty risk relating to derivative assets held with third parties and operational risk.

The ruling issued by the Luxembourg tax authorities endorsed the application of the Transactional Net Margin Method, having capital as profit level indicator. However, instead of choosing the total amount of accounting equity of Fiat Finance and Trade to serve as the indicator, an amount of capital that was considered necessary for Fiat Finance and Trade to perform its functions and bear its risks was estimated. This amount was arrived at by making various methodological choices[148] and adjustments[149] that are not envisaged by the OECD Guidelines. Moreover, a selection of various parameters was made in calculating the required level of return on capital. A remuneration – set through a comparable benchmark – was than applied to the capital.

The European Commission did not challenge the adoption of the Transactional Net Margin Method, as well as the choice of capital as profit level indicator. Indeed, the European Commission moves from the consideration that Fiat Finance and Trade's activities are comparable to

[148] For example, by using the Basel II Framework to calculate the hypothetical regulatory capital of Fiat Finance and Trade.

[149] For example, the deduction of Fiat Finance and Trade's participations in other group companies from the total level of equity.

those of a bank and that, as a consequence, the taxable profits for Fiat Finance and Trade can be determined in a similar way as for a bank, as a calculation of return on capital deployed by the company for its financing activities.

However, the European Commission challenged the above mentioned methodological choices underlying the practical application of the Transactional Net Margin Method, as well as the benchmark study performed for the determination of the arm's length remuneration. More specifically, according to the European Commission, "the tax ruling endorses an artificial and extremely complex methodology that is not appropriate for the calculation of taxable profits reflecting market conditions. In particular, it artificially lowers taxes paid by Fiat Finance and Trade in two ways:

- due to a number of economically unjustifiable assumptions and down-ward adjustments, the capital base approximated by the tax ruling is much lower thanthe company's actual capital;

- the estimated remuneration applied to this already much lower capital for tax purposes is also much lower compared to market rates.

As a result, Fiat Finance and Trade has only paid taxes on a small portion of its actual accounting capital at a very low remuneration".

More specifically, on the latter point, the European Commission stated that the "tax ruling issued by the Luxembourg authorities in 2012 gave a selective advantage to Fiat Finance and Trade, which has unduly reduced its tax burden since 2012 by €20 - €30 million".

In other words, the European Commission considered that the methodology endorsed by the ruling was not in line with the arm's length principle. Since the departure from the arm's length principle led to a decrease in the taxable profits of Fiat Finance and Trade as compared to the profit level of comparable stand-alone companies under the general

Luxembourg corporate income tax system, the ruling was considered as constituting State aid[150].

2.7. The domestic framework – Looking to the national level, it appears clear that the aforementioned principles provided by the OECD Transfer Pricing Guidelines and by the UN Practical Manual on Transfer Pricing are applied / interpreted in different ways by the national tax administrations.

The safe harbor provided for the low value – adding services represents a good example in this respect. As of today it has been adopted by the following countries[151]: Austria, Belgium, Czech Republic, Denmark, Finland, France, Hungary, Ireland[152], India, Ireland, Israel, Italy,

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[150] For further comments, see A. MILADINOVIC – R. PETRUZZI, *The Recent Decisions of the European Commission on Fiscal State Aid: An Analysis from a Transfer Pricing Perspective*, in *International Transfer Pricing Journal*, 2019, see para. 4.3. According to the authors, "the main debate between Luxembourg, on the one hand, and the European Commission, on the other, boils down to how much profit FTT (i.e. Fiat Finance and Trade) should have generated from its activities. More specifically, the focus was on whether FTT should have been seen as an entity bearing the full risk of the transactions or whether it was a limited-risk entity. This assessment should have derived from an accurate delineation and recognition of the actual transaction. These steps of the analysis would require a thorough functional analysis, including of how the functions relate to the wide generation of value by the whole group to which the entities belong. Unfortunately, this thorough analysis seems to be missing – to a great extent – in the details of the case. Performing such analysis would have ultimately answered the crucial question of whether FTT, in the context of the overall Fiat group, was the entity ultimately carrying all the risks (i.e. by exercising control over the risk and having the financial capacity to assume the risk) related to the transactions under scrutiny, or whether the risks were instead borne by another entity of the group.

If the assessment of the accurate delineation and recognition of the actual transaction would have led to the conclusion that FTT, in the context of the overall Fiat group, was the entity ultimately carrying all of the risks related to the transactions under scrutiny, the conclusions of the European Commission would most probably be correct. However, if the same assessment would have shown that the risks were borne by another group entity (e.g. the parent company of the group), the conclusions of the European Commission may not be entirely correct. In this scenario, the remuneration for FTT should have reflected the fact that the risks were ultimately undertaken by a different group entity. Irrespective of the amount that was calculated by FFT's tax adviser or by the European Commission, FFT should have remunerated the group entity that ultimately carried all of the risks, for example, by means of a guarantee fee".

See also R. SZUDOCZKY*, FIAT. Non-confidential version of decision on selective tax advantages for FIAT in Luxembourg. State aid. European Commission*, in *Highlights & Insights on European Taxation*, 2017 (2), p. 159.

[151] For further details see *https://www.oecd.org/ctp/transfer-pricing/transfer-pricing-country-profiles.htm*.

[152] The Irish tax authorities have indeed issued guidelines confirming that a markup of 5% of a taxpayer's relevant cost base will be accepted as an arm's length price for low-

Liechtenstein, Japan, New Zealand, Norway, The Netherlands, Singapore, Switzerland, United Kingdom and the United States. Moreover, the mentioned countries provide for some differences in the concrete application of the safe harbor.

Such jeopardization could potentially affect the success of the safe harbor. Indeed, the concrete consequence of the mentioned jeopardization is that the multinational group operating in different countries could be able to adopt the simplified approach in some countries in which it is present. At the same time, the mentioned multinational group should perform a full transfer pricing analysis in order to support its transfer pricing policy on front of the tax administrations of those countries which have not introduced the safe harbor. Moreover, also in those countries in which the simplified approach has been introduced, some differences should be implemented by the multinational group in order to be compliant with the different implementing regulations. Such a scenario frustrates the aims of the simplified approach, resulting in a less attractiveness for the multinational group of the simplified approach for the low value adding services.

2.7.1. The domestic framework – The Netherlands – Looking to the Netherlands – i.e. one of the country that traditionally reserves more attention to the transfer pricing matters –, the arm's length principle was codified in 2001 in the country by Section 8b of the 1969 Dutch Corporation Tax Act, with effective date from January 1, 2002.

The OECD Transfer Pricing Guidelines have not been incorporated into the Dutch law. However, from a policy perspective, the Secretary of

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value intra-group services Where this safe harbor applies, Irish tax authorities do not require a benchmarking analysis to support the pricing position.

The mentioned Guidelines are largely based on the approach prescribed in the 2017 version of the OECD Guidelines, notwithstanding that the 2017 version has not been incorporated into Irish domestic law. Irish Revenue have therefore effectively incorporated the certainty and efficiency of the safe harbor for low value adding services into Irish tax practice by publishing the Revenue Guidelines.

For further details see J. DUFFY – T. BAILEY, *Irish Revenue confirms services safe harbor*, in *International TP Journal*, 2018 (Volume 25), no. 5.

State is of the opinion that the OECD Guidelines intend to provide insight into the way in which the arm's length principle must be applied in practice.

Such an approach has been confirmed also by the practice of the local tax administrations. The Dutch administration has issued indeed in 2001 a decree with the aim to clarify the application of the arm' s length principle and of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[153]. The purpose of the Decree was to remove uncertainties and facilitate a more flexible approach within the scope of the OECD Transfer Pricing Guidelines, as a result of which the Netherlands should become a more attractive residence for multinationals. As outlined by the scholars[154], "the 2001 decree was the first decree that truly provided detailed guidance around the Dutch interpretation of the OECD Guidelines on a wide range of transfer pricing topics".

In 2004 a further decree has been issued, with the aim to make some amendments to the 2001 Decree, as well as to give additional guidance on some further transfer pricing issues, including group services and shareholder activities[155].

The 2001 decree was replaced by a revised Decree in 2013, with the aim to provide further guidance on the applicability of the arm's length principle and to align the interpretation given by the local tax authorities to the 2010 OECD TP Guidelines[156].

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[153] See Decree dated March 20 2001 no. IFZ2001/295M. For a comment, see D. OOSTERHOFF, *Transfer pricing landscape: legislation and guidance*, in *The New Netherlands Transfer Pricing Regime*, Amsterdam, 2002. For a comment, see also M. DOETS – H. VAN DAM, *Transfer Pricing in the Netherlands – The "Rules of the Road"*, in Bulletin, August / September 2006, p. 344.

[154] D. OOSTERHOFF, *New Transfer Pricing Decree: No Longer Ahead of the Curve*, in *International Transfer Pricing Journal*, 2018, p. 335.

[155] See decree dated 31 August 2004 (no. IFZ2004/680M). For a comment, see M. DOETS – H. VAN DAM, *Transfer Pricing in the Netherlands – The "Rules of the Road"*,*cit.*, p. 344; M.W. VAN DER VLIET, *Recharging Head Office Expenses: An Update*, in *International Transfer Pricing Journal*, 2005, p. 116.

Other aspects on which the 2004 Decree provided further guidance were the support activities, contract research, cost-contribution arrangements, credit for foreign withholding tax and the determination of the arm's length price when the valuation is uncertain at the time of the transaction.

[156] See Decree of 14/11/2013 No. IFZ 2013/184M issued by Directorate-General for Fiscal Affairs, International Fiscal Affairs Directorate. The text of the 2013 Decree has been published in the International Transfer Pricing Journal (March / April 2014), p. 125. For a detailed analysis of the 2013 Dutch Decree, which goes beyond the purposes of the

In 2018 – thus demonstrating a very proactive approach – the Dutch tax administration issued a revised decree in order to update the guidance provided in light of the 2017 OECD TP guidelines and to implement the BEPS measure on transfer pricing[157].

In light of the above, the basis for the evaluation of the applicable transfer prices in the Netherlands is currently formed by the following laws and guidelines: (i) article 8b of the Vpb, (ii) articles 29b – 29h of the Vpb, (iii) the Transfer Pricing Decree of 2018 (No. 2018-6865) (the 2018 Decree) of 22 April 2018 (effective from 12 May 2018), (iv) the APA Decree (DGB2014/3098), (v) the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the OECD in 1995 and amended in 2010 and 2017, and (vi) the EU Council Directive No. 2016/8812.

With specific reference to the intra – group services, the principles provided by the OECD Transfer Pricing Guidelines are confirmed by the local tax authorities.

In a nutshell, group services are defined as activities that add economic or commercial value and are carried out for the benefit of a group company which would normally be willing to pay compensation for the service. Shareholders' activities are not treated as group services and, as such, may not be charged to a group company. Examples of shareholder's activities include: i) the fulfilment of obligations under civil law; ii) the fulfilment of obligations under the General Law on Taxation; iii) the issue, transmission and division of the shares of a company or comparable securities traded on capital markets and the application or continuation of a listing on (foreign) stock exchanges; iv) the implementation and enforcement of legal regulations regarding the control of share transactions; v) the implementation and fulfilment of legal regulations and rules of conduct

present analysis, see J. REYNEVELD – E. SPORKEN, *New Dutch Transfer Pricing Decree*, in *International Transfer Pricing Journal*, 2014, p. 120.

[157] Decree of 22 Apr. 2018, Transfer pricing, application of the arm's length principle and the transfer pricing guidelines for multinational enterprises and tax administrations (OECD Guidelines). For a comment, see D. OOSTERHOFF, *New Transfer Pricing Decree: No Longer Ahead of the Curve*, *cit.*, p. 335.

concerning “corporate governance” in respect of the company or the group; and vi) communications regarding the company’s or group’s financial performance and expectations in relation to interested parties.

Companies may request an advance tax ruling on the classification of activities, i.e. group services or shareholders’ activities, or an advance pricing agreement on the classification of activities and the arm’s length character of the transfer price pursuant to Decrees DGB2014/3098, DGB 2014/3099 and DGB 2014/3101 of 12 June 2014.

Moreover, in relation to intra-group services, the 2018 Decree introduces the option of the simplified method for determining arm’s length fees for low value-adding services. Following the OECD Guidelines, this approach can be followed in the Netherlands provided that it meets the following conditions: i) the services are supportive in the overall business processes; ii) the services are not part of the primary business processes of the multinational enterprise; iii) the services do not require the use of unique and valuable intangibles and do not lead to the creation of such intangibles; and iv) the services are not associated with the key risks that the company is faced with.

Under these conditions, 5% of the markup, without the need for a comparability study, can be applied. This approach cannot be applied if these services are also rendered to third parties. Furthermore, a pragmatic approach will be followed in relation to the benefit test through a general approach instead of a benefit test on all the individual services. If the taxpayer does not opt for the simplified approach for such services, it is still possible to charge all relevant costs without a markup if the underlying services meet the low valued-adding criteria, consistent with the original Dutch guidance. However, this approach will only be accepted if all relevant costs are charged including financing costs.

In this respect, it is worth mentioning that the 2013 Decree already provides for a simplified approach for the so called “ancillary services”: for such services, indeed, it was accepted to charge the fee at cost without a mark-up. More specifically, para. 6.3 of the 2013 Decree moves from the

consideration that payments for the provision of group services are at arm' s length only if an appropriate profit margin was taken into account when determining the payment. In practice, such an arm's length payment for group services is often determined by applying the cost-plus method and a cost base derived from direct and indirect costs.

Moreover, the 2013 Decree lists several ancillary services for which no transfer pricing analysis should be performed, in the sense that the arm's length principle is deemed to be met provided that the relevant actual costs for rendering the services are charged back from the service provider to the service recipient. In some way, therefore, the costs for the ancillary services are treated as pass – through costs.

The functional analysis underlying the taxpayer' s transfer pricing system will determine which costs are relevant. In principle, the chargeable relevant actual costs include direct and indirect costs related to the respective ancillary services, as well as overhead costs (e.g. financing and exceptional costs).

It is interesting to note that – from a subjective point of view – the simplified approach applies regardless of which legal entity within the group provides the ancillary services. As stated by the Decree, "no adjustment will be imposed in cases where all the relevant costs in respect of ancillary services performed by an entity that also performs other activities are charged, nor in cases where the ancillary services are performed by a separate legal entity (this could include, for example, a shared service centre)".

The definition of ancillary services generally includes accounting services, legal services, tax services and services provided by human resources departments.

A case – by – case analysis is nevertheless required: on one hand, indeed, the Decree highlights that there could be the case in which services – that in principle fall within the definition of ancillary services – could be not qualified as ancillary services and therefore a mark – up is needed in order to be compliant with the TP regulation. This happens in all those cases in

which the services i) are part of and add more than marginal value to the primary business of the group and / or ii) are provided on a recurring basis to non-associated parties.

On the other hand and based on the same rules (i.e. the services (i) are not part of, or only add marginal value to the primary business of the group and (ii) are performed for third parties on a non-recurring basis), the Decree highlights that there could be the case in which services – that in principle do not fall within the definition of ancillary services – could be nevertheless qualified as ancillary services and be eligible for the simplified approach. In such cases, the tax payer is recommended to present a request in advance to the tax authorities, in order to ask the permission for charging the relevant actual costs for services (instead of determining the arm’s length remuneration).

As already pointed out, there are two main characteristics which should allow the distinction between ancillary services entitled to benefit to the simplified approach and non – ancillary services, i.e. i) the services (i) are not part of, or only add marginal value to the primary business of the group and (ii) are performed for third parties on a non-recurring basis. Further guidance is given in this respect by the 2013 Dutch Decree with reference to the first characteristic mentioned: such guidance further contributes to give more certainty in the relationship between the tax administration and the tax payer.

Indeed, according to the 2013 Dutch Decree, “[i]n determining whether this involves the primary business of the group, the Dutch Tax and Customs Administration will determine this on the basis of the following elements:

– What type of activities are involved? In general, primary business activities include: production, purchasing, sales, marketing, product development, and research and development.

– What is the relative scale of the activities within the group? The relative scale of the activities is evaluated on the basis of the total scale of comparable activities and activities that are in line with the particular

activities performed in the group as a whole. Factors taken into account are the number of staff involved, the costs related to the activities, the investment (equity and debt) required to perform the activity, or a combination of these factors.

– What is the added value of the activities?”[158].

2.7.2. The domestic framework – India – The 2001/02 Budget introduced for the first-time detailed regulations on transfer pricing into the

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[158] Further guidance is provided by several examples included in the Dutch Decree.

“– Example E: A group provides legal services to third parties. A foreign group company that is involved with advising a client on an international transaction receives advice on the local legal aspects of the transaction from an employee of one of the group companies. The charge for this activity should be at arm’ s length, because the activities performed form part of the primary business of the group. Moreover, the particular services are provided to non-associated parties on a recurring basis.

– Example F: The legal department of a bank is actively involved with the design of a bank product that another group company wants to offer. The activity performed by the legal department is an activity that adds more than marginal value to the primary business of the group. For that reason, an arm’ s length payment must be determined and charged to the other group company. It is not sufficient to charge all the relevant actual costs. A group provides legal services to third parties. A foreign group company that is involved with advising a client on an international transaction receives advice on the local legal aspects of the transaction from an employee of one of the group companies. The charge for this activity should be at arm’ s length, because the activities performed form part of the primary business of the group. Moreover, the particular services are provided to non-associated parties on a recurring basis.

– Example G: A help desk department is solely concerned answering the questions posed by employees of the different group companies regarding the computer system, the software, and helping solve minor user problems. On the basis of the type of activities involved, the relative scale of the activities within the group, and the added value of the activities, the taxpayer convincingly demonstrates that this does not involve the primary business of the group. It also convincingly demonstrates that the value added to the primary business of the group by the activities is only marginal. At the taxpayer’ s request, the Dutch Tax and Customs Administration may approve the relevant actual costs being charged, rather than an arm’ s length payment.

– Example H: A group operates an international hotel chain. One department is concerned with the implementation and maintenance of an intra-group computer application that will automatize the reservations, invoicing and inventory procedures. Although these activities presumably are not part of the primary business of the group, they do add significant (more than marginal) value to the primary business. The fee charged by the taxpayer for this activity must be at arm’ s length.

– Example I: A company is a contract manufacturer that performs its activities under the management and for the risk of another group company. These types of manufacturing activities generally form part of the primary business of the group. Furthermore, these activities, together with similar activities or activities that go hand in hand with these activities (such as, for example, the manufacturing activities of the principal) generally are an important part, in absolute or relative terms, of the total activities of the group. The fact that the added value of these activities is only marginal, is not sufficient reason to regard them as ancillary activities. The fee charged by the taxpayer for these activities must be at arm’ s length”.

Tax Code (see sections 92 to 92F). The fundamental feature of the transfer pricing provisions is the arm's length principle, which is determined through different methods depending on the nature of the transaction[159].

The Finance Act 2009 inserted section 92CB to provide that the determination of the arm's length price under section 92C or section 92CA is subject to safe harbor rules: the implementing regulation of such safe harbor rules should be issued by the Central Board of Direct Taxes.

Between September 2012 and April 2013, the Central Board of Direct Taxes issued six reports including safe harbor criteria for the six following specified sectors (due to a paucity of data for other sectors): information technology, IT-enabled services, contract research and development in the IT and pharmaceutical sectors; financial transactions (outbound loans and corporate guarantees) and automotive ancillaries (original equipment manufacturers)[160].

The safe harbor rules have been further revised in 2017[161]: the revision has been twofold. On one hand, the safe harbor for low value – adding services has been introduced: the safe harbor rules are broadly in line with the recommendations of the OECD/G20 BEPS initiative. On the other hand, the existing safe harbors have been moderated.

The aim of such safe harbor rules was – in the intention of the Indian government – to provide for a speedy and simple alternative route for concluding transfer pricing assessments: since the introduction of transfer pricing provisions, indeed, there is an increasing trend in transfer pricing litigation, which creates a negative impression in the minds of taxpayers and foreign investors.

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[159] For further details on the transfer pricing rules in force in India, see S. SHREYAS, *India – Corporate Taxation*, IBFD, 2019, available at <www.ibfd.org>.

[160] For a comment, see V. KRISHNAMURTHY, *India Aims To Reduce Transfer Pricing Disputes through Safe Harbour Rules*, in *Bulletin for International Taxation*, 2014, p. 47.

[161] See CBDT vide Not. 46/2017 dated 7 June 2017. For a comment, see S. KISHORE BILANEY, *India Transfer Pricing Round-Up for 2017*, in *Bulletin for International Taxation*, 2018 (Volume 72), No. 3.

The revised safe harbour rules apply for assessment year 2017/18 and the two immediately following assessment years, i.e. up to assessment year 2019/ 20. The earlier rules were applicable from assessment year 2013/14 and the four immediately following assessment years, i.e. up to assessment year 2017/18. For assessment year 2017/18, the taxpayer can choose either the old or new rules, whichever is more beneficial.

According to Section 92CB of the Indian Tax Code, the safe harbor rules should prevail over the normal transfer pricing assessment based on the arm' s length principle (ALP), referred to in sections 92, 92C and 92CA. In other words, the safe harbor rules require the taxpayer to determine transfer prices in such a manner that these generate the specified minimum income required to be taxed. In that situation, the tax authorities will accept the actual transfer prices so established and will not attempt to determine the arm's length remuneration.

However, if the taxpayer does not qualify or decides to opt out of the safe harbor option under section 92CB, the transfer pricing assessment is completed under sections 92C and 92CA.The same situation arises when the determined transfer prices result in the actual margins being lower than the safe harbor margins: the taxpayer cannot claim the protection of safe harbor rules and must undergo the traditional arm's length principle based assessment.

The safe harbors have been defined on the basis of the cost plus method.

In case of provision of software development services and information technology services with insignificant risks, the operating profit margin coming from the transaction should be:

- not less than 17% if the aggregate value of these transactions is lower than INR 1 billion;

- not less than 18% if the aggregate value of these transactions is more than INR 1 billion but less than INR 2 billion.

In case of provision of knowledge process outsourcing services with insignificant risks and with an aggregate value of such transactions lower than INR 2 billion, the operating profit margin rate should be:

- not less than 24% if the ratio of employee cost to operating expenses is at least 60%,

- not less than 21%, if the ratio of employee cost to operating expenses is greater than 40% but less than 60%;

- not less than 18% if the ratio of employee cost to operating expenses does not exceed 40%.

In case of provision of specified contract research and development services (contract R&D services), with insignificant risks, wholly or partly relating to software development, the operating profit margin rate should be not less than 24%, where the value of the international transaction is less than INR 2 billion.

In case of provision of contract R&D services, with insignificant risks, wholly or partly relating to generic pharmaceutical drugs, the operating profit margin rate should be not less than 24%, where the value of the international transaction is less than INR 2 billion.

In case of manufacturing and export of auto components, the operating profit margin rate should be:

- not less than 12% for the core auto components and;

- not less than 8.5% for the non-core auto components where 90% or more of total turnover relates to original equipment manufacturer sales.

In addition to the above, there are four safe harbors which are specifically provided for the financial services. As for example, the provision of corporate guarantee to wholly – owned subsidiary, safe harbor is given by 1% of the amount guaranteed[162].

The safe harbor provided for the low – value adding services is available provided that aggregate value of such transactions (including a markup not exceeding 5%), does not exceed INR 100 million.

Low value-adding intra-group services are defined as those services that are performed by one or more members of a multinational enterprise group on behalf of one or more other members of the same multinational enterprise group and which are in the nature of support services, are not part of the core business of the multinational enterprise group (i.e. such

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[162] However, the credit rating of the borrower must be certified by an SEBI registered agency to be of adequate to highest safety for amounts guaranteed exceeding INR 1 billion.

For further details on the other safe harbours provided for the financial transaction, see S. SHREYAS, *India – Corporate Taxation*, IBFD, 2019, p. 195, available at <www.ibfd.org>.

services neither constitute the profit-earning activities nor contribute to the economically significant activities of the multinational enterprise group), are not in the nature of shareholder services or duplicate services, neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles, neither involve the assumption or control of significant risk by the service provider nor give rise to the creation of significant risk for the service provider; and do not have reliable external comparable services that can be used for determining their arm's length price.

At the same time, the objective scope of the safe harbor does not include the following services: research and development services, manufacturing and production services, information technology (software development) services, knowledge process outsourcing services, business process outsourcing services, purchasing activities of raw materials or other materials that are used in the manufacturing or production process, sales, marketing and distribution activities, financial transactions, extraction, exploration, or processing of natural resources and insurance and reinsurance.

The applicability of all the aforementioned safe harbors (including that provided for the low – value adding services) is available only providing that the following requirements are met:

- only for the threshold related to the low – value adding services[163], a chartered accountant's certification for the method of cost pooling and the exclusion of shareholder costs and duplicate costs from the cost pool, and the reasonableness of the allocation keys used for allocation of costs is needed;

- several procedural obligations have to be fulfilled, including the filing of a specified form (i.e. Form 3CEFA) for exercising the option. In particular, taxpayers assessed under safe harbor rules for any year have to maintain the same level of documentation for that year as that required under the

[163] This aspect represents the main deviation existing between the Indian law and the OECD guidance.

traditional arm's length principle -based assessment (Rule 10TD(5)). Despite the fact that several objections to this requirement were made when the draft rules were circulated for comment, the government has chosen to retain it, possibly to ensure continuity in the documentation over years, since the taxpayer is given the option of using the safe harbor for any year and opting out of the safe harbor for the subsequent year.

Such an aspect has been criticized by the scholars who highlight that such aspects partially frustrates the aim of the safe harbor of making tax compliance easier for the taxpayer. This leads to a situation where the assessment is finalized on the basis of safe harbor margins, but the taxpayer has to maintain extensive transfer pricing documentation, in the absence of which penalties will apply[164].

- the safe harbor rules will not apply in relation to international transactions entered into with associated entities which is located in a no- or low-tax country (i.e. where the maximum tax rate is less than 15%) or with whom India does not have an information exchange agreement.

2.7.3. The domestic framework – Brazil – Brazil kept the same wording in Article 9(1) as found in the OECD and UN Model Tax Conventions (OECD and UN Models) throughout its network of income tax treaties (tax treaties). On the other hand, in its tax treaty network, with no exception, Brazil has not included Article 9(2) of the OECD and UN Models.

Looking to the domestic application of article 9(1) of the tax treaties, the possibility of primary adjustments was not being considered until the mid – 1990s since there was no domestic law on transfer pricing in place in Brazil. Despite the subsequent implementation of transfer pricing law, attention to the subject of economic double taxation remained unchanged in the treaties signed afterwards. This circumstance was made even clearer when, in 2003, Brazil made a reservation in the Commentary on Art. 9 of the OECD Model, as an observer of the work of the corresponding

[164] For further comments, see V. KRISHNAMURTHY, *India Aims To Reduce Transfer Pricing Disputes through Safe Harbour Rules*, in Bulletin for international taxation, January 2014, p. 47.

committee, in which it reserves the right not to include para. 2 in its treaties[165].

The Brazilian transfer pricing law was enacted in 1996 and entered into force on 1 January 1997. Paragraph 12 of the Explanatory Memorandum that accompanied the bill of law made quite clear the objectives aimed at incorporating this new issue into the tax system: "The norms contained in Articles 18–24 represent considerable progress for national law in the face of the major process of globalization experienced by contemporary economies. In this specific case, in accordance with rules adopted by the OECD member countries, norms are proposed that enable the control of so-called 'transfer prices' to avoid the practice, harmful to national interests, of transferring results abroad by manipulating agreed prices for imports or exports of goods, services or rights, in transactions with related non-resident persons"[166].

After its first enforcement, the transfer pricing regulation has been amended several times[167]. As of today, the Brazilian Transfer Pricing

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[165] See the 2017 OECD Transfer Pricing Guidelines, Position of Brasil on article 9, p. 632, according to which Brazil (as well as Thailand and Vietnam) reserves "the right not to insert paragraph 2 in their conventions".

[166] The anti-avoidance impulse to introduce transfer pricing rules in Brazil was therefore clear. This supports some arguments that classify the rules of Law 9,430/96 as specific anti-avoidance provisions.

[167] See Law 9,430 of 27 December 1996 named "Lei Dispõe sobre a legislação tributária federal, as contribuições para a seguridade social, o processo administrativo de consulta e dá outras providências" (i.e. Law on federal tax legislation, social security contributions, administrative process of consultation and other measures), available at <www.planalto.gov.br>.

Law 9,430/1996 was modified by Laws 10,451/2002, 10,637/2002, 10,833/2003 and 11,196/2005, which introduced a modification with regard to exchange rate appreciation of the Brazilian real against foreign currency, and then by Law 11,727/2008. More recently, important changes were introduced by Law 12,715/2012, the previous Provisory Measure 563 of 3 April 2012, converted into law by the Congress, which introduced a more flexible methodology for adjusting the profit margins in respect of the cost-plus method (CPM) and the resale price (RSP) method, and established different margins for various economic sectors in respect of the RSP method and a new methodology for the comparable uncontrolled price (CUP) method with regard to commodities. This law is currently regulated by Normative Instruction 1,312/2012, as amended.

For a more detailed description, see S. MATTOS, *Transfer Pricing in Brazil*, in *Intertax*, 1998 (Issue 6/7), p. 221; M.A.P. VALADÃO - R.M. LOPES, *Transfer Pricing in Brazil and the Traditional OECD Approach*, in *International Taxation*, 2013 (9), p. 57; M. B. A. P. VALADÃO, *Transfer Pricing in Brazil and Actions 8, 9, 10 and 13 of the OECD Base Erosion and Profit Shifting Initiative*, in *Bulletin for International Taxation*, 2016, p. 296.

legislation encompass the Law 9430/1996 and the Normative Instruction 1312/2012.

Despite basically being inspired by the OECD Guidelines – as symbolically declared by the mentioned explanatory memorandum – and seeking to adopt the commonly accepted arm's length principle, Brazilian law deviates from the OECD Transfer Pricing Guidelines in several aspects. Brazil is indeed widely recognized as the most significant country that does not follow the international transfer pricing standards.

Firstly, the Brazilian transfer pricing law permits the application of traditional transaction methods (i.e. the comparable uncontrolled price method, the cost-plus method and the resale price method), but not transactional profit methods (i.e. the profit split method and the transactional net margin method). Secondly, instead of making use of comparable transactions as suggested by the OECD Guidelines, the Brazilian transfer pricing law adopts fixed margins for gross profits and markups for the various traditional transaction methods. Brazilian transfer pricing rules are transaction-based oriented, deviating from the OECD Guidelines. A further difference from internationally adopted transfer pricing regimes refers to the absence of the 'best method' or 'most appropriate method' rule; In Brazil, the taxpayer may elect the most suitable method.

The system based on fixed margins allows to get the following two main advantages[168]. On one hand, the Brazilian transfer pricing regulation does not require the availability of specific comparables: this is not a secondary aspect in the view of practitioners. Indeed, finding comparables in a not developed country is not so easy, as it is already experienced in all those developing countries (e.g. India) in which the local administrations take the view that only companies active in the Brazilian market can be

[168] See M. B. A. P. VALADÃO, *cit.*, p. 303. See, with the same terms, also the See UN, *Practical Manual on Transfer Pricing*, Part D, p. 540. For the sake of completeness, please note that part D of the 2017 UN Manual on Transfer Pricing is especially reserved to five developing countries to present their domestic practices on transfer pricing. Brazilian practices are among those included, and this content was produced by the same Valadão, who, at the time of articulating the first version of the Manual, represented Brazil on the UN committee of Experts on International Cooperation in Tax Matters.

accepted as proper comparables for the transfer pricing analysis. The Brazilian system is therefore easy to be implemented by the tax payers, as well as easy to be checked by the tax authorities. The use of predetermined profit margins thus results in minor costs for the tax compliance of the local companies, as well as in minor possibilities for litigation between the tax authorities and taxpayers. Such a framework ultimately provides for clear and stable rules for the foreign investors.

On the other hand, as pointed out by the scholars[169], the Brazilian system does not remind that the transfer pricing is not an exact science: in other words, the system based on predetermined profit margins does not allow to take into consideration the specific situation of the taxpayer or the peculiarities of the business. This can concretely result in a tax treatment which could be not fair for the single tax payer. In this respect, three main weaknesses emerge from the Brazilian system based on the fixed margins:

"- the approach may lead to double taxation if there is no access to competent authorities to negotiate relief from double taxation;

- these methods require clear classifications and accounting conformity with respect to the allocation of expenses between COGS and operating expenses; and

- it is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability. This is because the fixed margin method applies regardless of the cost structures of taxpayers. For example, otherwise economically identical taxpayers with large COGS relative to operating costs will face higher tax burdens than taxpayers with low COGS relative to operating costs"[170].

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[169] See S. AVI-YONAH - N. SARTORI - O. MARIAN, *Global Perspectives on Income Taxation Law*, Oxford University Press, 2011, p. 161; A. E. MESSINEO, *Transfer Pricing in Latin America: New Rules in Mexico and Brazil*, in *International Transfer Pricing Journal*, 1997 (4-2), p. 47; J. M. DE MELO RIGONI, *A Brazilian View on Base Erosion and Profit Shifting: An Alternative Path*, in *Intertax* (Volume 46 - Issue 11), 2014, p. 730. For a very interesting analysis, see also R. MAROZZI GREGORIO, *Brazilian Transfer Pricing Rules: An Analysis of Effectiveness*, in *Intertax* (Volume 46 - Issue 11), 2018, p. 914: the author tries to understand with some concrete examples if the Brazilian transfer pricing regulation allows to reach in the facts the declared aim "to avoid the practice, harmful to national interests, of transferring results abroad'.

[170] See UN *Practical Manual on Transfer Pricing*, p. 540.

Moreover, the isolationist attitude of Brazil involves a considerably higher level of transactional costs for the multinational groups: cross-border transactions involving Brazil add complexity to the international transfer pricing policy of the multinational groups since it demands the compliance with a completely different set of regulations, distinct from the OECD and the UN models.

In this respect, it is worth underlining that the method with fixed margins provided by the Brazilian legislation does not represent a safe harbour, not being an option for taxpayers that must take into account specific situations[171].

Looking to the objective scope, transactions that are subject to the Brazilian transfer pricing adjustments include (i) the import and export of goods, services and rights with related parties; and (ii) payments or credits for interest paid or received on international loans[172]. By means of this generic definition, it is understood that rules apply to all transactions carried

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[171] In this respect, please note that the Brazilian legislation provides for some safe harbors rules which are mainly basis on the "de minimis" approach and are applicable only to the export transactions.

Under the first general safe harbor rule, which is expressly provided by the law, a taxpayer is deemed to have applied an appropriate transfer price when the average export sales price is at least 90% of the average domestic sales in the Brazilian market during the same period and under similar payment terms. A second safe harbor allows, as a general rule, a difference of up to 5% between the actual price and the comparable price. In the case of commodities, a difference of up to 3% is accepted between the parameter price obtained through the use of the comparable uncontrolled price method and the tested price.

In addition to the above, there are two further simplified rules which aim at simplifying the application of the transfer pricing rules. Specifically:

(1) Taxpayers that have net profit derived from export sales to related parties before taxes on income (taking into account the current tax year and the two preceding tax years) of at least 10% of such sales do not have to make transfer pricing adjustments regarding the income deriving from exports. However, this only applies where the net export revenue to related parties is less than 20% of the total export revenue and is subject to certain other restrictions.

(2) Taxpayers are not subject to the transfer pricing regulations with regard to exports when it can be demonstrated that the net export revenue in a tax year is equal to or less than 5% of their total net revenue in the same period. This is subject to certain other restrictions.

It is important to note that the rules described in (1) and (2):

- do not apply to transactions with persons or companies, either related or unrelated, that are established in low-tax or non-transparent jurisdictions, as defined by the Brazilian transfer pricing regulations;

- do not apply to transactions involving commodities;

- are not considered true safe harbors because the tax authorities remain required to observe the transfer pricing methods and may, in theory, assess the taxpayers.

[172] See articles 18 and 19 of Law 9,430/1996.

out by a controlled taxpayer whenever it may be able to consider the payment of a price as compensation for the advantage obtained from acquiring the property of a good, the provision of a service or the entitlement of a right. In this broad sense, tangibles and intangibles are considered goods. Concerning services, intra-group services and those provided under a cost sharing agreement are also included. Among rights, different legal forms of property remuneration can be covered, such as rent, interest and prizes.

This objective scope differs with regard to a very sensitive issue vis-à-vis the approach envisaged in international transfer pricing. Brazilian transfer pricing rules currently do not apply to cross-border payments of trademark or patent royalties, nor to fees payable as compensation for the transfer of technology or for the rendering of technical, administrative or scientific assistance services. This is an exception under the Brazilian transfer pricing legislation, which is motivated by the applicability of a special tax regime to the payments under analysis[173].

As already pointed out, Brazilian transfer pricing rules are transaction-based oriented: Brazil's TP rules define maximum price ceilings for deductible expenses on import transactions and minimum gross income floors on export transactions. Looking to the products, services or rights imported by Brazilian companies from related parties, there are currently four methods for determining the remuneration compliant with the arm's length principle. With reference to the export transactions, four transfer pricing methods have been approved: they apply whenever the average

[173] See Article 18(9) of Law 9,430/96, which expressly excludes from application of the rules those transactions involving payments of inbound royalties and transfers of technology, rather subjecting these situations to the preexisting limitations on deductibility that have been imposed by Law 3,470 since 1958.

With reference to the specific regime provided for the payments under analysis, see chapter 1. Here it is sufficient to remind that the Brazilian corporate income tax legislation only allows for a limited deduction with regard to these types of expenses, i.e. up to 5% of the turnover so derived and other restrictions may apply as well. Moreover, the transactions under analysis should be registered with the INPI and the Brazilian Central Bank. Furthermore, withholding tax as well as local taxes apply to the cross-border payments of trademark and patent royalties, as well as to fees payable as compensation for the transfer of technology or for the rendering of technical, administrative or scientific assistance services.

sales price of goods, services or rights exported by a Brazilian company in a taxable year is less than 90% of the average price applied in sales of the same goods, services or rights by such company in the domestic market within the same taxable year and under similar payment conditions. Moreover, there are transfer pricing rules for cross – border loans (both inbound and outbound)[174].

The Brazilian legislations mentioned above apply to intra-group services, but none of these legislations has specific guidance to intra-group services. Moreover, no special regime is provided for the low value – adding services.

In practical terms, this means that, under the Brazilian tax legislation, where the payments are embedded in the technology transfer, they are subject to limited deductibility and are not subject to the Brazilian transfer pricing legislation. On the other hand, where such payments are service payments, their deductibility is subject to conditions as prescribed by law. Among the other conditions prescribed by the Brazilian law, for such expenses to be deductible, a taxpayer must demonstrate that the payments are necessary to operate the business. This approach is similar to the benefit test, that the approach provided by the OECD Transfer Pricing Guidelines and the UN Practical Manual on Transfer Pricing aim at simplify. It should be noted that, under Brazilian income tax legislation, if the recipient

[174] For import transactions: i) comparable uncontrolled price method; ii) resale price method, in relation to which generally a 20% gross profit margin is recommended (different margins are provided for specific sectors, i.e. 40% for pharmaceutical chemicals and pharmaceuticals, tobacco products, equipment and optical instruments, photographic and cinematographic, machinery, apparatus and equipment for use in dental, medical and hospital, petroleum, and natural gas (mining industry) and petroleum products (derived from oil refineries and alike); 30% for chemicals (other than pharmaceutical chemicals and pharmaceuticals), glass and glass products, pulp, paper and paper products and metallurgy); iii) Cost Plus Method, i.e. a 20% markup (CPL) (Cost Plus).

For export transactions: i) comparable uncontrolled price method; ii) the wholesale price in the country of destination, less profit method, i.e. a 15% margin; iii) the resale price method in the country of destination, less profit method, i.e. a 30% margin and cost plus methods, i.e. a 15% profit margin.

For further details on the transfer pricing regulation provided by the Brazilian law, see V. ARRUDA FERREIRA, *Brasil - Corporate Taxation*, 2019, available at <www.ibfd.org>; R. MAROZZI GREGORIO, *cit.*, p. 917 – 918; M.B.A.P. VALADÃO, *Transfer Pricing in Brazil and Actions 8, 9, 10 and 13 of the OECD Base Erosion and Profit Shifting Initiative*, in Bulletin for International Taxation, May 2016, p. 296.

is a resident of an uncooperative and/or low-tax jurisdiction, such payments are subject to additional restrictions before a tax deduction is allowed.

As a final consideration in this respect, the consideration made by the doctrine[175] is worth mentioning: we "assume that an MNE group centralizes the entire range of low-value adding services in a tax haven or a place where it can benefit from a privileged tax regime. In this case, according to the new proposed regulation under the BEPS Project, the 5% mark-up is sufficient to remunerate the provision of these services, and the corresponding profit should be taxed (or not) in conformity therewith. Nevertheless, a Brazilian company related to the group, when using these services, may apply for the (20%) mark-up predefined by the CPL method. Therefore, there will be a waiver on this surplus that could even be compensated by the high source taxation on the gross value of services rendered by non-residents (rather than the international standard that taxes only when there is a permanent establishment). But the truth is that the source taxation is independent and would occur even without the waiver. This is why it would be incorrect to treat it as compensation".

2.7.4. The domestic framework – The United States of America – The introduction of a transfer pricing regulation in the United States of America dates back to the Revenue Act of 1921: it was continued in subsequent revenue acts and in the IRCs of 1939, 1954 and 1986. As of today, the US transfer pricing legislation is contained in IRC § 482. The US transfer pricing guidelines are contained in regulations issued by the US Treasury Department and the Internal Revenue Service under the authority of IRC § 482. These regulations define the arm's length standard and specify the transfer pricing methods that will be accepted by the Internal Revenue Service. The regulations are subject to revision on an ongoing basis[176].

[175] See R. MAROZZI GREGORIO, *cit.*, p. 922.

[176] For an overview, see R. T. COLE, *New IRS recordkeeping and summons requirements for enforcing US transfer pricing rules in foreign-owned situations*, in *Intertax*, 1990 (2), p. 83, P. D. MORRISON, *US Transfer Pricing Policy: Prospects for Continuing Controversy*, in *Intertax*, 1993 (2), p. 62, D. R. WRIGHT, *Transfer Pricing in the United*

The regulation for the controlled services transactions is included in the US Treasury Regulation § 1.482-9 which is entitled to the methods to determine taxable income in connection with a controlled services transaction[177] (hereinafter also referred to as the “Regulation”). Such Regulation confirms that the transactions related to provision of services between related companies should be tested according to the rules provided for all the intercompany transactions (e.g. the best method rule, the comparability analysis and the arm’s length range). However, the Regulation provides further for some specific provisions that should prevail on the general regulations and that appear to be of interest for the present analysis.

A controlled services transaction is defined as any activity by one member of a group of controlled taxpayers that results in a benefit to one or more other members of the controlled group. The definition of activity is broad and includes “the performance of functions, assumption of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge [as well as] making available to the recipient any property or resources of the renderer”[178].

The Regulation provides further that the arm’s length price of the controlled service transactions must be determined using one of the following methods: (i) the services cost method, (ii) the comparable uncontrolled services price method, (iii) the gross services margin method, (iv) the cost of services plus method, (v) the comparable profits method, (vi) the profit split method or (vii) an unspecified method.

While the methods listed from (ii) to (vii) are those applicable to all the intercompany transactions, the method mentioned under point (i) – i.e. the services cost method – represents the main derogation to the general

States: Recent Events and Expectations for the Future, in *International Bureau of Fiscal Documentation*, 2001, p. 417.

[177] See US Treasury Regulation § 1.482-9 – “*Methods to determine taxable income in connection with a controlled services transaction*”, available at <https://www.law.cornell.edu/>.

[178] See paragraph (l) of the Regulation entitled to the “Controlled service transaction”.

transfer pricing rules provided by US Regulation § 1.482-9 since it introduces an ad – hoc transfer pricing method for the intercompany services transactions. More specifically, the services cost method is an elective method ("cost safe harbor") that permits certain "non-integral" services to be priced at cost. Such safe harbor provides for several differences if compared to the approach provided for the low value adding services by the OECD Guidelines.

In this respect, the background of the US cost safe harbor is worth mentioning. A safe harbor similar to the regime currently under analysis was provided for the first time in 2003, when a simplified cost based method was introduced for the "non-integral services". However, such a regime was criticized by the commentators, who noticed that the service cost based method called for quantitative judgments that business people were not qualified to make by themselves: this implied an increasing compliance costs for those tax payers who decided to opt for the safe harbor or the decision for not opting for the safe harbors for the other tax payers (thus frustrating in both the mentioned cases the aim of the regime itself). In light of the above, the simplified cost-based method was replaced by the services cost method, which expressly aims to reduce the quantitative judgements to be performed by the tax payers and, at the same time, to minimize the compliance burden of the services included in the safe harbor, which would typically bear low arm's length markups[179].

The objective scope of the current service cost method includes the services which meet all the four conditions mentioned below.

1) The services should belong to one of the two following categories of services:

- the specified covered services, the definition of which is delegated to the Internal Revenue Service. The implementing regulation is included in the Rev. Proc. 2007-13[180]. As clearly stated in the mentioned document, the

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[179] In this respect, see the considerations available in the section 2 of the Rev. Proc. 2007-13, available at <https://www.irs.gov/irb/2007-03_IRB#RP-2007-13>.

[180] The document is available at < https://www.irs.gov/irb/2007-03_IRB#RP-2007-13>.

activities identified in this revenue procedure are "support services common among taxpayers in a variety of industry sectors, and generally do not involve a significant arm's length markup on total services costs". In addition, as further stated in the mentioned document, the definition of covered services is deliberately broad (i.e. 101 different services are mentioned) in order to include the variety of activities existing in the different business sectors.

In light of the above, the mentioned document includes the following categories of services: Payroll, Premiums for Unemployment, Disability and Workers Compensation, Accounts Receivable, Accounts Payable, General Administrative, Corporate and Public Relations, Meeting Coordination and Travel Planning, Accounting and Auditing, Tax, Health, Safety, Environmental and Regulatory Affairs, Budgeting, Treasury Activities, Statistical Assistance, Staffing and Recruiting, Training and Employee Development, Benefits, Information and Technology (IT) Services, Legal Services, Insurance Claims Management and Purchasing[181].

- the low margin covered services, which are defined by the Regulation § 1.482-9 as those services for which the median comparable markup on total services cost is seven percent or less. In this respect, further guidance is provided by the following example included in the Regulation: "Company P renders certain accounting services to Company S. Company P uses the services cost method for the accounting services, and determines the amount charged as its total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (b), the interquartile range of arm's length markups on total services costs for these accounting services is between 3% and 9%, and the median is 6%. Because the median comparable markup on total services costs is 6%, which is less than 7%, the accounting services constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section"[182].

[181] Each of the mentioned categories is further specified in the Rev. Proc. 2007-13.
[182] See the Regulation, example 15.

2) The services should not belong to one of the categories which are expressly excluded from the scope of the safe harbor, i.e. manufacturing, production, extraction, exploration, or processing of natural resources, construction, reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement, research, development or experimentation, engineering or scientific, financial transactions (including guarantees) and insurance or reinsurance.

3) The services should not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure in one or more trades or businesses of the controlled group (i.e. the business judgement rule).

4) The services should confer a benefit for the recipient / recipients of the services and should not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure for the business of the multinational group. According to the guidance provided by the Internal Revenue Service, "[a]n activity is considered to confer a benefit if an uncontrolled taxpayer in circumstances comparable to the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent basis, or if the recipient would have performed for itself the same activity or a similar activity". In other words, the American tax authorities makes reference here to the guidance provided by the OECD Transfer Pricing Guidelines with reference to the so called benefit test[183].

If the services meet all the four requirements mentioned above, the tax payer can decide to opt for the safe harbor under analysis, which concretely implies that: i) only the costs related to the covered services (without applying any mark -up) should be allocated to the beneficiaries of the services, ii) the allocation should be performed on the basis of the respective shares of the reasonably anticipated benefits derived by each beneficiary from the services (without regard to whether the anticipated

[183] See paragraph 2.2 above.

benefits are in fact realized) and iii) there is no need to perform a full transfer pricing analysis.

However, for benefitting of the safe harbor and satisfying his burden of proof, the tax payer should collect and keep documentation supporting the fact that the above requirements are satisfied[184] [185].

[184] Such documentation includes: i) a statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for covered services pursuant to a shared services arrangement, ii) a list of the participants and the renderer or renderers of covered services under the shared services arrangement, iii) a description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits; and iv) a description of any aggregation of covered services for purposes of the shared services arrangement, and an indication whether this aggregation (if any) differs from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(3)(ii) of this section. For further details in this respect, see art. 7(ii)(C)(4) of the Regulation.

[185] For the sake of completeness and as a final consideration, the so called base erosion and anti-abuse tax (introduced by Public Law 115-97 issued on 22 December 2017 and generally known as the Tax Cuts and Jobs Act) should be mentioned: in a nutshell, it is imposed on US corporations and on foreign corporations that are engaged in business in the United States and whose average annual gross receipts is above the threshold of USD 500 million over the 3-taxable-year period ending with the preceding taxable year. The base erosion and anti-abuse tax applies if the corporation has gross receipts above a statutory threshold and makes tax-deductible payments to foreign related persons (the “base erosion payment”) and, as a result, has a “base erosion percentage” that exceeds a permissible limitation .

A ‘base erosion payment’ is defined as any amount paid or accrued to a foreign related person that is a related party of the taxpayer and with respect to which a deduction is allowable, including interest and royalties. However, payments for services are excluded from the definition of “base erosion payment” if such services qualify for the services cost method under section 482: such determination is made without regard to the requirement that the services should not contribute significantly to fundamental risks of the business (mentioned under number 3 of the present analysis) and the benefit test (mentioned under number 4 of the present analysis). In addition, as second requirement, the payments for services should not include any mark – up element. Thus, services that constitute the group’s core business can qualify if they are charged out at cost.

Taxpayers electing to make such payments at cost to remove the intercompany payments from the base erosion and anti-abuse tax equation must consider consequences in the foreign jurisdiction. An affirmative transfer pricing adjustment may be required to satisfy local transfer pricing requirements, and taxpayers should consider whether the local jurisdiction will impose withholding on the resulting deemed dividends.

For an analysis of the base erosion and anti-abuse tax, see M. M. LEVEY – A. MINKOVICH – J. D. ODINTZ – K. E. RIMPFEL, *Taking Stock of US ‘Tax Reform’ as the Dust Settles*, in *Intertax*, 2018 (Volume 46, Issue 4), p. 352; R. AVI-YONAH – G. MAZZONI, *BEPS, ATAP, and the New Tax Dialogue: ¿A Transatlantic Competition?*, in *Intertax*, 2018 (Volume 46, Issue 11), p. 885; C. P. GAUTRIN, *US Tax Cuts and Jobs Act: Part 1 – Global Intangible Low-Taxed Income (GILTI)*, in *Bulletin for International Taxation*, 2019, p. 73; C. P. GAUTRIN, *US Tax Cuts and Jobs Act: Part 2 – The Base Erosion and Anti-Abuse Tax (BEAT)*, in *Bulletin for International Taxation*, 2019, p. 154; M. HERZFELD, *Can GILTI + BEAT = GLOBE?*, in *Intertax*, 2019 (Volume 47, Issue 5), p. 504.

CHAPTER 3
TREATMENT OF CROSS BORDER DIGITAL SERVICES

Summary: 3.1. Some preliminary remarks – 3.2. The initiatives at the OECD level – 3.3. The initiatives at the UN level – 3.4. The initiatives at the European Union level – 3.4.1. The Digital Service Tax Proposal – 3.4.2. The Significant Digital Presence Proposal – 3.5. The unilateral measures at domestic level – 3.5.1. The Indian equalization levy.

3.1. Some preliminary remarks – A preliminary question arises with reference to the object of this second chapter, which is entitled to the treatment of cross border intra – group services: which is the impact of the digital economy on the topic under analysis (i.e. the taxation of services)?

As of today, there is no shared definition of digital economy; however, such a lack is quite understandable. On one hand, the digitalization represents indeed an extensive phenomenon, which encompasses all the businesses, with the consequence that «the digital economy is increasingly becoming the economy itself»[186]. Considering this aspect, scholarship has articulated the view according to which the term «digitalization of the economy» instead of «digital economy» would better apply to the current scenario. On the other hand, any tentative definition of the phenomenon under analysis is probably destined to become outdated in a short time, given the rapid development characterizing the digital economy. Having said that, the term «digital economy» is conventionally used in the context of this paper as a collective name making reference to a range of different activities – including the provision of services –, all of which have the following four salient characteristics in common[187].

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[186] OECD / G20 BEPS PROJECT, *Addressing the tax challenges of the Digital Economy – Action 1: 2015 Final Report*, 2015, available at <www.oecd.org>.

[187] For the description provided in the present analysis, the position of the European Union has been mainly taken into consideration since the Paper focuses on the EU Commission's proposal and also because the position of the European Union is quite aligned to that of the OECD. More specifically, the OEDC lists the following aspects as key features of the digital economy: i) mobility with respect to intangibles, users and business functions, ii) reliance on «big data», iii) network effects, iv) use of multi-sided business models, v) tendency toward monopoly or oligopoly and vi) volatility due to low barriers to entry and rapidly evolving technology (see OECD, *Action 1 Final Report (2015)*, *cit.*, at para. 4.3). In the more recent Interim Report published by the OECD, such aspects have been

i) Limited physical presence of the businesses active in the digital economy, as a consequence of the decreased need for local personnel to perform business functions and the corresponding increased ability to conduct the business activity remotely (so – called «scale without mass» phenomenon). In other words, digital undertakings are able to manage their global operations on an integrated basis from a jurisdiction, which may differ from that / those jurisdictions in which the operations are carried out and the suppliers and customers are located.

ii) The importance of intangible assets which are crucial contributors of value for digitalized businesses. In this respect, it is worth underlining that the aforementioned feature of «mobility» applies also to the intangible assets on which the digital companies rely on, since the function of managing intangible assets can be assigned and transferred from one location to another (particularly within the same multinational group), with important consequences on where business' profits are subject to tax.

iii) Tendency toward monopoly or oligopoly, especially in case of immature markets where the company acting as first actor is usually able to achieve a dominant position in a very short time;

iv) Reliance on big data which are available to digital business thanks to the user participation[188]. Data has always played an important role for businesses – also the traditional ones –; what characterizes the digital economy is the fact that data represent a component of the value creation process of such a relevance as never before: the use, collection and

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confirmed as key features of the digital economy, even if partially combined with each other. The result is a final list which includes the following aspects among the salient characteristics of the digital economy: i) cross – jurisdictional scale without mass, ii) reliance upon intangible assets (including intellectual property rights) and iii) data and user participation (see BEPS, *Tax Challenges Arising from Digitalisation – Interim Report*, Paris, 2018, at para 2.5).

[188] For a further analysis, see J. SINNIG, *The Reflection of Data-Driven Value Creation in the 2018 OECD and EU Proposals*, in *EC Tax Review*, 2018 (6), p. 326 s. For an interesting perspective, see also J. BECKER – J. ENGLISCH, *Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?*, in *Intertax*, 2019 (Volume 47 - Issue 2), p. 161. See also P. HOFMANN – N. RIEDEL, *Comment on J. Becker & J. Englisch, 'Taxing Where Value Is Created: What's "User Involvement" Got to Do with It?'*, in *Intertax*, 2019 (Volume 47, Issue 2), p. 172; A. S. SAMARI, *Digital Economy and Profit Allocation: The Application of the Profit Split Method to the Value Created by a "Significant Digital Presence, in International Transfer Pricing Journal*, 2019 (Volume 26), at para. 2.

analysis of data is becoming an integral part of the digitalized business models. In order to better understand such consideration, it is important to further analyse the process – consisting of several phases – through which data become value. First of all, data have to be generated thanks to online activities performed by the digital services users; such data are stored and collected and, after a relatively short period of time, become big data, because of their increasing volumes. Big data are than processed, interpreted and analyzed: such step is essential in order to make the collected big data valuable; only through such analysis indeed, big data become readable and, as such, valuable.

According to a persuasive reconstructive study made by the OECD[189], the involvement of the users in the phase of data origination characterizes all the business models of the digital economy. The level of such an involvement can instead vary from one business model to another. On one hand, the user participation is qualified as passive in all those cases in which the user does not perform any activity different to those strictly necessary in order to enjoy the online services (e.g. downloading an app, using a particular device or providing consent for user data to be collected). In all other cases, the user participation is qualified as active, even if with different possible levels. The lower level of user participation is required in case of recommendation mechanisms, involving activities such as bookmarking, tagging and rating, as it is typical for platforms providing for digital contents or IT solutions and e-commerce websites. An intermediary level of user participation characterizes instead activities such as writing comments and reviews (e.g. TripAdvisor) and taking and uploading photos and videos (e.g. Instagram and YouTube). The highest level of user participation is needed in case of social network (e.g. Facebook), in relation to which the user is asked to add friends and actively contribute to the creation of the community.

Moreover, also the way through which value is created from big data can differ from one digital business to another: several companies use

[189] OECD, *Interim Report (2018)*, *cit.*, at para 143 – 149.

directly the customer data collected for improving their own business operations while others monetize them by selling targeted online advertisements or, in any case, by transferring the user data to third parties.

Since the international tax rules currently in place have been established in the Twenties when the digital revolution was still far from happening, they disregard all the key features of the digital economy mentioned above. In very basic term, under the current international tax system, some sort of physical presence is required, being the permanent establishment the threshold for allocating any taxing right on the business profits of a non – resident company[190] to the market jurisdiction. However, as noted above, the business models of the digital economy are characterized by a limited physical presence: hence the major tension between the framework of reference provided by the international tax regime and the essential features of digital business models emerges. The result is the perception of the existence of what the scholarship has defined as a «(digital) international tax gap»[191].

3.2. The initiatives at the OECD level – Many initiatives have been taken both at the level of the OECD and at the level of the United Nations, in order to find a common solution for the challenges posed by the digital economy.

At the OECD level, the debate on how to fill the digital international tax gap dates back at least to 2013, when the OECD launched the 15 – point Action Plan on Base Erosion and Profit Shifting. As part of such Action Plan, the OECD requested for public comments in relation to the tax challenges raised by digitalization. After 2 year–long work, the OECD issued in October 2015 a final report (Action 1) acknowledging that the digital

[190] The threshold of the permanent establishment is met in case that the non – resident company operates through a fixed place of business in a given jurisdiction or, as an alternative, through a dependent agent (the so called «agency permanent establishment»).

[191] A. TURRINA, *Which "Source Taxation" for the Digital Economy?*, in *Intertax*, 2018, p. 495.

economy exacerbates BEPS risks, as well as poses some challenges for the international taxation.

In order to face such challenges, the OECD took into consideration three main options, namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalization levy. None of these three options were recommended at this stage by the OECD. The reason for such an approach was explained by the OECD through the following statement: "[t]his is because, among other reasons, it is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges, and that consumption taxes will be levied effectively in the market country"[192]. In other words, the result of the OECD work was the adoption of a «wait and see» approach, the main reason of which was the expectation that the anti – BEPS effects of other measures implemented within the BEPS project would have had a substantial impact not only on the BEPS issues, but also on the broader tax challenges posed by the digital economy.

However, OECD allowed countries to "introduce any of these three options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments"[193].

Starting from 2017, the debate on digital economy was further intensified both at international, EU and national level, suggesting that the "wait and see" approach proposed by the OECD was no more viable while there was a quite common political pressure to act quickly. Therefore, the

[192] OECD / G20 BEPS PROJECT, *Addressing the tax challenges of the Digital Economy – Action 1: 2015 Final Report*, cit., p. 13.

[193] OECD / G20 BEPS PROJECT, *Addressing the tax challenges of the Digital Economy – Action 1: 2015 Final Report*, cit., p. 13.

deliver of a follow-up of Action 1 was requested by the G20 Finance Ministers. Hence, in September 2017, the OECD opened a public consultation, the outcome of which was an Interim report issued in March 2018. In this occasion, the OECD takes a step forward if compared with the position expressed in BEPS Action 1: it acknowledges indeed that the tax challenges of the digital economy go beyond the boundaries of the BEPS concerns and address the redefinition of the criteria for the allocation of taxing rights on business profits among different jurisdictions. In this respect, the OECD states further that a consensus – based solution is needed for facing the challenges of the digital economy, that such kind of solution is not yet achievable since there are divergent views on how the issue should be approached and that, as a consequence, further work is needed, with the goal of producing an update in 2019 and a final report in 2020. In such an occasion, it appeared clear that reaching an agreement at global level was likely to be challenging.

Such an update consists of a new report entitled to "Addressing the tax challenges of the digitalization of the economy" (hereinafter also referred to as the "Report"), which has been opened for public consultation in March 2019[194]. At the time of the present analysis, the public consultation is closed: a report – updated in the light of the comments received during the public consultation – is than expected from the OECD.

The Report provides for three main proposals for revising the profit allocation and nexus rules in response to these challenges posed by digitalization. The first proposal is named the user – participation proposal: it moves from the consideration that "the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses". The user – participation proposal is implemented as a targeted measure since it would be applicable only to highly digitalized businesses above a size threshold for which user participation is seen to represent a significant contribution to value creation.

[194] See OECD / G20 BEPS PROJECT, *Public Consultation Document – Addressing the tax challenges of the digitalization of the economy*, 16 February – 6 March 2019, available at <www.oecd.org>.

A profit split approach is recommended. More specifically, such an approach would consist of the following four phases: 1. Calculating the residual or non-routine profit of a business, i.e. the profits that remain after routine activities have been allocated an arm's length return; 2. Attributing a proportion of those profits to the value created by the activities of users, which could be determined through quantitative/qualitative information, or through a simple pre-agreed percentage; 3. Allocating those profits between the jurisdictions in which the business has users, based on an agreed allocation metric (e.g. revenues); and 4. Giving those jurisdictions a right to tax that profit, irrespective of whether the business has a taxable presence in their jurisdictions that meets the current nexus threshold.

In case that such an approach would have been agreed, an ad – hoc regulation would be needed, in order to define the profit allocation and nexus rules. More specifically, with reference to the phase 1 mentioned above, the Report takes the view that the "amount of profit (or loss) to be re-allocated would likely not be determined by using existing transactional transfer pricing methods. Instead, a new type of residual profit split method could be mandated, relying on more simplified conventions for determining such profit and approximate results consistent with an application of the arm's length principle". The same view is confirmed also for phases 2 and 3, in relation to which the Report states that the "profit (or loss) to be re-allocated to the relevant user or market jurisdictions must be apportioned based on an agreed allocation metric. This metric would need to be a reasonable proxy for the relative value created in each jurisdiction and be administrable by taxpayers and tax authorities alike. The most straight-forward approach may be to allocate this profit to user or market jurisdictions based on sales or revenues, though other approaches involving users, expenditures in particular jurisdictions, etc., might also be considered".

The second proposal is named marketing intangible proposal: it moves from the consideration that a multinational "group can essentially "reach into" a jurisdiction, either remotely or through a limited local presence (such as an LRD), to develop a user/customer base and other marketing

intangibles". The marketing intangible proposal has a wider application than the user – participation proposal: it is indeed not implemented as a targeted measure since it would be applicable to the tax payers active in all the industry sectors (i.e. not only to the highly digitalized businesses). However, a size threshold is recommended in order to exclude the small companies from the objective scope of the regulation.

A profit split approach is recommended also in this case. More specifically, such an approach would consist of the following four phases: 1. calculating the residual or non-routine profit of a business, i.e. the profits that remain after routine activities have been allocated an arm's length return; 2. attributing a proportion of those profits to the value created by the marketing intangibles (in this respect, a customer list would seem to be the marketing intangible that has the closest "intrinsic functional connection" to a market jurisdiction); 3. allocating those profits between the jurisdictions in which the business has marketing intangibles on the basis of an agreed allocation metric (e.g. revenues); and 4. giving those jurisdictions a right to tax that profit, irrespective of whether the business has a taxable presence in their jurisdictions that meets the current nexus threshold.

In case that such an approach would have been agreed, an ad – hoc regulation would be needed, to define the profit allocation and nexus rules. The same considerations made above for the user – participation proposal apply also to the marketing intangible proposal under analysis.

The third proposal is named the "significant economic presence" proposal: it moves from the consideration that the "digitalization of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence. According to this view, these technological advances have rendered the existing nexus and profit allocation rules ineffective".

Under this proposal, a taxable presence in a jurisdiction would arise when a non-resident enterprise has a significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with

the jurisdiction via digital technology and other automated means. As example of factors, we can mention the revenue generated, the existence of a user base and the associated data input, the volume of digital content derived from the jurisdiction, billing and collection in local currency or with a local form of payment, the maintenance of a website in a local language, responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance or sustained marketing and sales promotion activities, either online or otherwise, to attract customers. Such an approach would consist of the following three phases: 1. the definition of the tax base to be divided, 2. the determination of the allocation keys to divide that tax base, and 3. the weighting of these allocation keys.

The Report does not include the details of the proposal based on the concept of significant economic presence, since these latter were "still emerging at the time of drafting this consultation document"; however, the significant economic presence proposal essentially is worldwide formulary apportionment.

Looking to the comments received on the occasion of the public consultation[195], the proposals included in the Report have been widely criticized: almost all the practitioners claim to avoid the introduction of new ad hoc profit allocation and nexus rules; an effort is asked in order to adapt the existing profit allocation and nexus rules to the new challenges posed by the digitalization of the economy.

A program of work laying out a process for reaching a new global agreement for taxing multinational enterprises has been approved in May 2019 by members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting[196]: the aim is to design a commonly accepted long – term solution in 2020.

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[195] See the comments available at <www.oecd.org>. The comments presented by the Digital Economy Group and Bonelli Erede appear of particular interest for the purposes of the present analysis.

[196] OECD / G20 BEPS PROJECT, *Programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy*, May 2019, available at <www.oecd.org>.

3.3. The initiatives at the UN level – At the United Nations Level, the Committee of Experts on international cooperation in tax matters has issued a report entitled to the «Tax Challenges in the Digitalized Economy», with the aim to take a proactive approach in the on - going debate on the solution required for tackling the challenges of the digital economy, with particular attention to the needs of the developing countries[197].

As a result of such debate, the introduction of article 12A in the UN Model Convention, which allows for a withholding tax on the service fees paid to non – resident entities, is worth recalling, since it represents the main measure taken at the UN level for facing the challenges posed by the digital economy: for an analysis, see the above chapter 1.4.

3.4. The initiatives at the European Union level – The initiative at the European level dates back to the 2013 launch of the BEPS project and in particular of Action 1 related to the Digital Economy. More specifically, with the aim to be proactive in response to the OECD initiative, the European Commission set up a group of experts, assigning them the task to develop a comprehensive Union position on tax issues in the digital economy. The outcome of the experts' work was included in a report, according to which, among the others, no special tax regime should be introduced for digital companies, but any reform should have structured in general terms, with the introduction of simple, stable and predictable tax rules, the need of which has been strengthened by the digitalization.

In these years, the European Commission kept on working on the challenges of the digital economy, setting the creation of a Digital Single Market as one of its ten key priorities, with the aim of making Europe as world leader in the digital economy. Within the so called Digital Single Market strategy, the Commission committed to ensure access to online activities for individuals and businesses under conditions of fair competition,

[197] UN COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS, *Tax challenges in the digitalized economy. Selected issues for possible Committee Consideration*, 17 – 20.10.2017, available at <www.un.org>.

as well as to open up digital opportunities for people and business and enhance Europe's position as a world leader in the digital economy[198]. Direct taxation was deemed by the European Commission to be one of the topics to be addressed – even if, at this stage, not the most important one – in order to make such a Digital Single Market concrete.

The importance of setting up a Digital Single Market has been further remarked by the European Commission in May 2017. In the following July, a discussion on the challenges of the taxation of profits of the digital economy was launched within the Council of the European Union. On September 2017 in the contest of his State of the Union speech, the President of the European Commission sent a letter of intent to the President of the European Parliament and the President of the European Council, announcing a legislative proposal establishing rules at EU level allowing taxation of profits generated by multinationals through the digital economy. The Finance Ministers of Germany, France, Spain and Italy signed a joint political statement in support of EU law compatible and effective solutions “based on the concept of establishing a so called equalization tax on the turnover generated in Europe by the digital companies”. At the informal ECOFIN meeting in Tallinn on 16 September 2017, six more member states expressed their interest and support to the approach suggested in the aforementioned joint political statement. In its communication entitled to «A Fair and Efficient Tax System in the European Union for the Digital Single Market» adopted on 21 September 2017, the Commission identified the challenges that the digital economy poses for existing tax rules and committed to analyze the policy options available. Following the Digital Summit in Tallinn on 29 September 2017, the European Council adopted on 19 October 2017 conclusion that underlined the «need for an effective and fair taxation system fit for the digital area». The ECOFIN Council conclusions of 5 December 2017 invited the

[198] EUROPEAN COMMISSION, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee and the Committee of the Regions 'A Digital Single Market Strategy for Europe'* (COM(2015) 192 final of 6.5.2015), available at <http://eur-lex.europa.eu/>.

Commission to adopt proposals responding to the challenges of taxing profits in the digital economy, highlighting the interest of many Member States for temporary measures, such as for example an equalization levy based on revenues from digital activities in the EU that would remain outside the scope of double tax conventions. Moreover, the ECOFIN Council conclusions of 5 December 2017 underlined that a globally accepted definition of permanent establishment and the related transfer pricing and profit attribution rules should also remain pivotal when addressing the challenges of taxation of profits of the digital economy" and encourages "close cooperation between the EU, the OECD and other international partners in responding to the challenges of taxation of profits of the digital economy.

In March 2018, the European Commission published a package on fair taxation of the digital economy, which should represent the answer given by the European Commission to the aforementioned calls coming from several Member States of reacting quickly to the international tax gap. Indeed, as clearly acknowledged by the Commission itself, "the ideal approach would be to find multilateral, international solutions to taxing the digital economy, given the global nature of this challenge. The Commission is working closely with the OECD to support the development of an international solution. However, progress at international level is challenging, due to the complex nature of the problem and the wide variety of issues that need to be addressed, and to reach international consensus may take time. This is why the Commission has decided to take action. The present proposal is intended to contribute to the ongoing work at OECD level, which remains essential in order to reach a global consensus on this topic. By setting out the EU's vision on how to address in a comprehensive way the challenges of the digital economy, the proposed Directive will serve as an example to influence the international discussions on a global solution"[199].

[199] See the explanatory memorandum accompanying the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence (COM(2018) 147 final of 21.03.2018), available at <http://eur-lex.europa.eu/>, p. 4.

The aforementioned package consists of a directive proposal for the introduction of an interim digital service tax within the European Union[200], which – in the intention of the European Commission – would represent a short – term solution able to face immediately the challenges posed by the digital economy ("Digital Service Tax Proposal"). Alongside the Proposal, the European Commission has issued another legislative proposal which constitutes the Commission's preferred long – term solution since it aims to reform corporate tax rules by introducing the concept of «significant digital presence»[201] ("Significant Digital Presence Proposal"). The distinction between the long – term and the short – term solution lies in the fact that only the former requires an amendment of the tax treaty framework currently in place (and, as a consequence, needs more time to be effectively implemented)[202]. The interaction between the two proposals lies thus in the fact that the Digital Service Tax Proposal should apply on a temporary basis until the comprehensive solution included in the Significant Digital Presence Proposal is in place.

The package issued by the European Commission includes also a recommendation "relating to the corporate taxation of a significant digital presence"[203], which sets the recommendations to Member States for including corresponding rules on a significant digital presence and profit allocation in their double taxation treaties with third countries. The package includes also a communication setting the context and explaining the articulation between the proposals[204].

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[200] EUROPEAN COMMISSION, *Proposal for a Council directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services* (COM (2018) 148 final of 21.03.2018), available at <http://eur-lex.europa.eu/>.

[201] EUROPEAN COMMISSION, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence (COM (2018) 147 final of 21.3.2018)*, available at http://eur-lex.europa.eu/. For an analysis, see R. PETRUZZI - V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, in European Taxation, 2018, p. 58.

[202] In this respect, see A. TURRINA, *cit.*, p. 502.

[203] EUROPEAN COMMISSION, *Commission Recommendation of 21.3.2018 relating to the corporate taxation of a significant digital presence* (C(2018) 1650 final of 21.3.2018), available at http://eur-lex.europa.eu/.

[204] EUROPEAN COMMISSION, *Communication from the Commission to the European Parliament and the Council - Time to establish a modern, fair and efficient taxation standard*

Even if it is now clear that the unanimity of all the Member States required for their approval is lacking (see the outcome of the EU Finance Ministers' meeting held in March 2019 in Brussels), the proposed directives appear to be still of interest, since they represent the first legislative tentative coming from a regional organization to face the challenges posed by the digital economy. In last paragraph 5, the domestic framework is taken into consideration, with reference to the Indian equalization levy.

3.4.1. The Digital Service Tax Proposal – Preliminarily, it appears important to warn as from now the reader that all the available scholars' comments on the Proposal are quite negative[205].

The objective scope of the digital service tax is defined by article 3 of the Digital Service Tax Proposal, which qualifies as taxable revenues those resulting from the following services:

i) The placing on a digital interface of advertising targeted at users of that interface as well as the transmission of data collected about users and generated from users' activities on digital interfaces. The word «interface» is broadly interpreted by the Digital Service Tax Proposal (art. 2.3), in order to include any software, website or application that can be accessed by a user – both individual or business (art. 2.4 of the Digital Service Tax

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for the digital economy (COM(2018) 146 final of 21.3.2018), available at http://eur-lex.europa.eu/.

[205] J. BECKER, J. ENGLISH, *EU Digital Services Tax: a populist and flawed proposal*, in *Kluwer International Tax Blog* (March 2018), available at http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/; CFE FISCAL COMMITTEE, *Opinion Statement FC 1/2018 on the European Commission Proposal of 21 March 2018 for a Council directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services*, in *European Taxation*, 2018, p. 371; C. DIMITROPOULOU, *The Proposed EU Digital Services Tax: An Anti-Protectionist Appraisal Under EU Primary Law*, in *Intertax*, 2019 (Volume 47 - Issue 3), p. 268; M. LAMENSCH, *Digital Services Tax: A Critical Analysis and Comparison with the VAT System*, in *European Taxation*, 2019 (Volume 59 - No. 6); A. M. JIMÈNEZ, *BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties*, in *Intertax*, 2018, p. 635; G. KOFLER – J. SINNIG, *Equalization Taxes and the EU's 'Digital Services Tax*', in *Intertax*, 2019 (Volume 47 - Issue 2), p. 176; L.A. SHEPPARD, *Digital permanent establishment and digital equalization taxes*, in *Bull. Intl. Taxn.*, 2018; D. STEVANATO, *"Digital Tax" all'europea: una creatura deforme* (March 2018), available at https://www.leoniblog.it/2018/03/23/digital-tax-alleuropea-creatura-deforme-dario-stevanato/; A. TURRINA, *cit.*; F. VAN HORZEN – A. VAN ESDONK, *Proposed 3% Digital Services Tax*, in *International Transfer Pricing Journal*, 2018, p. 267.

Proposal). By this way and making reference to the taxonomy included in the Impact Assessment[206], the proposed directive aims to tax all the fees resulting from those business models, in which access to a service (e.g. social network or search engine) is granted to users for free and personal data obtained from such users are than monetized by selling targeted advertisement placements or by selling the data itself to others businesses (e.g. Google and Facebook). In those cases where the supplier of the advertising service and the owner of the digital interface are different entities, only the former should be taxed, in order to prevent cases of double taxation (art. 3.3 of the Digital Service Tax Proposal).

ii) The making available to users of a multi-sided digital interface which allows users to find other users and to interact whit them, and which may also facilitate the provision of underlying supplies of goods or services directly between users (art. 3.1 b) of the Digital Service Tax Proposal). With reference to such kind of revenues, the Digital Service Tax Proposal aims to tax those fees paid by the users to access a platform, where the users offer services or goods among themselves (e.g. Airbnb or Blablacar). The revenues resulting from the supplies of goods and services made directly by the users connected thanks to the digital interface do not fall instead within the definition of taxable income according to the proposed Directive.

As expressly provided for in article 3.4.a of the Digital Service Tax Proposal, fees paid by users for accessing digital platforms which make available to them digital contents / IT solutions fall outside the scope of the Digital Service Tax Proposal (i.e. digital platforms providing media / content, gaming, electronic communication and payment services, cloud computing services and other digital solutions / software; in order to give some concrete examples, we can mention Netflix or Spotify). Further exemptions are provided for financial trading and crowd funding (art. 3.4.b – c of the

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[206] EUROPEAN COMMISSION, *Commission staff working document. Impact Assessment accompanying the documents "Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence" and "Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services"* (SWD (2018) 81 final/2 of 21.3.2018), available at http://eur-lex.europa.eu/, Box 1 at p. 15.

Digital Service Tax Proposal). Also revenues related to distant sales model / e- commerce (Amazon) do not fall within the objective scope of the proposed digital service tax (preamble 13 of the Digital Service Tax Proposal).

In light of the above, it appears clear that the European Commission has opted for a targeted approach, selecting only some of the revenues resulting from the digital services. The reasoning of the European Commission underlying such selection appears quite articulate, even if it is not so clearly expressed in the Impact Assessment. Trying to build up all the logical steps, it appears correct to describe the reasoning of the European Commission as follows: the user participation contributes significantly to the creation of value for the digital businesses; such value is created in the user's jurisdiction and should be taxed there, according to the common shared «value creation» rationale which is a widely accepted principle pervading the whole BEPS project; however, under the current international tax rules, no taxing right is recognized to the user's jurisdiction because the services are provided remotely by the digital businesses with no physical presence in the market country or, in any case, with a very limited physical presence not meeting the permanent establishment threshold; in order to provide for a «fair» taxation – «fairness» is a recurring key word in the Digital Service Tax Proposal –, the best solution would be to implement a long term measure which would however require a global consensus – based solution and (probably) a coordinated amendment of the double tax treaties (and more time); but since there is a political imperative from some Member States to react quickly, a short term measure to be implementable within a reasonable time span is proposed, by selecting only those services «where the participation of a user in a digital activity constitutes an essential input for the business carrying out that activity and which enable that business to obtain revenues therefrom»[207], provided that they «are responsible for the greatest difference between where profits are

[207] In this respect, see considerations made in paragraph 2 above.

taxed and where value is created»[208]. In other words, «[t]he interim solution is meant to be a good and simple interim proxy to deal with the most extreme cases of mismatches between the location of taxation and value creation»[209].

Taxpayers for the purposes of the digital service tax are all those legal entities[210] –irrespective of their tax residence –, which meet both of the following thresholds in a given year: i) a worldwide turnover exceeding Euro 750 million and ii) an amount of revenues subject to the digital service tax obtained within the European Union above Euro 50 million (art. 4 of the Digital Service Tax Proposal).

The first threshold (based on the total annual worldwide revenues) aims mainly to limit the application of the tax to companies of a certain scale, assuming that, as noted above[211], digital economy is characterized by big players taking the most advantage from the current digital international tax gap[212]. In this respect, the choice of the European Commission to set the same threshold as that provided for the country – by – country reporting[213] and for the common corporate tax base[214] appears positive, since it contributes to set up a coherent and easy framework in which market operators are required to take always the same threshold as reference for the applicability of a given tax regime / requirement. The second threshold aims instead, according to the European Commission's intentions[215], to limit the application of the digital service tax to those cases where there is a significant digital footprint at Union Level in relation to the revenues covered by the digital service tax.

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[208] EUROPEAN COMMISSION, *Explanatory memorandum of the Proposal*, *cit.*, at para. 5.

[209] EUROPEAN COMMISSION, *Impact Assessment*, *cit.*, at para. 9.3.2, where further considerations of the European Commission are available.

[210] Meaning any legal person or legal arrangement that carries on business through either a company or a structure transparent for tax purposes (art. 2.1 of the Proposal).

[211] In this respect, see considerations made in paragraph 2 above.

[212] EUROPEAN COMMISSION, *Explanatory memorandum*, *cit.*, p. 10.

[213] EUROPEAN COUNCIL, *Directive EU 2016/881 of 25 may 2016 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation*, available at http://eur-lex.europa.eu/.

[214] EUROPEAN COMMISSION, *Proposal for a council directive on a common corporate tax base* (COM (2016) 685 final of 25.10.2016), available at http://eur-lex.europa.eu/.

[215] EUROPEAN COMMISSION, *Explanatory memorandum*, *cit.*, p. 10.

The applicability of the digital service tax is extended by the Commission to both EU and non – EU entities, in order to make it compatible with the European Union law as well as with the International Trade Law. More specifically, with reference to the European Union primary law, the freedom to provide services (article 56 of the Treaty on the Functioning of the European Union ("TFEU")) implies the elimination of all discrimination on grounds of nationality, as well as the abolition of any restriction which is liable to prohibit, impede or render less attractive in concrete the activities of a foreign service provider[216]. At the international level, an analogous constraint is provided by article XVII of the General Agreement on Trade in Services, which prohibits a less favorable treatment of foreign service providers compared to the domestic one[217].

In this respect, some authors[218] have taken the view that the proposed digital service tax would in concrete address mainly non – EU (US) digital companies, determining a de facto discrimination for the foreign service providers. Such a conclusion seems to be confirmed by the data provided by the European Commission itself[219], according to which only a 7,2% share of the EU digital companies will meet both the thresholds set up by the European Commission.

Moreover, in a broader perspective, such an extension of the subjective scope of the digital service tax does not appear coherent with the ultimate rationale of the tax under analysis, i.e. to tax fairly those entities who are non – resident within the European Union but create value there thanks to the European Union's users. In other words, because of the

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[216] CJEU, Judgment of 22 October 2014, *Blanco and Fabretti*, joined cases C-344/13 and C-367/13, EU:C:2014:2311, available at http://curia.europa.eu/.

[217] For an in – depth analysis (also with reference to the doubts of compatibility with the EU State aid law and VAT law), see N. BAMMENS - Y. BRAUNER - V. CHAND - R.J. DANON - L. DE BROE - P. PISTONE - L. SPINOSA - A. TURRINA, *Request for input on work regarding the tax challenges of the digitalized economy* (October 2017), available at http://www.unil.ch/taxpolicy/. See also C. DIMITROPOULOU, *The Digital Services Tax and Fundamental Freedoms: Appraisal Under the Doctrine of Measures Having Equivalent Effect to Quantitative Restrictions*, in *Intertax*, 2019 (Volume 47, Issue 2), p. 201.

[218] J. BECKER, J. ENGLISH, *EU Digital Services Tax: a populist and flawed proposal*, *cit.*; A. M. Jimènez, *BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties*, *cit.*; L.A. SHEPPARD, *Digital permanent establishment and digital equalization taxes*, *cit.*

[219] EUROPEAN COMMISSION, *Explanatory memorandum*, *cit.*, p. 68.

aforementioned comprehensive approach, the Digital Service Tax Proposal seems to go beyond its purposes, providing for the introduction of a new indirect tax also to entities which are assumed to be already fairly taxed, i.e. Member States tax resident entities, as well non – EU entities operating with a permanent establishment within the European Union. This would lead to a situation of double taxation, about which the Digital Service Tax Proposal provides only for a deductibility of the digital service tax from the corporate tax basis[220].

As far as the place of taxation is concerned, those revenues deemed as taxable according to article 3 of the Digital Service Tax Proposal shall be treated as obtained in a member state if the user of the corresponding digital service is located in that Member State. In other word, the users create the connection between the taxpayer and the European Union. More in detail:

i) With reference to the placing on a digital interface of targeted advertising, the user shall be deemed to be located in a member state if the advertising in question appears on the user's device when the device is being used in that member state (article 5.2.a). In case of transmission of data collected about users and generated from users' activities on digital interfaces, the territorial condition is met if the data transmitted are those generated from the user while using a device in that member state (article 5.2,c).

ii) With reference to the multi – sided digital interfaces instead, a distinction is made if there is an underlying supply of services or goods between the users of the platform. If this is the case, the territorial requisite is met if the user uses a device in that Member State to access the digital interface and conclude the underlying transaction. Otherwise, the user shall be deemed to be located in a member state only if he has an account opened using a device in that Member State (article 5.2.b).

In this respect, the Digital Service Tax Proposal further clarifies that the Member state where a user's device is used shall be determined by

[220] See Recital 27 of the Proposal, which in any case represents only a recommendation to the Member States and not an obligation.

reference to the Internet Protocol address of the device (art. 5.5 of the Digital Service Tax Proposal).

The provisions related to the place of taxation are probably the most interesting ones since their wording, as well as their structures appear totally new for the current tax system. Somehow such provisions disclose more than the others the European Commission's tentative (and the corresponding difficulty) to find adequate measures to fill the currently existing international tax gap.

The combined presence of the three aforementioned elements (i.e. taxable revenues obtained by a taxable person in a Member State) would make the proposed digital service tax applicable.

Moreover, from a practical point of view, this means that, in case that a digital business has (as it is quite likely to be) both EU and non – EU users, the share of revenues related to users non located within the European Union (and thus not covered by the digital service tax) should be firstly split from the total taxable revenues and then the remaining share of revenues should be apportioned within the Member States according to the several allocation keys laid down in article 5.3 of the Digital Service Tax Proposal for each type of taxable service. In case of businesses with users active only within the European Union, only the aforementioned second step should be implemented, in order to define the proportion of taxable revenues obtained in each Member State. Finally, in case of a pure domestic situation in which all the users of a digital business are located in the same member state, all the relevant revenues should be taxed there. Once determined the share of taxable revenues of each Member State in a given tax year, the digital service tax due in that member state shall be calculated applying the single rate of 3%.

As far as the administrative aspects are concerned, a One – Stop – Shop simplification mechanism is provided by the Digital Service Tax Proposal: digital businesses can enjoy a single contact point, through which they can identify themselves for the purposes of the digital service tax, submit the relevant return and provide for the corresponding payments. A

system of administrative cooperation should than allow the exchange of information as well as the transfer of the relevant payments between the member state of identification and the others where digital service tax is due (chapter 4 of the Digital Service Tax Proposal): by this way, a new requirement for administrative cooperation has been introduced within the current EU framework[221]. About such collection system, many doubts arise since it would probably share the same problem of the VAT one – stop – shop.

Being at the end of our critical reading of the Digital Service Tax Proposal, it seems appropriate to go back to the first line of the proposed directive, according to which its legal basis is article 113 of TFEU stating that the European Union is admitted to adopt «provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition». This means that, in order to recognize the competence of the European Union with reference to the Digital Service Tax Proposal, two conditions should be met. First of all, the digital service tax should be qualified as an indirect tax – as the European Commission does[222]. Moreover, the Digital Service Tax Proposal should be a necessary measure in order to eliminate, as far as possible, factors that may distort conditions of competition or hinder the free movement of goods and services, whether at the national or community level. Moreover, a special legislative procedure should be followed, which requires unanimity of all the Member States for the adoption of the Digital Service Tax Proposal.

[221] For a reconstructive study of the framework currently provided at the European Union level with reference to the administrative cooperation in the field of taxation, see G. MARINO, *International and European measures for de – offshoring: global ambitions and local hypocrisies*, in *Intertax*, 2017, p. 530.

[222] EUROPEAN COMMISSION, *Impact assessment*, *cit.* For a critical position of such qualification, see, among the others, A. TURRINA, *cit.* See also D. HOHENWARTER – G. KOFLER – G. MAYR – J. SINNIG, *Qualification of the Digital Services Tax Under Tax Treaties*, in *Intertax*, 2019 (Volume 47, Issue 2), p. 140. See the results of the EU Finance Ministers' meeting held in March 2019 in Brussel.

As of today, such unanimity does not exist[223]. One could argue if, in case of absence of unanimity, the Member States in favor of the Commission's Digital Service Tax Proposal (as Italy would be) could decide to introduce the interim measure by means of enhanced cooperation; however, also this root does not appear feasible since such a cooperation shall in any case not imply an undermining of the internal market, a barrier to trade between Member States, a distortion of the competition or a violation of the sovereignty of the other member states (see articles 326 – 327 of the TFEU). The result is that the adoption of the Digital Service Tax Proposal appears far from obvious, calling the European Union to keep on working on a global solution at the OECD level.

As it has been noted, «in one way or another, it would seem that the existing body of international and supranational rules posing counter-limits on the adoption of unilateral measures are so pervasive that, were they to be eventually implemented, could actually appear as an equalization levy in name only or as a type of levy with fairly concerning distortive effects. Such a conundrum would seem to suggest that the current international legal framework appears more successful than anticipated in making international tax coordination unavoidable, virtually undermining the enactment of unilateral measures that would be in line with the policy objectives that have been outlined above»[224].

A final consideration should be articulated with reference to the item of the data protection. As mentioned above, the place of taxation for the purposes of the proposed digital service tax should be determined on the basis of the Internet Protocol address of the device of the users or, if more accurate, on the basis of other methods of geolocation. In this respect, the Proposal provides in generic terms that data should be collected for the purposes of the Proposal in a way that does not allow for the identification of the users (art. 5.6 of the Proposal). In addition to the above, recital 34 of

[223] See F. GUARASCIO, *EU digital tax on corporate turnover faces uphill road*, Reuters, 2018, available <at https:// www.reuters.com/article/us-eu-ecofin-tax/eu-digital-tax-on-corporateturnover-faces-uphill-road-idUSKBN1HZ0JS>.

[224] A. TURRINA, *Which "Source Taxation" for the Digital Economy?*, *cit.*, p. 519.

the proposed Directive (even if not legal binding for the Member States) provides that any processing of personal data should be conducted in accordance with the EU Regulation 2016/679[225], with the further clarification that «[w]henever possible, personal data should be rendered anonymous» (emphasis added). The perception is that, at least in the field of taxation, the concerns about the right of the tax payers to protect their data still remain unanswered.

3.4.2. The Significant Digital Presence Proposal – As stated in the explanatory memorandum accompanying the Significant Digital Presence Proposal, the latter aims at "addressing the issues raised by the digital economy by setting out a comprehensive solution within the existing Member States' corporate tax systems. It provides a common system for taxing digital activities in the EU which properly takes into account the features of the digital economy".

In light of such an aim, the objective scope of the Significant Digital Presence Proposal includes rules for establishing a taxable nexus for digital businesses operating across border in case of a non-physical commercial presence (i.e. extending the concept of permanent establishment in order to include the concept of significant digital presence), as well as rules for attributing profits to a digital business (i.e. the significant digital presence) (art. 1 of the Significant Digital Presence Proposal).

Looking to the subjective scope of the Significant Digital Presence Proposal (art. 2 of the Significant Digital Presence Proposal), it covers i) corporate taxpayers resident in a Member State, ii) corporate taxpayers resident in a third country (i.e. a non-EU Member State) with which there is no treaty for the avoidance of double taxation in force with the Member State where a significant digital presence of the taxpayer is identified; and iii) corporate taxpayers resident in a third country (i.e. a non-EU Member State)

[225] EUROPEAN PARLIAMENT AND COUNCIL, *Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC*, available at http://curia.europa.eu/.

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with which there is a treaty for the avoidance of double taxation in force with the Member State where a significant digital presence of the taxpayer is identified including a similar provision on a significant digital presence that creates similar rights and obligations in relation to that non-EU jurisdiction.

Regarding point iii), as already pointed out, the European Commission published a recommendation for Member States aimed at including corresponding rules on significant digital presence and profit allocation in their treaties for the avoidance of double taxation with third countries. Moreover, it appears clear that, in case of entry into force of the Significant Digital Presence Proposal, the concept of similarity should be clarified by the jurisprudence of the European Court of Justice. The vagueness of the term has been indeed pointed out by the scholars[226]: it is clear that the concept of "similarity" in this context means substantive similarity, i.e. similar rights and obligations, instead of similarity of wording, there remains room for interpretation as to whether the similarity between the corresponding concepts of the relevant tax treaty and the Significant Digital Presence Proposal are sufficiently alike. A related question is if the regime provided by the Significant Digital Presence Proposal still applies to a business of a third country even if treaty provisions correspond to a large extent to the Significant Digital Presence Proposal, but not completely[227].

Moreover, the provisions will remain quasi inapplicable in relation to third countries especially in Member States with a well-developed treaty network, as long as Double Tax Conventions are not adapted on a more global level. Such an aspect appears particularly true for the United States resident companies, which represent the main target of the European Union initiative and do not seem to aspire for a (prompt) adaptation of their double

[226] M. NIEMINEN, *The Scope of the Commission's Digital Tax Proposals*, in *Bulletin for International Taxation*, 2018, p. 664, available at <www.ibfd.org>.

[227] For instance, the concept of a significant economic presence that is somewhat similar to the Significant Digital Presence Proposal is being introduced in India and may eventually find its way into the tax treaties that India concludes with Member States (see Government of India, Memorandum Explaining the Provisions in The Finance Bill, 2018 p. 8, available at <www.indiabudget.gov.in/memo.asp>). This implies that, with regard to India, a Member State must determine if the definitions of a permanent establishment and the profit attribution rules correspond in a way that permits the application of the regime provided by the Significant Digital Presence Proposal to Indian businesses.

tax conventions: here it emerges clear the rationale existing behind the short – term measure.

Article 4 of the Significant Digital Presence Proposal sets the definition of the concept of significant digital presence. Such proposed new taxable nexus aspires to establish a proxy for a high degree of economic integration in the source jurisdiction equivalent to that of a traditional permanent establishment.

This is founded on the significant digital presence of the non-resident enterprise in the source jurisdiction and is proposed to be applicable in addition to and in parallel with the traditional permanent establishment concept. According to article 4(2) of the Significant Digital Presence Proposal, indeed, the permanent establishment set by a significant digital presence "shall be in addition to, and shall not affect or limit the application of, any other test under Union or national law for determining the existence of a permanent establishment in a Member State for the purposes of corporate tax, whether specifically in relation to the supply of digital services or otherwise". It is evident from this paragraph that the digital permanent establishment concept will co-exist with, instead of replacing, the traditional permanent establishment concept, which will not be affected by the new nexus. Therefore, it seems that the new definition will not prevail over the traditional one. However, questions might arise regarding whether the same enterprise could have both a digital and a traditional permanent establishment in the same EU Member State by virtue of the same activities or whether two different source rules (digital and traditional PE) could be applicable in respect of (part of) the same activity. This would be the situation especially for businesses that rely on both physical and digital presence. Although this situation would undoubtedly give rise to an assessment of the presence of a nexus in the source state, the rules for the determination of the profits attributable to that PE would need to be clarified in circumstances in which these rules apply different profit attribution concepts based on the type of nexus (i.e. physical versus digital presence).

This digital footprint is deemed to exist i) when the business carried on by the non-resident entity consists wholly or partly of the supply of digital services and ii) when the mentioned digital business carried by the non – resident entity benefits of a large user base in the source jurisdiction, which is to be substantiated through the application of three different objective tests, i.e. the amount of revenue from the provision of digital services to users, the number of users of digital services and the number of contracts for digital services.

As already pointed out, the business carried on by the non-resident entity should consist wholly or partly of the supply of digital services through a digital interface[228] (art. 4(3) of the Significant Digital Presence Proposal). The digital services are defined by art. 3(5) of the Significant Digital Presence Proposal as those "services which are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology". On one hand, the mentioned article 3(5) provides for an illustrative list of the digital services, including i) supply of digitalized products generally (e.g. software), ii) services providing or supporting a business or personal presence on an electronic network (e.g. website or a webpage), iii) services automatically generated from a computer via the internet or an electronic network in response to specific data input by the recipient, iv) the transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market on which potential buyers make their bids by an automated procedure and on which the parties are notified of a sale by electronic mail automatically generated from a computer, v) Internet Service Packages (ISP) of information in which the telecommunications

[228] The meaning of "digital interface" is given by article 3(2) of the Significant Digital Presence Proposal: according to the mentioned article, a digital interface is "any software, including a website or a part thereof and applications, including mobile applications, accessible by users". However, the wording is not completely clear, creating uncertainty as to whether applications are an example of software or a separate concept. Further, it is not clear whether accessibility by users refers to the software or both the software and the applications.

component forms an ancillary and subordinate part (i.e. packages going beyond mere internet access and including other elements such as content pages giving access to news, weather or travel reports, playgrounds, website hosting, access to online debates or any other similar elements) and vi) the services listed in Annex II, which includes, inter alia, website hosting and webpage hosting, automated, online and distance maintenance of programs, remote systems administration, online news, traffic information and weather reports, subscription to online newspapers and journals and accessing or downloading of music, jingles, excerpts, ringtones or other sounds and films[229].

On the other hand, the mentioned article 3(5) provides for a list of services which are not included in the definition of digital service, i.e. i) the services listed in Annex III, which includes, inter alia, radio and television broadcasting services, telecommunications services, CD-ROMs, floppy disks and games on a CD-ROM[230] and ii) the sale of goods or other services which is facilitated by using the internet or an electronic network.

Looking to the three different objective tests, instead, it is worth mentioning on a preliminary basis that conditions mentioned below under 1, 2 and 3 are alternative, in the sense that the significant digital presence exists provided that (at least) one of the three conditions are met by the entity itself or together with associated enterprises[231].

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[229] For the full list see Annex II of the Significant Digital Presence Proposal.

[230] For the full list see Annex III of the Significant Digital Presence Proposal.

[231] For the definition of associated enterprise, see article 3(9) of the Significant Digital Presence Proposal, according to which "'associated enterprise' means an entity that is related to the particular entity in question in one or more of the following ways: (a) one of them participates in the management of the other by being in a position to exercise a significant influence over the other; (b) one of them participates in the control of the other through a holding, directly or indirectly, in the other that exceeds 20% of the voting rights; (c) one of them participates in the capital of the other through a right of ownership, directly or indirectly, in the other that exceeds 20% of the capital.

If more than one entity participates in the management, control or capital of the same entity in one or more of the ways specified in points (a) to (c), all of those entities shall be regarded as associated enterprises of each other too.

If the same entity participates in the management, control or capital of more than one entity in one or more of the ways specified in points (a) to (c), all of those entities shall be regarded as associated enterprises of each other too.

In case of indirect participations, fulfilment of the criteria set out in points (b) and (c) shall be determined by multiplying the percentages rates of holding through the

1) The revenues resulting from the supply of the digital services to users located in that Member State in a given tax period exceeds EUR 7.000.000. In this respect, the Significant Digital Presence Proposal further specifies that a user shall be deemed to be located in a Member State in a tax period if the user uses a device in that Member State in that tax period to access the digital interface through which the digital services are supplied[232]. The Member State where a user's device is used shall be

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successive tiers. An entity holding more than 50% of the voting rights shall be deemed to hold 100%".

The definition under analysis seems to deviate from that used in article 5(8) of the OECD Model (2017), which prescribes a higher percentage of voting rights or capital, and in article 9 of the OECD Model and the EU Arbitration Convention (90/436), which only make reference to the need to participate in the management, control or capital without setting any specific threshold. The existence of a multitude of "associated enterprise" definitions might create confusion (and, potentially, mismatches) as to the characterization of an enterprise, in terms of whether or not it is associated/closely related, depending on the applicable framework.

[232] The proposed directive deviates in this regard from earlier scholarly proposals: see P. HONGLER – P. PISTONE, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD 2015, p. 25: this proposal is based on the domicile of users to locate taxation, linked to time and revenue thresholds in a cumulative manner. See also M. OLBERT – C. SPENGEL, *International Taxation in the Digital Economy: Challenge Accepted?*, in *World Tax Journal*, 2017, p. 16. For other proposals made by the scholars – without being exhaustive - see L. SPINOSA – V. CHAND, *A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?* in *Intertax*, 2018 (Volume 46, Issue 6 - 7), p. 476: the authors assert a 'shared taxing rights' mechanism, i.e. a new distributive rule that could be built into tax treaties to tax specified digital activities or services that operate on a remote basis. See also W. SCHOEN, *Ten Questions About Why and How to Tax the Digitalized Economy*, 2017, available at <https://papers.ssrn.com>.

See also R. PETRUZZI – V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, in *European Taxation*, 2018, pp. 395 – 396, according to which "[i]n particular, with regard to the "number of users" threshold, it is questionable whether this benchmark relates to value creation by users. Considering that not all users contribute equally to a digital enterprise and that different business models allow for a different degree of engagement and involvement of users; the number of users could be an arbitrary threshold reflecting neither significant economic activity nor value created by users. By way of example, the creation of an account on a multi-faceted digital interface (for example intermediation platform) does not equal a contribution of value to a digitalized business, since it requires the active involvement and interaction of the user with other users. If the account is dormant, it will be taken into consideration for SDP purposes. In addition, when measuring the number of users during a tax period it is not clear how long a user should be located in the source jurisdiction, for example, during the whole tax period or even for a limited time (the latter option seems to apply based on the current wording of the provision). Apart from the duration of the presence of the user in the source jurisdiction, the location, as such, also raises some concerns. The wording of article 4 seems to disregard the user's place of residence, focusing only on the location at which revenue from the provision of digital services is generated, use is made of the digital services or business contracts are concluded. If a user moves from one jurisdiction to another, either for professional or

determined by reference to the Internet Protocol address of the device or, if more accurately, any other method of geolocation[233].

2) The number of users of the digital services who are located in that Member State in a given tax period exceeds 100.000. For defining if a user shall be deemed to be located in a Member State, the same rules mentioned above under point 2 apply.

3) The number of business contracts (i.e. contracts concluded by the user in the course of carrying on business) for the supply of any such digital service that are concluded in a given tax period by users located in that Member State (i.e. the user is resident / has a permanent establishment in the Member State) exceeds 3.000. Although the option for the residence of the contracting business to indicate the place of contract conclusion is not entirely coherent with the remaining proposal, especially the user threshold, this is certainly easier to administer.

In light of the above, it appears clear that, in the context of the Significant Digital Presence Proposal, the connection to user value creation is much more distant than in the context of the Digital Service Tax Proposal, as the regime also covers a range of digital services, where user participation is of marginal importance: the key in defining the objective

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personal reasons, that user could be counted more than once for the purposes of examining whether one of the thresholds has been met, such that a single individual/legal entity could be considered as more than one user in respect of a single digital service provider. A further issue might be users using multiple access points to a website (for example, different devices) or accessing a website via a VPN. The double counting of users could likely be avoided through the application of benchmarks or other criteria for distinguishing between active and passive users". According to the two Authors, "A better solution might be to simply refer to the concept of value creation as a tool in assessing taxable nexus to a country. Such a solution, although quite radical and potentially subject to interpretational issues (that could be solved, nevertheless, by means of more developed guidance and more effective dispute avoidance and dispute resolution mechanisms), could avoid the issues highlighted herein". For further details on such solution, see R. PETRUZZI - S. BURIAK, *Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?*, in *Bulletin for International Taxation*, 2018 (4a/Special Issue), p. 14.

[233] Article 5(3) of the Significant Digital Presence Proposal further specifies that the amount of revenues that are deemed to be obtained from a Member State in the tax period is determined by comparing the times the platform has been accessed by users in the Member State to the times the platform has been accessed by users in the world in the tax period. That number (EU users / worldwide users) is then multiplied by the amount, in euro, in respect of the overall worldwide revenues from digital services. If the outcome exceeds EUR 7 million, the business has a permanent establishment based on an Significant Digital Presence in that Member State.

scope of the Significant Digital Presence Proposal is indeed not user participation, but simply what can be considered to fit within the concept of "digital services", which, apparently, is intended to be interpreted broadly. With regard to the definition of digital services the Commission's Impact Assessment also provides an important clue. It states that such broad concept of digital services already exists in the European Union for VAT purposes and that this definition could "inspire" the definition of digital services for purposes of the Significant Digital Presence Proposal [234]. When comparing the definition of "electronically supplied services" in the EU VAT system and the definition of "digital services" in the Significant Digital Presence Proposal it can be concluded that the "inspiration" has indeed been remarkable.

The mentioned baseline definition for digital services in article 3(5) of the Significant Digital Presence Proposal is word for word the same as the definition of electronically supplied services in article 7(1) of the Council Implementing Regulation concerning the VAT Directive. In addition, the list of examples of digital services provided in article 3(1) (5)(a) to (f) of the Significant Digital Presence Proposal is exactly the same as the list of examples provided in article 7(2)(a) to (f) of the mentioned VAT Implementing Regulation. Finally, Annexes II and III referred to in article 3(1)(5) of the Significant Digital Presence Proposal that provide more examples of taxable digital services as well as on situations that are not considered to be digital services, are again word for word the same as those in article 7(3) and Annex I as referred to in article 7(1)(f) of the VAT Implementing Regulation. The conclusion cannot be anything but that the concept of "digital services" in the SDP Directive is intended to have the same, or at least a very similar, scope as the concept of "electronically supplied services" for VAT purposes.

This connection helps in understanding why certain situations that seem more or less parallel are treated differently for Significant Digital

[234] Commission's Impact Assessment, *cit.*, p. 44.

Presence Proposal purposes. For instance, it is specified in Annex III(f) of the Significant Digital Presence Proposal that the sale of CDs in an online store is not a digital service, while downloading the same content directly to a laptop or accessing the content by way of a streaming service is a digital service under Annex II(t). According to the Commission's Impact Assessment, the exclusion of the e-commerce of goods is grounded by the fact that such an activity often requires local physical infrastructure and that commissionaire arrangements have already been considered by the OECD/G20 Base Erosion and Profit Shifting (BEPS) initiative. Moreover, it appears that inbuilt need of the VAT system to distinguish between goods and services is being transferred to the world of direct taxation.

In addition to the online sale of goods, the selling of "non-digital" services is excluded also from the scope of the Significant Digital Presence Proposal Directive, even if sold or executed via the Internet. A basic example of such service is when a lawyer or a consultant advises a client by e-mail. These services typically require more than "minimal human intervention", for example, some level of human interaction, and, therefore, do not meet the basic requirements for the application of the Significant Digital Presence Proposal Directive in article 3(1)(5). Moreover, in article 3(1)(5) of the Significant Digital Presence Proposal Directive, the sale of goods or services that is facilitated by using the Internet or an electronic network is excluded from the scope of the Significant Digital Presence Proposal.

In other words, it seems that the VAT regulation is destined to become an important tool for the practitioners in order to define the objective scope of the Significant Digital Presence Proposal. The concept of "electronically supplied services" has been part of the EU VAT system for fifteen years. In that time, a multitude of case law, EU level working papers and guidelines as well as academic literature has evolved around the concept[235].

[235] For further details in this respect, see M.M.W.D. MERKX, *VAT and E-Services: When Human Intervention Is Minimal*, in *International VAT Monitor*, 2018, p. 664.

In light of the above, one general aspect of the proposed concept is that the Significant Digital Presence Proposal does not reflect in any way the concept of "permanency", which is, by definition, included in the term "permanent establishment" that is used also in article 4(1) of the Significant Digital Presence Proposal. While permanency, whether in terms of time or of geography, may be a somewhat outdated feature for a nexus rule of the digital age, there remains still the question of whether, for example, a simple one-off agreement on the delivery of digital services that exceeds Euro 7 million should constitute taxable presence considering, in particular, the fragmentation of the taxable base. A further profoundly different attribute of the proposed nexus rule compared to the traditional permanent establishment definition is that, in determining whether the threshold for a Significant Digital Presence is met, it is not the digital operations of just one company but, rather, that of the whole group which are considered. In this respect, it should be noted that the proposal does not exclude associated companies located outside the European Union. As a result, it appears that even if an European Union resident company itself performs very little digital services, still it could have a virtual permanent establishment in another Member State if an associated company, resident inside or outside the European Union, also provides such services in that other Member State. Consequently, digital services provided by non-European Union entities, who may as such be outside the scope of the Significant Digital Presence regime due to the existence of a tax treaty, can contribute to the formation of an Significant Digital Presence for an associated entity located in the European Union.

The choice of three alternative criteria based on revenues, users and contracts concluded between businesses makes sense, albeit the nature of them being alternative rather than cumulative can be disputed as this sets a very low threshold. As the criteria are alternative, the fulfilment of one of them is sufficient to find significant digital presence and hence to grant the right to tax to that state. In other word, if the thresholds remain at the absolute very low numbers as they stand now, at least one of these criteria

will be practically fulfilled in almost any state: this will imply lead to multiple permanent establishments in various EU Member States, increasing the risk of double taxation and the compliance burden for companies[236]. It is a political choice to have a modified permanent establishment concept as broad as possible; which does however not fit into the Commission's self-set objective of respecting proportionality especially with regard to smaller businesses. The high administrative burden of declaring taxable profits, attributing profits to the significant digital presence and respecting other legal obligations in the state of the significant digital presence will hit smaller businesses harder than bigger businesses disposing of a more sophisticated administrative structure and legal advice.

Moreover, all three alternative criteria to establish significant digital presence are absolute numbers, which is unfortunate if the proposal intended to fairly measure activity of companies in a Member State in relation to its seize and population. Absolute numbers rather than relative percentages put Member States on an unequal footing, favoring increased tax collection by large states or states, which are subject to frequent transits, to the detriment of small, less frequented states or states located at the geographical margin of the Union: the possibilities of a fixed number threshold being met in the latter cases are indeed limited if compared to a larger / more frequented EU member state[237].

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[236] W. SCHOEN, *Ten Questions About Why and How to Tax the Digitalized Economy*, *cit.*, at p. 9; R. PETRUZZI – V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, in *European Taxation*, 2018, p. 395; D. PINTO, *Options to Address the Direct Tax Challenges Raised by the Digital Economy – A Critical Analysis*, in *Canadian Tax Journal*, 2017 (65), p. 326.

[237] See, in this respect, M.M.W.D. MERKX, *cit.*, p. 666; J. SINNIG, *The Reflection of Data-Driven Value Creation in the 2018 OECD and EU Proposals*, in *EC Tax Review* 2018/6, p. 331. See also R. PETRUZZI – V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, *cit.*, p. 395: the Authors are of the opinion that "[a] possible solution to this unequal treatment could be the use of external benchmarks, based on which the digital presence of an enterprise in a particular jurisdiction could be measured by comparison to that of its competitors providing digital services in that same jurisdiction. In this manner, such external benchmarks could constitute indicators of the market share of digitalized businesses in each particular Member State, with the result that a PE will only be deemed to exist with regard to the top digital service providers, thus taking into account the market characteristics of the source jurisdiction. This alternative threshold, apart from being easily enforceable, leaves little room for manipulation, since its application relies on factors that

Once a digital permanent establishment is deemed to exist in a Member State, the amount of profits that should be attributed to that digital permanent establishment must be determined.

In general terms, based on the authorized OECD approach[238], the attribution of income to a permanent establishment requires a two-step analysis. First, a functional and factual analysis should be performed pursuant to which the permanent establishment and the headquarters are treated, hypothetically, as separate entities undertaking their own functions, owning and/or using their own assets and assuming their own risks. In this step, the economically significant activities undertaken by the permanent establishment are identified. Secondly, the transfer pricing tools, as established in article 9 of the OECD Model, are applied by analogy to a hypothetical transaction between the permanent establishment and the headquarters and by reference to the functions performed, assets used and risks assumed by the hypothetically separate entities.

The OECD approach relies on a functional analysis and attributes to a permanent establishment the relevant risks connected to the performance of significant people functions by the permanent establishment. It also attributes economic ownership of assets relevant to the performance of these significant people functions by the permanent establishment. The task of attributing income to a digital permanent establishment may, however, be quite demanding, due to a double fiction, i.e. deemed independence and a deemed permanent establishment. Since no physical presence is required for a digital permanent establishment to be substantiated, identifying the functions performed by the digital permanent establishment, which assets may be attributed to it and which risks are being assumed by that entity will be key questions. Such questions may become even more complicated due

are not under the control of the digital service provider, for example, the performance of its competitors. Alternatively, more flexible numbers or relative numbers (i.e. percentages), rather than fixed amounts, would be preferable, depending on the overall number of established individuals and companies. It should be noted, nevertheless, that, based on the wording of the proposal, what is of interest is the location of users and not their place of establishment”.

[238] OECD, *Report on Attribution of Profits to Permanent Establishments*, 2008, available in <www.ibfd.org>.

to the significant involvement of intangible assets in highly digitalized businesses[239].

After extending the concept of permanent establishment to the concept of significant digital presence, the Significant Digital Presence Proposal confirms the commonly accepted rules for attributing profits to the permanent establishment as rules for attributing profits also to the significant digital presence, even if some adjustments are provided (see article 5 of the Significant Digital Presence Proposal which is entitled to "Profits attributable to or in respect of the significant digital presence").

Specifically, as a preliminary point, the Significant Digital Presence Proposal clarifies that "[t]he profits that are attributable to or in respect of a significant digital presence in a Member State shall be taxable within the corporate tax framework of that Member State only" (see art. 5(1) of the Significant Digital Presence Proposal)[240].

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[239] See P. HONGLER – P. PISTONE, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, cit., p. 25: the Authors have considered four options to allocate profits to the jurisdiction of the digital permanent establishment: (i) formulary apportionment; (ii) gross income taxation; (iii) a redefinition of functions and risks relevant in determining an appropriate transfer price; and (iv) modification of the existing profit split method with an upfront allocation of partial profits to the market jurisdictions. See R. PETRUZZI - S. BURIAK, *Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?*, cit., p. 14: the Authors have proposed the attribution of profits to the market jurisdiction based on net-basis taxation, which is in line with the principles of a direct taxation system, and on a value creation concept that would define the proper amount of profits to be allocated to the country where the active customers, being "unconscious" contributors and/or employees of the company who generate valuable data for the company, are located.

[240] In this respect, see the comment of R. PETRUZZI - V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, *cit.*, p. 397: the Authors are of the opinion that "the wording of this provision is quite different from the wording of article 7(1) of the OECD Model (2010) and will potentially lead to two different allocations based on whether the PE is a traditional or digital one (to this end, see section 3.3.). For example, references to concepts such as "in respect of" or "within the corporate tax framework" are not completely clear. Furthermore, the reference to "the profits" (similar to the former wording of article 7(1) of the OECD Model (1963) rather than to "profits" (as in the wording of article 7(1) of the OECD Model (2010)), might imply that it is not possible to attribute greater profits to the PE than to the headquarters (i.e. in the presence of a company in a loss position the PE cannot be profitable). Moreover, the word "only" at the end of the paragraph indicates that the application of this provision will limit the taxing rights of the residence state, who, even when it follows the worldwide taxation principle, will not be able to tax the profits generated by the digital PE. This mechanism is different from that of article 7(1) of the OECD Model (2010). Potentially, mismatches between the two provisions will result in conflicts and the application of different allocation rules to different PE concepts, inevitably giving rise to double taxation or less-than-single taxation. Moreover, if the residence company provides

Moreover, on one hand, confirming the general rule, it is stated that the determination of profits attributable to the significant digital presence shall be based on a functional analysis. According to article 5(2) of the Significant Digital Presence Proposal, indeed, “profits attributable to or in respect of the significant digital presence shall be those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, in particular in its dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface”. In other words, the Significant Digital Presence Proposal confirms that the mentioned authorized OECD approach represents the general reference framework aimed at attributing profits to the new permanent establishment type (i.e. the significant digital presence).

On the other hand, looking to the adjustments, art. 5(3) of the Significant Digital Presence Proposal states - with reference to the functional analysis – that “in order to determine the functions of, and attribute the economic ownership of assets and risks to, the significant digital presence, the economically significant activities performed by such presence through a digital interface shall be taken into account”.

Since, as already pointed out, in respect of a digital permanent establishment, the non-resident enterprise does not have a physical presence in the source jurisdiction, including through the presence of employees, who are traditionally understood as those performing the significant functions, for the OECD approach, the factors contributing to value creation must be analyzed and taken into account in determining significant functions in a digital era context. For these purposes, the proposal uses the notion of “economically significant activities”, i.e. activities related to data and users based on which risks and economic ownership of assets are attributed to the significant digital presence. This concept is

for an exemption mechanism, the question will become how to attribute the losses generated by the digital PE”.

intended to reflect the indisputably significant role of users and their data in value creation for highly digitalized businesses and attribute profits to the significant digital presence based on the value contributed by these two factors[241].

However, the Significant Digital Presence Proposal does not seem to explain in detail how users and their data actually contribute to value creation and how assets and risks, and subsequently profits, can be attributed to the significant digital presence. The guidance to this issue is limited to that provided by paragraphs 4 and 5 of article 5 of the Significant Digital Presence Proposal. Mentioned paragraph 4 states that "due account shall be taken of the economically significant activities performed by the significant digital presence which are relevant to the development, enhancement, maintenance, protection and exploitation of the enterprise's intangible assets"[242]. Paragraph 5 sets out an indicative list of economically significant activities, including i) the collection, storage, processing, analysis, deployment and sale of user-level data, ii) the collection, storage, processing and display of user-generated content, iii) the sale of online advertising space, iv) the making available of third-party created content on a digital marketplace and v) the supply of any digital service[243].

Finally, the profit split is the transfer pricing method recommended by the Significant Digital Presence Proposal. According to article 5(6) of the

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[241] In this respect see the considerations included in the above paragraph 3.1.

[242] In this respect, see R. PETRUZZI - V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, cit., p. 397: the Authors point correctly out that "[a]part from the unclear notion of "due account", the reference to the development, enhancement, maintenance, protection and exploitation (DEMPE) analysis creates confusion since this analysis only applies to intangibles and not to other types of economically significant activity. Therefore, it is unclear how users and their significant role in value creation might relate to the DEMPE analysis. Moreover, the DEMPE concept is currently not included in the AOA [i.e. OECD, *Report on Attribution of Profits to Permanent Establishments*, 2008, available in <www.ibfd.org>]". See also A. S. SAMARI, *Digital Economy and Profit Allocation: The Application of the Profit Split Method to the Value Created by a "Significant Digital Presence*, *cit.*, at para. 4.

[243] In this respect, see R. PETRUZZI - V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, cit., p. 397: the Authors highlights that the activities listed in art. 5(5) of the Significant Digital Presence Proposal share "similarities with certain activities the performance of which is excluded from the creation of a PE (article 5(4) of the OECD Model (2017)) creating concerns regarding the consistency of the tax system".

Significant Digital Presence Proposal, indeed, "[i]n determining the attributable profits under paragraphs 1 to 4, taxpayers shall use the profit split method unless the taxpayer proves that an alternative method based on internationally accepted principles is more appropriate having regard to the results of the functional analysis. The splitting factors may include expenses incurred for research, development and marketing as well as the number of users and data collected per Member State"[244].

The idea of applying the profit split method by default is totally unknown under the OECD principles, according to which a case-by-case assessment of the particular business model and its value chain has to be performed in order to choose the most appropriate transfer pricing method. The profit split method, which is as important as the other methods identified by the OECD, should be applied only in specific circumstances. The default application of the profit split method to digital permanent establishment might result in significant inconsistencies in the alignment between value creation and profit attribution.

Finally, as done for the Digital Service Tax Proposal, it seems appropriate to go back to the first line of the proposed directive, according to which its legal basis is article 115 of TFEU stating that the European Council "shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market". As seen for the Digital Service Tax Proposal, the unanimity of all the Member States is required also for the adoption of the Significant Digital Presence Proposal. Moreover, also in this case, the root of the enhanced cooperation appears to be not viable for the same reasons already outlined for the Digital Service Tax Proposal. The result is that the adoption of the Significant Digital

[244] With reference to the item of the data protection, article 8 of the Significant Digital Presence Proposal states that "[t]he data that may be collected from the users for the purposes of applying this Directive shall be limited to data indicating the Member State in which the users are located, without allowing for identification of the user".

Presence Proposal appears remote, calling the European Union to keep on working on a global solution at the OECD level.

A final consideration should be articulated with reference to the item of the data protection. As mentioned above, the place of taxation for the purposes of the proposed digital service tax should be determined on the basis of the Internet Protocol address of the device of the users or, if more accurate, on the basis of other methods of geolocation. In this respect, the Proposal provides in generic terms that "[t]he data that may be collected from the users for the purposes of applying this Directive shall be limited to data indicating the Member State in which the users are located, without allowing for identification of the user" (art. 8 of the Proposal). In addition to the above, recital 9 of the proposed Directive (even if not legal binding for the Member States) provides that any processing of personal data should be conducted in accordance with the EU Regulation 2016/679[245], with the further clarification that «[w]henever possible, personal data should be rendered anonymous» (emphasis added). The perception – confirmed also within the context of the Significant Digital Presence Proposal – is that, at least in the field of taxation, the concerns about the right of the tax payers to protect their data remain still unanswered.

3.5. The unilateral measures at domestic level – In this context, some countries have either adopted or announced the adoption of unilateral measures for the taxation of the digital activities. In 2013, even before the publication of the Final Report on Action 1 of the OECD/G20 BEPS initiative, the Inland Revenue Board of Malaysia released guidelines on the taxation of e-commerce[246]. Whilst discussions regarding the OECD/G20 BEPS initiative were still ongoing before the release of final deliverable reports, also the United Kingdom enacted the diverted profits tax regime, which

[245] EUROPEAN PARLIAMENT AND COUNCIL, *Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC*, available at http://curia.europa.eu/.

[246] INLAND REVENUE BOARD OF MALAYSIA, *Guidelines on Taxation of Electronic Commerce 2013*.

applies from 1 April 2015: the diverted profit tax regime seeks to counter arrangements that are intended to divert profits from the United Kingdom by avoiding a taxable presence through a permanent establishment in the United Kingdom and/or by way of other contrived arrangements between connected parties[247]. Australia soon followed the United Kingdom's approach and amended its domestic general anti-abuse rule (GAAR) by enacting the Multinational Anti-Avoidance Law as a part of its Budget for 2015/16. The Multinational Anti-Avoidance Law introduces the concept of a "notional" permanent establishment and grants greater taxing rights to Australia as a source state[248].

In February 2016, the Spanish tax authorities approved general guidelines that outline the focus of the tax authorities on tax audits. Under the general guidelines, the tax authorities would examine online transactions to verify that these are being taxed correctly in Spain. In April 2016, the Israeli tax authorities released a circular on the Internet activity of foreign companies in Israel[249]. In 2016, through its Finance Bill, also India took a clear position on the matter through the introduction of an equalization levy.

The issue of the two proposals by the European Commission gave new impulse to the unilateral measures within the Member States. As for example, Spain has proposed a unilateral measure – still a draft law – that will be provisional until the solutions proposed within the European Union are implemented, i.e. the Tax on Certain Digital Services, the aim, structure and content of which correspond to those envisaged by the Proposal for a Council Directive on the common system of a digital services tax[250]. In

[247] UK, Finance Act 2015, Part 3, Sec. 77. For an in – depth analysis, see L. CERIONI, *The New "Google Tax": The "Beginning of the End" for Tax Residence as a Connecting Factor for Tax Jurisdiction?*, in *European Taxation*, 2015, p. 185; S. MACLENNAN, *The Questionable Legality of the Diverted Profits Tax Under Double Taxation Conventions and European Union Law*, in *Intertax* (Volume 44 - Issue 12), 2016, p. 903; Y. USLU, *An Analysis of "Google Taxes" in the Context of Action 7 of the OECD/G20 Base Erosion and Profit Shifting Initiative*, in *Bulletin for International Taxation*, 2018 (Volume 72 - No. 4a/Special Issue).

[248] See Y. USLU, *cit.*

[249] ISRAEL TAX AUTHORITY, Circular No. 04/2016, Apr. 2016.

[250] The wording of the Draft Law on Tax on Certain Digital Services may be found at http://www.congreso.es/public_oficiales/L12/CONG/BOCG/A/BOCG-12-A-40-1.PDF.

France, the proposal has become law: a digital services tax – built on the basis of the Proposal issued by the European Commission – was indeed introduced by Law 2019-759 of 24 July 2019, with effect from 1 January 2019[251]. United Kingdom is moving in the same direction: the UK government is intending to press ahead with a unilateral Digital Service Tax from April 2020, unless by then an appropriate international measure is already in place. The Digital Service Tax would be chargeable at the rate of 2% - thus lower rate if compared to the 3% rate proposed by the European Commission - on those revenues of certain digital business models that are linked to the participation of UK users[252].

3.5.1. The Indian equalization levy – In India the discussion about hot to tax the digital economy starting at the jurisprudence level: courts in India have ruled indeed on the concepts of digital presence and online permanent establishments. More specifically, the need for the equalization levy arose due to number of decisions of the Income Tax tribunal as well as

For an analysis, see F. J. NOCETE CORREA, *The Spanish Digital Services Tax: A Paradigm for the Base Enlargement & Profit Attraction (BEPA) Plan for the Digitalized Economy*, in *European Taxation*, 2019, pp. 346 – 348.

[251] The Digital Service Tax applies to resident and non-resident companies with a worldwide turnover (at a consolidated level) exceeding EUR 750 million and a French turnover exceeding EUR 25 million. The rate of the tax is 3%.

The tax base is the French-source turnover derived from online advertising, from the sale of personal data for advertising purposes and from the provision of peer-to-peer online platforms. Among other services, the following are excluded from the tax base: online sales of goods or services (including digital services such as video-on-demand or music-on-demand), payment or e-mail services, regulated financial services and sales of personal data not obtained through the Internet. The French-source turnover is calculated using a digital presence coefficient based on the proportion of French users.

The tax is deductible from profits subject to French corporate income tax, if any. It must be declared every year and paid along with other turnover taxes (e.g. VAT). Taxpayers who are not established within the European Union (or Norway, Iceland and Liechtenstein) must appoint a tax representative who is subject to VAT and who pays the tax on behalf of the taxpayers.

The tax applies retroactively with effect from 1 January 2019 and until an agreement on the taxation of the digital economy is concluded at OECD level.

[252] See HM Treasury, Budget 2018 Digital Services Tax, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf and GOV.UK, Digital services tax: consultation (7 Nov. 2018), available at www.gov.uk/government/consultations/digital-services-tax-consultation. For a comment, see A. BURCHNER, *Extracting the Digit: Recent UK Reforms and New Proposals for Taxing the Digital Economy*, in *Bulletin for International Taxation*, 2019, p. 316.

other High Courts going in favor of the taxpayer depriving the government of its necessary revenue.

Taking into consideration the most known case, the Indian Income Tax Appellate Tribunal dealt in 2013 with a Permanent Establishment - related issue of taxability of payment made for online advertising on the search engines of Google (Ireland) and Yahoo (United States)[253]. More specifically, a florist – who was tax resident in India – paid fees to Google US and Yahoo US for online advertising services: both websites made available online advertising space to the taxpayer in such a way that whenever someone used keywords on search engines run by Google and Yahoo, that person was shown the advertisement of the taxpayer along with the search results. The taxpayer did not deduct any withholding tax on the payment of the related fees, thereby taking the position that the income paid to Google and Yahoo was not taxable in India.

The tax officer challenged such taxpayer' s position, claiming that – in the first instance – the activities performed by Google and Yahoo triggered a permanent establishment in India and – as an alternative, even if a permanent establishment was not triggered – the payments made by the Indian florist for the online advertising services provided by Google and Yahoo fall within the definition of royalties / technical services and, therefore, should be subject to a withholding tax in India.

However, the position of the Indian Income Tax Appellate Tribunal was totally in favor of the tax payers on the basis of the treatment provided by the applicable tax treaty. More specifically, the Indian Income Tax Appellate Tribunal relied on the Commentary on Article 5 of the OECD Model to hold that Google and Yahoo could not be said to have a permanent establishment in India merely because the search websites were accessible in India. The Indian Income Tax Appellate Tribunal supported the view in the OECD Commentary on Article 5, which states that a website does not have a physical existence or location and, therefore, cannot be regarded as

[253] INCOME TAX APPELLATE TRIBUNAL, 12 Apr. 2013, ITO v. Right Florist Pvt. Ltd., I.T.A. No. 1336/Kol./2011. See also INCOME TAX APPELLATE TRIBUNAL, 24 June 2011, Yahoo India Pvt. Ltd. v. DCIT, ITA No. 506/ Mum/2008, available in <www.ibfd.org>.

a fixed place of business for a taxpayer, while the server on which the website is stored and through which it is accessible is a piece of equipment with a physical location and, hence, that location may constitute a "fixed place of business" of the enterprise that operates the server. However, in the case under analysis, the server was not in India. It was further held that the online revenues were not generated in India and, hence, no business connection existed in India.

Looking to the second aspect related to the qualification of the payments made by the Indian florist to Google and Yahoo, the Indian Income Tax Appellate Tribunal held that they could not be characterized neither as royalties nor as fees for technical services. The Tribunal denied the payment made for online advertisement as royalty relying on the decisions in the case of Pinstorm Technologies Pvt. Ltd. and Yahoo India Pvt. Ltd[254]. The tribunal negated also the claim that the payments were in the nature of fees for technical services since there was no human touch involved in the whole process of advertising service provided by Google and Yahoo. The services provided by Google and Yahoo were the generation of certain text in a search engine result page. This was a wholly automated process. No human input was required in respect of the services provided by the search engines, which additionally provided the advertising opportunities. The results were therefore completely automated. In so holding, the Indian Income Tax Appellate Tribunal reiterated the important principle that as the word "technical" is placed between the words "managerial" and "consultancy" services in the definition of fees for technical services, in applying the noscitur a sociis principle of interpretation, the technical services would take the meaning of these two words. Consequently, as human involvement is necessary to provide managerial and consultancy services, the same would apply to technical services. As a result, the Indian Income Tax Appellate Tribunal held that the provision of

[254] See Pinstorm Technologies Pvt Ltd. v. ITO, (2012) 54 SOT 78 (Mum) and Yahoo India Pvt. Ltd. v. DCIT, (2011) 140 TTJ 195 (Mum), both mentioned by S. BASAK, *Equalization Levy: A New Perspective of E-Commerce Taxation*, in *Intertax*, 2016 (Volume 44 - Issue 11), p. 845.

automated services without any human involvement in the case in question could not be regarded as technical services in the context of Indian tax law and for treaty purposes.

In light of the above, the existing provisions in source rules of the Indian tax law have been largely unsuccessful in subjecting digital transactions to tax, as the courts have rejected the positions taken by tax authorities by relying on the favorable treaty provisions. Such case law results in the need perceived by the Indian government / tax authorities for the introduction of a new legislation that would grant mutual exclusivity to Indian tax law in subjecting digital transactions to tax. According to the tax authorities, such new legislation, as it would be divorced from the income tax code, would enable them to adopt a position that the provisions of the tax treaty would not override the new legislation. As a result, a committee was established to evaluate the options to introduce new legislation into Indian law that would apply to the taxation of e-commerce.

The report of the Committee on the Taxation of E-Commerce evaluated the following three options given in the Final Report on Action 1 of the OECD/G20 BEPS initiative regarding the taxation of the digital economy: (1) a new nexus test to take the form of a significant economic presence requirement; (2) a withholding tax on certain types of digital transactions; and (3) an equalization levy[255]. The Committee' s report acknowledged the fact that the OECD had not recommended any of the three options but had, rather, observed that countries could adopt some, or all, of these options in their domestic laws and tax treaties. Given the difficulties that may be encountered in the adoption of options (1) and (2) – mainly because both the options require an amendment of the tax treaties –, the Committee recommended the introduction of an equalization levy[256]. The Committee' s Report on the taxation of e-commerce formed the basis

[255] For further details see paragraph 3.1 above.

[256] For further details on the proposals made by the Committee on the Taxation of E-Commerce, see S. WAGH, *The Taxation of Digital Transactions in India: The New Equalization Levy*, in *Bulletin for International Taxation*, 2016, p. 547 – 548.

of the introduction of the equalization levy in the Budget 2016, with effective date June 1, 2016.

Such a levy is described as an equalization levy as the word "equalization" represents the objective of ensuring tax neutrality between different businesses using differing business models (i.e. traditional and digital business model). The levy is meant to tax the non-resident entities that earn income from India and evade paying taxes by avoiding a permanent establishment status in India.

The equalization levy does not form part of the Income Tax Act but it is governed by a separate chapter (Chapter VIII) in the Income Tax Act. The reason for such placement is to keep the equalization levy separated from the Income Tax Act (1961) to enable it to be protected from provisions of tax treaties that could be favorable in nature.

Looking to the subjective scope, the equalization levy applies to all the non – resident companies, which receive – as consideration for the provision of a relevant service – a payment from an Indian tax resident or from a non-resident taxpayer with a permanent establishment in India (exluded the State of Jammu and Kashmir) provided that the latter use the services for the purpose of carrying on a business or profession in India.

Looking to the objective scope, relevant payments are those made for the provision of the following services, i.e. services in the nature of online advertising, digital advertising space and any other facility or service provided for the purpose of online advertising[257]. A *de minimum* threshold applies: no equalization levy is due where the aggregate consideration for the specified service is less than INR 100,000. The rate of the equalization levy is 6%.

Looking to the payment mechanism, the equalization levy is structured as a withholding tax: a resident or a non-resident with a permanent establishment in India is obliged to withhold 6% equalization levy

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[257] In this respect, it is worth mentioning that the Committee on the Taxation of E-Commerce in its report included a greater number of services under the ambit of specified services not restricted to only online advertising. The government, however, retained the power to notify any new specified service in due course of time. This has been done keeping in mind the rapid expansion of e-commerce.

from payments made to a non-resident services provider in respect of specified services, such as online advertisements, provision of digital advertising space, or any other facility or service for the purpose of online advertisements or any other notified services. The payer will not be entitled to a deduction of such specified services payments to non-residents if the equalization levy is not withheld or after withholding it is not deposited with the government by the due date. Such expenditure is allowed as a deduction to the payer in the year of payment of the equalization levy[258].

A specific regime applies for those cases in which the service provider is a non-resident who has a permanent establishment in India to which the service is effectively connected and such income is attributable. In this case, indeed, the equalization would be payable by the permanent establishment on the income it derived in India at a higher rate of 40% on net income.

There are several open points with reference to the aforementioned equalization levy[259]. First of all, it is unclear whether the non-resident service provider could take advantage of foreign tax credits and/or an exemption arising as a result of a tax treaty in respect of the amounts withheld by the payer in India. In substance, the equalization levy is a tax on the income derived by a non-resident from the provision of specified services. However, as already outlined, it has been introduced as separate legislation only to divorce it from treaty provisions. One could argue that the equalization levy falls within the definition of "identical or substantially similar taxes" to which the provisions of the income tax treaties apply in accordance with article 2 of the income tax treaties[260]. Much will depend on the interpretation placed

[258] For the procedural framework for the implementation of the equalization levy, see notifications no. 37 and 38 issued on 27 May 2016 by the Central Board of Direct Taxes. Among the others procedural fulfillment, the payer is required to furnish a statement of specified services in Form 1, duly verified in the manner indicated therein, on or before 30 June immediately following the relevant financial year. For further details in this respect, see S. SHAH, *India – Corporate Taxation*, 1 April 2019, available at <www.ibfd.org>, p. 110.

[259] See S. BASAK, *cit.*, pp. 850 – 851; S. WAGH, *cit.*, p. 551.

[260] Article 2(4) of the OECD Model reads as follows: "The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws".

by tax authorities of the residence state of the non-resident taxpayers who are service providers, as the non-resident taxpayers could obtain a credit and/or exemption in respect of the equalization levy withheld in India in their residence state.

Moreover, the scholars doubt that the equalization levy is compatible with the Indian constitutional law. It is indeed one of the basic legal principles under Indian constitutional law that only the Parliament can legislate for the territory of India. Looking to the equalization levy, the only territorial nexus that it provides for in relation to the equalization levy is that the services should be utilized for business and professional activities carried on in India. The equalization levy seems to be extraterritorial in nature, thus resulting in some doubts of the compatibility of the equalization levy with the Indian constitutional law[261].

Moreover, the wording of the equalization levy leaves room for interpretative uncertainties and / or gives rise to difficulties in the concrete application of the equalization levy. As for example, this could be the case of the bundled advertising services, which represent both publishing advertising in print and digital advertising in respect of which a single payment is made. It could be difficult to split the payment into two corresponding parts of the remuneration (i.e. the part related to the print advertising and the part related to the digital advertising).

Another interesting aspect is related to the provision of intra – group services. Take the example of a multinational group where one of the group entities situated outside India places an order for digital advertising with a service provider that is also situated outside India. The group entity recovers the cost of the advertising services paid to the third-party service provider from all the group entities that may be the direct or the indirect beneficiaries of the services, including an Indian entity. In this case, the question arises whether the Indian entity must withhold the equalization levy when making payments to the foreign associated enterprise. This is because the foreign

[261] For further details in this respect, see S. WAGH, *cit.*, p. 551.

associated enterprise is only collecting the payment to pay the common service provider and is not itself engaged in the provision of the services.

In other words, the transfer pricing guidelines appear to be not properly taken into consideration. If levy is imposed on a transaction which is at arm's length and a transfer pricing analysis of that transaction has already been done properly taking into consideration the functions performed, assets used and risk assumed (FAR analysis) by the enterprises involved in such transactions then it would be a clog on the freedom of trade and business and hinder the growth prospects of the Indian Digital Industry. The levy should not override any Advance Pricing Agreements signed between the government and the entity for a particular transaction under the Income Tax Act, 1961.

A further question arises whether the benefit test applies in such cases where the withholding of the equalization levy would only apply if the Indian entity could demonstrate that it was the beneficiary of services. Where, under income tax proceedings, the transfer pricing authorities hold that the benefit test has failed and, hence, no deduction of payment of services should be availed, a taxpayer could argue that the equalization levy should not have been applied.

CHAPTER 4
CONCLUSIONS IN LIGHT OF THE ITALIAN EXPERIENCE

As analyzed in chapter 1 of the present PhD Thesis, the tax treatment provided by the current version of the OECD Model Convention is that the profits from services performed in the territory of a contracting state by an enterprise of the other contracting state are not taxable in the first-mentioned state if they are not attributable to a permanent establishment situated therein and as long as they are not covered by other articles of the convention that would allow such taxation. In other words, although several revisions, the same tax treatment of service fees provided by the first OECD Model Convention has been confirmed over times, even if with some amendments of the permanent establishment concept.

The UN Model Convention – which traditionally reserves more attention to the interests of the developing countries – includes several deviations from the OECD Model Convention on the taxation of service fees. Firstly, article 5 of the UN Model provides for the service permanent establishment, which instead represents only an option within the OECD Commentary.

Article 7 on business profits included in the UN Model Convention confirms – in line with the OECD Model Convention – the relevance of the permanent establishment threshold for taxation of business income, including services. However, a limited force of attraction rule is also provided: once a permanent establishment exists in the source state through which services are provided, all income from services of the same or similar kind provided in the source state may be attributed to that permanent establishment, irrespective of whether or not the services are actually provided through that permanent establishment. In this respect, the limited force of attraction represents an extension of the source state's right to tax, which is not foreseen by the OECD Model Convention.

Article 12 of the 2017 UN Model Convention provides in principle for the residence taxation over royalties' income: royalties arising in a Contracting State and paid to a resident of the other Contracting State may

be taxed in that other State. However, differently from the OECD model convention, taxing rights are attributed also to the source country, which is entitled to apply for a withholding tax.

A further deviation between the OECD Model Convention and the UN Model Convention has been introduced on the occasion of the 2017 revision. Indeed, the current UN Model Convention includes a specific article on fees from technical services (article 12A) providing for a shared competence of residence and source state. The objective scope of the article is extended to any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made: (a) to an employee of the person making the payment; (b) for teaching in an educational institution or for teaching by an educational institution; or (c) by an individual for services for the personal use of an individual.

The same approach is confirmed by article 21 included in the UN model convention: differently from the OECD Model Convention, indeed, taxing rights over the items not dealt in any other article of the Model Convention are attributed both to the residence state and to the source state.

From the analysis performed in the last paragraph of chapter 1 of the treaty policy adopted by Brazil and India as examples of developing countries, it has emerged that both the countries reserve a lot of attention to the taxation of service fees: they negotiate indeed treaties which attribute a withholding taxing right to the source country. Such an approach appears to be in with their domestic legislations which provide for a withholding tax on the service fees paid to non-resident entities.

Looking to Italy as further example to be considered within the present analysis, the Italian treaty policy appears to be in line with the OECD Model Convention: Italy indeed usually does not negotiate treaties which provide for a withholding tax on service fees in the source countries, unless the treaty partner – usually a developing country – asks for such a provision. In this respect, in order to give a complete picture, all the tax treaties signed by Italy and providing for a deviation from the OECD Model will be

mentioned while the analysis will focus on those cases which appears to be of most interest for the present PhD thesis.

Article 12 of the tax treaty in force between Italy and Brazil[262] includes in the definition of royalties “the right to use industrial, commercial or scientific equipment”, resulting in leasing activities being treated as royalty payments. Article 12 of the mentioned treaty does not provide for any other deviation from the OECD Model. However, in the protocol signed between the two countries - in line with the treaty policy of Brazil, as mentioned in the above chapter 1 -, it has been agreed that the reference to the payments “for information concerning industrial, commercial or scientific experience” falling within the definition of royalties should be interpreted as including also any income deriving from the rendering of technical assistance and technical services. The maximum applicable withholding tax is 15% to be applied on the gross amount of the service fee.

Second example is given by the tax treaty in force between Italy and India[263], the article 13 of which is entitled to royalties and fees for technical services. Such an article attributes taxing rights to the source country on the fees for technical services, which are defined – within paragraph 4 of the same provision – as “payments of any amount to any person other than payments to an employee of the person making payments, in consideration for the services of a managerial, technical or consultancy nature, including the provisions of services of technical or other personnel”. The maximum withholding tax applicable by the source country is 20%, to be computed on the gross amount of the fees for technical services. In this case also, as outlined in chapter 1, such a provision is quite common for the government of India, which takes particular attention to the taxing rights on the service

[262] *Convention between the government of the Italian republic and the government of the federative republic of Brazil for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income*, Rome, October 3, 1978, available at <www.ibfd.org>.

[263] *Convention between the government of the Republic of Italy and the government of the Republic of India for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income*, New Delhi, February 19, 1993, available at <www.ibfd.org>.

fees, having negotiated a deviation from the OECD Model Convention in all its tax treaties.

Thirdly, article 12 of the agreement between Vietnam and Italy[264] gives withholding taxing rights on the fees for technical services (in addition to royalties) to the source country. The withholding tax rate for such fees is equal to 7,5% to be computed on gross amount of such fees. The term "fees for technical services" is defined as any payment of any kind to any person, other than payments to an employee of the person making the payment, in consideration for any services of a managerial, technical or consultancy nature.

Further example is given by article 13 of the treaty between Italy and Uganda[265] giving taxing rights on technical fees to the source country. The term "technical fees" is defined as payments of any kind to any person, other than to an employee of the person making the payments in consideration for any service of an administrative, technical, managerial or consultancy nature. The maximum withholding tax rate that can be claimed by the source country is 10% on the gross amount of the technical fees.

Lastly, even if not yet in force, also the convention agreed upon Italy and Jamaica[266] is worth mentioning since it provides for a deviation from the OECD model and appears to be in line with the updated version of the UN Model Convention. Article 13 entitled to the service fees of the aforementioned treaty provides for a withholding tax in the source country for an amount not exceeding 10% of the gross amount of the fees. In the treaty under analysis, the term "service fees" include any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made: a) to an employee of the person

[264] *Agreement between the government of the Socialist Republic of Vietnam and the Government of Italian Republic for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion*, Hanai, November, 26, 1996.

[265] *Convention between the government of the Republic of Uganda and the Government of the Italian Republic for the avoidance of double taxation*, Kampala, October 6, 2000, available at <www.ibfd.org>.

[266] *Agreement between the government of the Italian Republic and the Government of Jamaica for the elimination of double taxation with respect to taxes on income and the prevention of tax evasion and avoidance*, January 19, 2018, available at <www.ibfd.org>. The treaty has been approved by the Italian Council of Minister on March 20, 2019.

making the payment; b) for teaching in an educational institution or for teaching by an educational institution; or c) by an individual for services for the personal use of an individual.

In any case, such withholding tax does not apply to routine support and administrative services related to the ordinary course of business. These services include accounting and finance control, financial management, insolvency, taxation, procurement and warehousing, legal and personnel matters and the provision of advice related to the ordinary course of business.

Looking to the Italian domestic legislation, it does not provide for any withholding tax over the service fees paid to non-resident entities. Conversely, in case of a withholding tax applied by a foreign tax administration over the service fees paid to an Italian resident entity, a tax credit is admitted only if such withholding tax is provided by the relevant tax treaty (see articles 165 and 23 of the Italian Tax Code, i.e. Presidential Decree no. 917 /1986 and Circular Letter no. 9/E issued by the Italian tax administration on March 5, 2015). If there is no tax treaty (e.g. Peru and Jamaica) or if the withholding tax is not provided by the applicable tax treaty (e.g. Argentina), no tax credit is admitted in Italy for the withholding tax paid abroad: the result is a double taxation for the tax payer.

The analysis performed in chapter 1 has revealed / confirmed the very significant variety that exists in respect of the tax treatment of service fees in the current international tax system: material deviations exist between the OECD and the UN Model Conventions; the treaty policy and the domestic legislations further vary from one country to another. Such scenario – which has not been mitigated by the BEPS Project – can result in fact in situations of double taxation for the tax payers, exactly what our international tax system aims in principle to prevent.

The transfer pricing implications of the provision of intra – group cross – border services have been investigated in Chapter 2: in this case the approaches recommended in the OECD and in the UN Guidelines appear to be aligned, i.e. the benefit test, the determination of the arm's length

service fee, the safe harbors and the peculiarities applicable to the provision of financial intra – group services. The BEPS project has impacted the item under discussion since it has introduced a simplified approach for the so called low value adding services (i.e. costs plus 5% mark – up without the need to perform a benchmark analysis for supporting the mark – up percentage). Such a safe harbor was not new; a simplified method was already admitted within the European Union by the EU Joint TP Forum; moreover it was already provided by several national legislations (see for example the Netherlands and the USA where the recharge without mark – up was already admitted for the low value adding services, without the need to perform a full TP analysis). Such a simplified approach is included also in the UN Transfer Pricing Guidelines.

Looking to Italy, the work done within the BEPS project has deeply influenced the Italian legislation. A decree has been issued on 14 May 2018 by the Ministry of Economy and Finance: such decree has been welcomed, since it sets forth the general guidance for the correct application of the arm's length principle in line with the current version of the OECD TP Guidelines and overrides the previous circular letter on transfer pricing which dated back to 1980.

The mentioned Decree also provides for the simplified approach for the low – value adding services: subject to the preparation of specific documentation, taxpayers may elect to price low-value-adding services by (i) aggregating all the direct and indirect costs deriving from the supply of these services, and (ii) adding a profit markup of 5%.

Even if the safe harbor still presents several open points (e.g. effects and legal form of the elective simplified approach, non-alignment with the mentioned domestic regimes, applicability of the "all – in" or "all – out" approach), the inclusion of the simplified approach within the OECD TP Guidelines should be welcomed since it would contribute to further increase the acceptability / applicability of the simplified approach within the different tax administrations.

Chapter 3 has focused on the taxation of cross – border digital services. At the OECD level, the debate on how to fill the digital international tax gap dates back at least to 2013, when the OECD launched the 15 – point Action Plan on Base Erosion and Profit Shifting. As part of such Action Plan, the OECD requested for public comments in relation to the tax challenges raised by digitalization. After 2 year–long work, the OECD issued in October 2015 a final report (Action 1) acknowledging that the digital economy exacerbates BEPS risks, as well as poses some challenges for the international taxation. However, at this stage, the result of the OECD work was the adoption of a «wait and see» approach, the main reason of which was the expectation that the anti – BEPS effects of other measures implemented within the BEPS project (especially those provided by Action 7 on the permanent establishment concept) would have had a substantial impact not only on the BEPS issues, but also on the broader tax challenges posed by the digital economy.

Starting from 2017, the debate on digital economy was further intensified both at international, EU and national level, suggesting that the "wait and see" approach proposed by the OECD was no more viable while there was a quite common political pressure to act quickly. Therefore, the delivery of a follow-up of Action 1 was requested by the G20 Finance Ministers. Hence, in September 2017, the OECD opened a public consultation, the outcome of which was an Interim report issued in March 2018. In this occasion, the OECD takes a step forward if compared with the position expressed in BEPS Action 1: it acknowledged indeed that the tax challenges of the digital economy went beyond the boundaries of the BEPS concerns and addressed the redefinition of the criteria for the allocation of taxing rights on business profits among different jurisdictions. In this respect, the OECD stated further that a consensus – based solution was needed for facing the challenges of the digital economy, that such kind of solution was not yet achievable since there were divergent views on how the issue should be approached and that, as a consequence, further work was needed, with the goal of producing an update in 2019 and a final report

in 2020. In such an occasion, it appeared clear that reaching an agreement at global level was likely to be challenging.

Such an update consisted in a new report entitled to "Addressing the tax challenges of the digitalization of the economy", which has been opened for public consultation in March 2019[267]. At the time of the present work, the public consultation is closed: a report – updated in the light of the comments received during the public consultation – is than expected from the OECD, which aims to design a commonly accepted long – term solution in 2020.

The United Nations have been more proactive on the topic: the introduction of the already mentioned article 12A within the UN Model Convention – which provides for a withholding tax on the service fees – aims indeed to answer to the challenges posed by the digital economy, providing for the applicability of a withholding tax on the fees coming from the digital services.

The European Commission has also taken an active role in the debate: the European Commission published indeed in March 2018 a package on fair taxation of the digital economy, which should represent the answer given by the European Commission to the calls coming from several Member States of reacting quickly to the international tax gap. Indeed, as clearly acknowledged by the Commission itself, "the ideal approach would be to find multilateral, international solutions to taxing the digital economy, given the global nature of this challenge. The Commission is working closely with the OECD to support the development of an international solution. However, progress at international level is challenging, due to the complex nature of the problem and the wide variety of issues that need to be addressed, and to reach international consensus may take time. This is why the Commission has decided to take action. The present proposal is intended to contribute to the ongoing work at OECD level, which remains essential in order to reach a global consensus on this topic. By setting out the EU's vision on how to address in a comprehensive way the challenges

[267] See OECD / G20 BEPS PROJECT, *Public Consultation Document – Addressing the tax challenges of the digitalization of the economy*, 16 February – 6 March 2019, available at <www.oecd.org>.

of the digital economy, the proposed Directive will serve as an example to influence the international discussions on a global solution”[268].

Such digital package has been rejected in March 2019: the unanimity of all the Member States required for the approval of the Commission Proposals is indeed lacking and – as a consequence – the European Union calls to keep on working on a global solution at the OECD level (see the outcome of the EU Finance Ministers' meeting held in March 2019 in Brussels).

In this context, several States have introduced unilateral measures, such as the Indian equalization levied described in the above paragraph 3.5.1. Italy appears to be at the forefront of the on – going debate on the taxation of the digital companies. In 2017, a procedure of cooperation and enhanced collaboration has been introduced: it allows large multinational groups to discuss and examine jointly with the Italian tax authorities whether they may be deemed to have a permanent establishment in Italy (see art. 1*bis* of Law Decree No. 50 of 4 April 2017, converted by Law No. 96 of 21 June 2017). According to the intention of the Italian legislator, such measure is mainly targeted to companies active in the digital economy[269].

The introduction of a short-term solution appears instead more disputed, although several legislative attempts have been performed in the recent years. A short-term solution was initially introduced by article 1, paras 1011–1019 of Law N. 205 of 27 December 2017 (Finance Bill 2018), with a deferred planned application starting from 1 January 2019. The objective scope of the proposed tax should have been further specified by a decree issued by the Italian Ministry of Finance; such a decree – expected for April 2018 - has never been published. Italy decided indeed to prevent the entry into force of the measure, preferring to wait for the adoption of an interim

[268] See the *Explanatory memorandum accompanying the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence (COM(2018) 147 final of 21.03.2018)*, available at <http://eur-lex.europa.eu/>, p. 4.

[269] For an in – depth analysis, see M. CERRATO, *La procedura di cooperazione e collaborazione rafforzata in materia di stabile organizzazione (c.d.* web tax *transitoria)*, in *Rivista di diritto tributario*, 2017, p. 751.

tax at the European level. The mentioned digital tax – which has never become effective – has been repealed by article 1(50) of Law no. 145/2018.

Article 1(35-49) of L 145/2018 enacted a new digital services tax (*imposta sui servizi digitali*) that is substantially in line with the digital services tax proposed by the European Commission. In this case also, the Ministry of the Economy and Finance and the tax authorities are expected to issue, respectively, a decree and a Commissioner's Regulation to set forth the implementing rules of the digital service tax. The digital service tax will apply from the 60th day following the publication in the Official Gazette of the mentioned documents: as of today, such publication is still pending.

In light of the above, it appears clear that international tax coordination is unavoidable in order to properly face the challenged posed by the digital economy. In other words – as clearly noted in this respect – «in one way or another, it would seem that the existing body of international and supranational rules posing counter-limits on the adoption of unilateral measures are so pervasive that, were they to be eventually implemented, could actually appear as an equalization levy in name only or as a type of levy with fairly concerning distortive effects. Such a conundrum would seem to suggest that the current international legal framework appears more successful than anticipated in making international tax coordination unavoidable, virtually undermining the enactment of unilateral measures that would be in line with the policy objectives that have been outlined above»[270].

Any different solution could indeed cause situations of double taxation for the tax payers, exactly what (with situations of non-taxation) our international tax system has built on to prevent.

[270] A. TURRINA, *Which "Source Taxation" for the Digital Economy?*, *cit.*, p. 519.

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