Stjepan Gadžo

Nexus Requirements for Taxation of Non-Residents' Business Income

A Normative Evaluation in the Context of the Global Economy

IBFD DOCTORAL SERIES 41

Nexus Requirements for Taxation of Non-Residents' Business Income

Winner of the 2017 European Academic Tax Thesis Award, jointly awarded by the European Association of Tax Law Professors (EATLP) and the European Commission.

Why this book?
This book explores one of the most fundamental issues of international tax law: the conditions under which a state may assert a taxing claim over business income derived by a person who is neither its national nor its resident. The term "nexus" or "genuine link" is commonly used in international tax scholarship to describe such basic requirements for the exercise of income tax jurisdiction. When it comes to non-residents, income tax is intimately connected to the notion of "source", in that every state has the right to tax income derived from sources located within its territory.

The main purpose is to analyse the appropriateness of different nexus norms used by states in the taxation of non-resident business income. Particular attention is drawn to developments associated with the global economy, e.g. the introduction and expansion of e-commerce and the rise in cross-border services trade. Methodologically, the value-oriented approach is followed, analysing the research question in light of traditional tax policy benchmarks, such as equity, neutrality and administrability.

A substantial part of the analysis is devoted to the permanent establishment (PE) concept, which acts as a general proxy for the source of business income in a tax treaty context. One conclusion is that the use of a PE nexus in its traditional forms (i.e. fixed place PE and agency PE) places inappropriate restrictions on the tax jurisdictions of the "market states", where the customer base for taxpayer goods and services is located and important benefits related to the derivation of non-resident income are provided.

Title:	Nexus Requirements for Taxation of Non-Residents' Business Income
Subtitle:	A Normative Evaluation in the Context of the Global Economy
Author(s):	Stjepan Gadžo
Date of publication:	June 2018
ISBN:	978-90-8722-448-6 (print/online), 978-90-8722-449-3 (ePub), 978-90-8722-450-9 (PDF)
Type of publication:	Book
Number of pages:	408
Terms:	Shipping fees apply. Shipping information is available on our website
Price (print/online):	EUR 115 / USD 140 (VAT excl.)
Price (eBook: ePub or PDF):	EUR 92 / USD 112 (VAT excl.)

Order information
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ISBN 978-90-8722-448-6 (print)
ISBN 978-90-8722-449-3 (eBook, ePub)
ISBN 978-90-8722-450-9 (eBook, PDF)
ISSN 1570-7164
NUR 826

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Sample Content

General Introduction

1.1. Background to the problem

Professional comedians normally have little or nothing to say about taxation, probably due to its serious and inaccessible jargon.[1] Former comedy group Monty Python is a notable, if unsurprising, exception. In a sketch devoted to the otherwise dry subject of fiscal policy, one character, among other suggestions, declares: "To boost the British economy I'd tax all foreigners living abroad".[2] Why does this proposal seem at once so surreal and absurd – simply "Pythonesque"[3] – to the man on the street, ignorant to the intricacies of taxation and tax law? A layman's explanation, provided with the risk of spoiling the joke, would probably take account of the lack of benefits that foreigners living outside United Kingdom receive from the state, thus making the taxation uncalled for.

International lawyers, not necessarily experts in taxation, would spot a basic issue with the proposal: since foreigners not living in a state are well outside the state's sphere of sovereign powers, the state lacks a valid jurisdictional claim under international law. On the other hand, every tax lawyer having a grip on the basics of international taxation would follow up on this line of thought and add a vital observation: the taxation of aliens living outside of the state is actually a very common phenomenon. Namely, states regularly and legitimately tax non-resident aliens' income that has been generated within their territory.[4] In tax jargon, this is called source taxation. Therefore, a truly Pythonesque proposal – from the international tax law perspective – which no government with common sense would follow up on, is to tax non-resident aliens on their foreign-source income. This conclusion is derived from the very fundamentals of taxation and the nature of the tax relationship arising between states on the one side and natural/juristic persons on the other.

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1. As noted by one prominent scholar, "[T]ax law is nasty, brutish ... and long". *See* J. Avery Jones, *Tax Law: Rules or Principles?*, 17 Fiscal Studies 3, p. 68 (1996).
2. Available at http://www.ibras.dk/montypython/episode15.htm#4.
3. The dictionary description of this adjective is as follows: "denoting a kind of humour that is absurd and unpredictable; zany; surreal", available at http://www.thefreedictionary.com/Pythonesque.
4. W. Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 *Georgia Law Review* 1, pp. 6-7 (2003).

Modern states can exercise their taxing powers only in accordance with the pertinent legal framework. This is a corollary of a long battle against arbitrary taxation in the Western world.[5] Conversely, as observed by Kemmeren, "imposition of taxes merely on the basis of physical power cannot be considered acceptable nowadays, because it lacks a legal basis".[6] The legal framework for the taxation of cross-border economic activities is complex, due to the existence of multiple sovereigns interested in their share of the potential tax base. The doctrine of state sovereignty provides the conceptual underpinning to the legal framework within which states exercise their taxing power over cross-border economic activity.[7] In the language of public international law, sovereignty demarcates the state's tax jurisdiction, i.e. the right of the state, under international law, to regulate tax matters and to enforce ensuing tax claims. Therefore, the outer limits of a sovereign state's taxing powers, viewed in relation to other states, are set by public international law. Within these limits, every state is free to set rules that regulate its tax jurisdiction over natural and juristic persons. It does so either unilaterally, in its domestic law, or by entering into international treaties with other states.

The totality of principles and rules of tax jurisdiction forms part of international tax law, i.e. the specific body of law governing transnational fiscal facts.[8] In fact, questions of the existence and extent of a state's tax jurisdiction constitute the core problem of this body of law.[9] By regulating jurisdictional clashes in the taxation of cross-border activities, international tax law not only mitigates the undesirable effects of potential multiple taxation, but also seeks to accomplish other important policy goals.[10]

5. F. Vanistendael, *Legal Framework for Taxation*, in: *Tax Law Design and Drafting: vol 1* (V. Thurony ed., International Monetary Fund 1996). For an overview of historic evolution of taxation, *see*, e.g. F.H.M. Grapperhaus, *Tax Tales from the Second Millennium: Taxation in Europe (1000 to 2000) the United States of America (1765 to 1801) and India (1526 to 1709)* (IBFD 2009); C. Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization* (Madison Books 2001); M. Alink & V. van Kommer, *Handbook on Tax Administration* pp. 7-16 (IBFD 2011), Online Books IBFD.
6. E. Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* p. 18 (Pijnenburg Vormgevers/Uitgevers 2001).
7. *See*, in detail, sec. 2.1.1.
8. For a definition of international tax law, *see* sec. 1.7.
9. In the words of Miller and Oats: "The essence of the subject of international taxation is the issue of whether, and to what extent, a country has a right to tax an individual or a company. In legal terminology, what is the jurisdiction to tax?". *See* A. Miller & L. Oats, *Principles of International Taxation* p. 24 (Tottel Publishing 2014).
10. For a brief overview of the main policy goals of international tax law, *see* B.J. Arnold & M.J. McIntyre, *International Tax Primer* pp. 4-7 (Kluwer Law International 2002); M. Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* pp. 14-23 (Cambridge University Press 2011).

Under the existing international tax framework, the power of states to tax the cross-border income of an individual or a juristic person is legally constrained on several levels.[11] Firstly, on the level of the legal justification for taxation, a sufficient connection (nexus) between the state and the pertinent income as taxable object must be present. Secondly, on the level of the interaction of overlapping legitimate tax claims by two or more states, each state will, in principle, refrain from taxing if it recognizes a superior tax claim by other state(s), in order to avoid double or multiple taxation. Thirdly, on the level of the tax base quantification, tax authorities usually have to abide by specific principles and rules governing the attribution of profits to the taxpayer and/or the entities he is somehow associated with, such as the so-called arm's length principle. Taken together, these and other rules form the framework for the allocation of rights to tax cross-border income, having profound fiscal and non-fiscal effects globally.

This framework is enshrined in the network of bilateral international tax treaties, as main sources of international tax law. Moreover, its elements are reflected in the domestic tax law of most countries. Since their origins can be traced to the seminal work of academics and governmental experts under the auspices of the League of Nations in the 1920s, principles and rules of international tax allocation can be described as "time-honoured".[12]

This book focuses on the first rule of the above-mentioned set of rules, namely that one of the most important limitations of state tax jurisdiction is the requirement for a sufficient legal connection between a sovereign state and a targeted subject, giving rise to the state's right to tax.[13] In the words of Hellerstein: "[I]n fiscal terms, there are no questions more fundamental than whether, and the circumstances under which, a national or

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11. *Compare* e.g. A. Cockfield et al., *Taxing Global Digital Commerce* p. 43 (Kluwer Law & Business 2013).
12. W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax J. 1, p. 67 (2009), Journals IBFD.
13. R.S.J. Martha, *The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction* p. 46 (Springer 1989). Similarly, *see* K. Vogel, *Double Tax Treaties and Their Interpretation*, 4 Berkeley Journal of International Law 1, p. 7 (1986); W. Schön, *Persons and Territories: On the International Allocation of Taxing Rights*, British Tax Review 6, p. 554 (2010).
Schindel and Atchabahian use the term "jurisdictional connection" by referring to the factors signalling sufficient legal connection: "The jurisdictional connection is defined as the criteria connecting the material element of the taxable event with the scope of a state's taxing power". (A. Schindel & A. Atchabahian, *General Report*, in: *Source and Residence: A New Configuration of Their Principles*, IFA Cahiers de droit fiscal international, vol. 90a, p. 21 (2005). *Compare*, e.g., Kemmeren, *supra* n. 6, pp. 19-20.

subnational state may require a person to contribute to the public treasury".[14] Knechtle – who uses the term "fiscal attachment" in describing the legal relationship between a state and a taxable subject – distinguishes personal fiscal attachment from economic fiscal attachment, noticing that this specific legal relationship can be based either on the factors pertaining to the personality of the taxable subject or on the factors pertaining to his economic interests.[15] Martha advocates a classification that seems to be more accurate from a public international law perspective. He highlights the difference between the nationality criterion, signifying the only connecting factor that subjugates the taxable subject to the sphere of the state's personal sovereignty, and different criteria that subjugate the subject to the sphere of the state's territorial sovereignty.[16] In the latter group, the two criteria most often invoked in state practice are fiscal residence, on the one hand, and source of income, on the other. In short, fiscal residence may be described as a special, intimate relationship formed between a taxpayer and a state on the basis of the taxpayer's personal attributes (e.g. the domicile of a natural person).[17] Conversely, the source of income stands for a connection that is based on the location of the taxpayer's economic interests (e.g. economic activity giving rise to income) in the state territory.[18]

Notwithstanding the divergent views on their proper taxonomy, all of the connecting factors produce a fundamentally identical effect: they legitimize the state's income tax jurisdiction.[19] The existence of this legitimizing connection is often labelled in the literature as tax nexus.[20] As Mines put

14. W. Hellerstein, *Jurisdiction to Tax in the New Economy: International, National, and Subnational Perspectives*, 38 Georgia Law Review, p. ix (2003).

15. A.A. Knechtle, *Basic Problems in International Fiscal Law* pp. 35-36 (Kluwer 1979). In a similar vein Kemmeren, analysing the legal relationship between the state and the taxable subject, asserts that "[a] relationship can, therefore, reveal itself through a political and/or economic connection with the state concerned" (Kemmeren, *supra* n. 6, p. 20). Pires similarly makes a difference between factors of a personal nature (e.g. nationality and residence) and factors of a real nature (e.g. permanent establishment location). *See* M. Pires, *International Juridical Double Taxation of Income* p. 109 (Kluwer Law and Taxation Publishers 1989).

16. Martha, *supra* n. 13, p. 47.

17. A more detailed insight into the notion of fiscal residence is provided in sec. 2.2.7.2.

18. A more detailed insight into the notion of "source" is provided in sec. 2.2.7.3.

19. On the other hand, different connecting factors lead to very different results when it comes to the extent of the tax liability of the person in question, i.e. the issue of whether a subject is liable to tax on his/her income without taking account of the sources of income (unlimited tax liability), or only on his/her income arising from the sources within the territory of the state in question (limited tax liability). *See*, e.g., Knechtle, *supra* n. 15, pp. 36-37; Martha, *supra* n. 13, pp. 48-55; Arnold & McIntyre, *supra* n. 10, p. 15.

20. *See*, e.g., Arnold & McIntyre, *supra* n. 10, p. 15.; R.L. Doernberg & L. Hinnekens, *Electronic Commerce and International Taxation* (Kluwer Law International 1999); L. Cerioni &

it, "nexus describes whether a taxpayer, property, or activity has sufficient connection with a state to be subject to that state's tax jurisdiction".[21] It should be noted that a number of international tax scholars use the term only in respect of source taxation.[22] Even the definition of the term given in the IBFD Tax Glossary starts by describing it as a "term generally used in the context of a state's jurisdiction to tax foreign or non-resident persons".[23] The reason for such an approach probably lies in the unambiguity of fiscal residence as a connector that legitimizes taxation by the residence state of the taxpayer. However, it should be noted that such an approach ignores the fundamental point that fiscal facts not related to the source of income – such as nationality or fiscal residence of the taxpayer – also represent connecting factors from which income tax nexus ensues. Against this backdrop, concepts of source and residence are effectively two sides of the same coin, reflecting the idea that a sufficient nexus between a sovereign state and a person must be present to justify that state's taxing right. By the same token, Bird and Wilkie find the nexus requirement as a question prior to the endless "source versus residence" debates.[24]

P.M. Herrera, *The Nexus for Taxpayers: Domestic, Community and International Law* in: *Value Added Tax and Direct Taxation: Similarities and Differences* p. 571 (M. Lang, P. Melz & L. Kristoffersson eds., IBFD 2009), Online Books IBFD.
The dictionary definition of this word of Latin origin (*nexus*) is "a connection or link, often a causal one". *See Black's Law Dictionary* p. 3307 (West Publishing 2008). Original usage of the term in the tax jargon can be traced back to the issues related to the allocation of taxing powers between sub-federal levels of government in the United States. *See*, e.g., E.A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit and the Dormant Commerce Clause*, 28 Virginia Tax Review 1 (2008).

21. P. Mines, *Nexus*, in: *The Encyclopedia of Taxation & Tax Policy* (J.J. Cordes, R.D. Ebel & J. Gravelle eds., The Urban Institute 2005), p. 269.

22. J. Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* p. 88 (Canadian Tax Foundation 2003). In a similar vein, Arnold notes that "nexus rules are used to determine whether a non-resident's connections with a country justify taxation by that country". *See* B.J. Arnold, *Threshold Requirements for Taxing Business Profits Under Tax Treaties*, in: *The Taxation of Business Profits Under Tax Treaties* p. 62 (B.J. Arnold, J. Sasseville & E.M. Zolt eds., Canadian Tax Foundation 2003).

23. *Nexus* in *International Tax Glossary*, Glossary IBFD (accessed 9 Dec. 2015). The entry continues by describing the essence of the term: "As such it refers to whether the relevant factors connecting that person to the jurisdiction in question are such as to justify the exercise of such jurisdiction. Factors that may be considered relevant – which may vary according to the facts and circumstances or the tax in question within one jurisdiction, or as between jurisdictions – include physical presence or economic activity or a combination of both".

24. R.M. Bird & J.S. Wilkie, *Source vs. Residence-Based Taxation in the European Union: The Wrong Question?* in: *Taxing capital income in the European Union: issues and options for reform* pp. 94-96 (S. Cnossen ed., Oxford University Press 2000).

When it comes to the taxation of cross-border business income,[25] connecting factors signalling the existence of a nexus can be manifold, as demonstrated by the rules of international tax law *de lege lata*. Fiscal residence of a natural/juristic person is a factor unequivocally constituting a nexus in the residence state, deep-rooted both in domestic tax law and tax treaties. On the other hand, there are divergent approaches to what constitutes a nexus in other, non-resident states. The most important set of rules regulating the nexus for the taxation of non-residents' business income is the so-called permanent establishment (PE) rules.[26] According to these rules – embodied in virtually every one of more than 3,000 bilateral tax treaties currently in force – a state can tax a non-resident's business income only if he is carrying on business through a fixed place of business located in the territory of that state, or through a person present in that state, deemed to be his "dependent agent".[27] The presence of these connecting factors indicates that the economic attachment of a person with the PE state is strong enough to justify the taxing rights of that state.

The modern economic environment challenges the appropriateness of using the PE nexus in the taxing rights allocation framework.[28] Against this backdrop, three distinct but intertwined phenomena – instigated by the forces of globalization – deserve special emphasis: (1) the rapid increase in the volume of cross-border trade in services; (2) the advent and expansion of electronic commerce; and (3) the development of new business models, based on the fragmentation of value-added chains.

It is a natural consequence of the first phenomena that the portion of total cross-border business income attributable to the services sector is ever-increasing, which poses serious issues for determining tax nexus. In many cases, service providers can cater to their customers in foreign markets without the need either to establish a local subsidiary company or to provide services via a PE situated therein. Service importing countries, especially

25. Business income or active income is a "term used generally to describe the distinction made by many countries between income from business activities and income from capital". *See Active Income* in *International Tax Glossary*, Glossary IBFD (accessed 9 Dec. 2015). More on the notion of active (business) income in a tax treaty context, *see* sec. 4.2.
26. Arnold, *supra* n. 22, p. 55; J. Schaffner, *The Territorial Link as a Condition to Create a Permanent Establishment*, 41 Intertax 2, p. 638 (2013); J. Schwarz, *Schwarz on Tax Treaties* p. 183 (Kluwer Law International 2013).
27. *See*, in detail, sec. 4.5.
28. For a landmark critique of the PE concept in a new economic context, *see* A.S. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* p. 557 (Kluwer Law and Taxation Publishers 1991).

those with large consumer markets (e.g. India and China), therefore feel that the existing nexus rules lead to the unfair depletion of their tax base. Opportunities for spatial separation between service providers and the customer base have been taken to a completely different level by the second of the above-mentioned phenomena – the rise of electronic commerce.[29] Not only has the use of computer and information technology transformed many business operations, but it has also paved the way for the creation of a completely new market for so-called digital goods (or e-goods), objects of customers' desire existing only in the form of binary digits (bits), e.g. digital video content.[30] In this changed context, the search for "brick and mortar" facilities (e.g. a factory) in ascertaining a taxing nexus seems like an antediluvian joke. The third of the above-mentioned phenomena pertains to the means by which the business community has adapted to the new economic realities, concurrently exploiting rigid international tax rules. This holds true especially for multinational companies (MNCs), subjects that – in the course of their business restructuring and supply chain management – enjoy broad freedom to select in which countries they want to have taxable presence.[31]

1.2. Aim of the book

The main research question of this book is the following: What are the appropriate nexus norms for taxing non-residents' business income, in the light of developments in the contemporary global economy? We aim to provide the answer by conducting a normative legal analysis, i.e. using a value-oriented approach.

It follows that a prerequisite to fulfilling the overarching aim of the book is to construct a robust analytical framework, against which the nexus rules can be evaluated. Specifically, traditional tax policy objectives – equity, efficiency and administrability – will be used as normative benchmarks. In addition, due to the international law facet of the research question, nexus rules, both current and proposed, need to be examined regarding their alignment with the outer limits of a state's tax jurisdiction, which are derived from the doctrine of state sovereignty. Respect for these limits is acknowledged as an *a priori* nexus requirement, stemming from the general

29. *See*, e.g., OECD, *Addressing Base Erosion and Profit Shifting* p. 25 (OECD 2013), International Organizations' Documentation IBFD.
30. *See*, e.g. Doernberg & Hinnekens, *supra* n. 20, p. 245.
31. OECD, *supra* n. 29, p. 20.; K. Sadiq, *Jurisdiction to Tax and the Case for Threshold Reform*, 1 Journal of the Australasian Tax Teachers Association (2005).

international law.[32] Thus, in essence, we start from the assumption that the standard normative framework, used in the evaluation of the domestic tax policy, should be modified when analysing the rules of international tax law, due to the reality of multiple sovereigns.[33]

Accordingly – upon the formation of the assessment framework – the book will aim to realize five specific objectives:
(1) identify and examine nexus requirements in *lex lata*, both on a domestic level and on the tax treaty level;
(2) explore the challenges that *lex lata* faces in the wake of changes to the modern economic environment;
(3) identify and examine prominent proposals *de lege ferenda*;
(4) evaluate both *lex lata* and *lex ferenda* from a normative perspective; and
(5) present the main research findings in the form of a policy proposal.

Four hypotheses, which will be tested throughout the book, are offered at the outset:
(1) current nexus norms, embodied both in tax treaty law and in domestic law, fail to attain the normative ideals of tax equity, tax efficiency and administrability;
(2) the main problem, from a normative perspective, is the usage of the time-honoured concept of PE in the taxation of non-residents' business income;
(3) from a *de lege ferenda* perspective, nexus norms for the taxation of non-residents' business income should be reformed by decreasing the role of physical presence requirements; and
(4) the usage of a new nexus norm based on a *de minimis* revenue threshold is both normatively appropriate and administratively feasible.

1.3. Relevance of the research

Two dimensions, a practical and a theoretical one, need to be taken into account in considering the relevance of the book.

32. *See* Martha, *supra* n. 13, p. 17.
33. For such a proposal on the conduct of research in international taxation, *see* D. Ring, *The Promise of International Tax Scholarship and Its Implications for Research Design, Theory and Methodology*, 55 Saint Louis University Law Journal, pp. 14-15 (2010). Douma also emphasizes that relations between sovereign states differentiate the research in the area of international and EU tax law from general legal research. *See* S. Douma, *Legal Research in International and EU Tax Law* p. 35 (Kluwer 2014).

Firstly, the practical importance of the nexus issue is displayed in a number of ways, ranging from high-value disputes between businesses and tax authorities to the newly launched, international agendas forcing the re-examination of the existing rules. New economic realities, briefly sketched above (*see* section 1.1.), have driven many governments to pay more attention to the nexus issue. The most obvious and mundane motive is that of fiscal nature. Schaffner stresses this point: "There is a tension between developing countries and developed economies who both try to define the tax nexus of a given kind of activity so that they may be able to increase their fiscal revenue".[34] The problem is that – at least in the present institutional framework of international taxation – there are limited options for the short-term reform of the time-honoured nexus norms. This is accentuated particularly in the case of capital and service importing countries with extensive tax treaty networks. Partly due to the "lock-in effect" of tax treaty rules[35] (i.e. the PE rule), various countries have resorted to the troubled path of the creative interpretation of relevant treaty provisions in their administrative and judicial practice. Of particular importance is the marked rise in PE disputes over the last few years, even if this trend is still to some extent country-specific.[36]

Furthermore, a new wave of international tax coordination has been gaining widespread political momentum in the aftermath of the biggest global economic crisis since the Great Depression of the 1930s. The initiative against tax base erosion and profit shifting (BEPS), endorsed by the G20 and managed by the OECD, is a paradigmatic example. The BEPS Project was aimed at an ambitious re-examination of the taxing rights allocation framework. It was launched in a 2013 report,[37] continued with a comprehensive action plan[38] and rounded up with the adoption of concrete policy proposals

34. Schaffner, *supra* n. 26, p. 639.
35. *See* E.A. Baistrocchi, *The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications*, British Tax Review 4, pp. 387-388 (2008).
36. *See*, e.g., R. Collier, *BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status*, British Tax Review 5, p. 639 (2013); A. Martin Jiménez, *Preventing Avoidance of Permanent Establishment Status*, in: *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* p. 325 (A. Trepelkov, H. Tonino & D. Halka eds., United Nations 2015). An interesting report on tax authorities' approach to the PE interpretation reveals that even many developed European countries are taking more "aggressive" positions. *See* PWC, *Permanent Establishments 2.0: The Heart of the Matter* pp. 9-11 (2014), available at http://www.pwc.com/gx/en/tax/publications/permanent-establishments.jhtml.
37. OECD, *supra* n. 29.
38. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD.

in 2015.[39] Two items of the BEPS Action Plan deal with the nexus issues, one aiming to restore integrity to the PE concept (Action 7)[40] and the other dealing with the tax aspects of digital commerce (Action 1)[41] While the fate of the project is still very uncertain, many scholars see it as evidence of the far-reaching power shift in the global political and economic order in favour of the developing and emerging economies, such as the BRICS countries.[42] As noted above, nexus norms *de lege lata* do not serve their interests well.

In fact, the BEPS Project may be perceived as a bridge between practical and theoretical dimensions of the research problem.[43] The present system of taxing rights allocation was conceived in the 1920s (the so-called formative years) and was grounded in a robust theoretical framework.[44] While the ensuing tax treaty provisions may be attributed to the balances of political and economic power,[45] fundamental legal and economic concepts (e.g. tax fairness and tax neutrality) have dominated the debates on international taxation.[46] Indeed, any reform, however significant, of the allocation norms should be based upon legitimate policy objectives. Undoubtedly, nexus norms constitute the core of the entire system, thus calling for their detailed re-examination in the light of relevant theoretical concepts. For instance, the topical question of whether the "market state" could claim to have a nexus solely because the consumer base is located in its territory, cannot be answered without taking into consideration the legal and economic fundamentals of international tax allocation.[47]

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39. The final BEPS reports are available online at http://www.oecd.org/ctp/beps-2015-final-reports.htm.
40. *See* OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.
41. OECD, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014), International Organizations' Documentation IBFD.
42. *See*, e.g., Y. Brauner & P. Pistone, *The BRICS and the Future of International Taxation*, in: *BRICS and the Emergence of International Tax Coordination* (Y. Brauner & P. Pistone eds., IBFD 2015), Online Books IBFD.
43. The link between "BEPS issues" and the framework for international tax allocation is discussed in e.g. H.J. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 Tax Notes International 12, p. 1199 (2013).
44. *See* League of Nations Economic and Financial Commission, *Report on Double Taxation submitted to the Financial Committee* (League of Nations 1923).
45. Kemmeren, *supra* n. 6, p. 18.
46. For an overview of these concepts, *see* Schön, *supra* n. 12, pp. 71-84.
47. *See*, e.g., M.J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax Law Review 3, p. 299 (2001); W. Schön, *International Tax Coordination for a Second-Best World (part III)*, 2 World Tax J. 3, pp. 256-257 (2010), Journals IBFD.

1.4. Methodology

The methodological approach is fully determined by the aim and objectives of the book. Notwithstanding the idiosyncrasies of international tax law research, it must be recognized at the outset that this research is not, due to the chosen subject, fundamentally different than legal research in general.[48] All legal research can be divided, based upon the methodological approach, into two broad categories: doctrinal and non-doctrinal research.[49] While doctrinal research aims to answer the question of what the law is, non-doctrinal research goes beyond the "black letter" of the law. Smits divides non-doctrinal approaches into three sub-categories – empirical, theoretical and normative – on the basis of questions they ask about the law.[50]

As explicated in section 1.2., this book poses the question of what the law of nexus ought to be, against the framework built on certain normative ideals (values). Using only the doctrinal legal approach would clearly be unsuitable for answering this question. Nevertheless, a description of the black-letter law of nexus is necessary to evaluate its merits and demerits. Therefore, a significant part of the research is descriptive, in that primary and secondary sources are used in examining the legal framework and its organization. While one subpart of the descriptive part of the book deals with nexus rules in tax treaties, the other examines the nexus rules in the domestic law of a selected group of countries. In the latter, the comparative method is used in order to identify the main substantive differences and the underlying causes thereof. The added value of a comparative study is that it enables us to find solutions that differ from the generally accepted international tax norms, such as the PE norm.

The second part of the research takes on a normative approach. By assessing different nexus rules against selected benchmark values (protection of state sovereignty, equity, neutrality and simplicity), it is aimed at giving normative statements about the law, i.e. what the law ought to be.[51] While it

48. *See* Douma, *supra* n. 33, p. 35.
49. M. McKerchar, *Design and Conduct of Research in Tax, Law and Accounting* pp. 115-116 (Thomson Reuters 2010); I. Dobinson & F. Johns, *Qualitative Legal Research*, in: *Research methods for law* p. 17 (M. McConville & W. Hong Chui eds., Edinburgh University Press 2007). *Compare also*, in the context of tax law research, M. Myrsky, *Basic Research in Tax Law*, 44 Scandinavian Studies in Law, p. 277 (2003).
50. J.M. Smits, *The Mind and Method of the Legal Academic* pp. 8-11 (Edward Elgar 2012). *Compare also* Dobinson & Johns, *supra* n. 49, pp. 19-21.
51. Burton uses the term "normative legal theory" to describe this type of approach to legal research. *See* S.J. Burton, *Normative Legal Theories: The Case for Pluralism and Balancing*, 98 Iowa Law Review 2, p. 537 (2013). This type of research is frequently also

has been commonplace to question the legitimacy of normative approaches to law,[52] we share Smits' views on the merits of normative legal research.[53] Smits asserts that the law (as a scientific discipline) is pre-eminently an argumentative discipline, reflecting the world of ideas about what the law (as a body of authoritative statements) ought to be.[54] The role and the value of the normative approach are, then, to assess the argumentative power of conflicting normative positions.[55] In this book, we largely employ what Smits describes as the "empirical-normative method". This method, in essence, observes positive rules from different jurisdictions as sources of information on the power of specific normative argument, enabling their comparison and evaluation.[56] In his discussion on the use of the normative perspective in international and EU tax law, Douma suggests two possible approaches, the "procedural-normative" and the "substantive-normative",[57] adding that Smits' empirical-normative method is suitable for the latter. This approach is taken in the present book with respect to the evaluation of pertinent nexus norms, stipulated both on the domestic and on the international level.

1.5. Delimitations of the research

Foremost, delimitation of the present study is that it is a result of a single-disciplinary approach to research. We are aware of the serious misgivings on the aptness of legal research in providing tax policy solutions, that being the main aim of this book. Since taxation is a social phenomenon par excellence – in the illuminating words of Picciotto: "[T]axation is the point of most direct interaction between government and citizens, the state and the

described as policy-oriented (or reform-oriented) research. *See*, e.g., McKerchar, *supra* n. 49, p. 116. To embark on this type of research presupposes the researcher's view that the legal scholarship is ultimately directed towards policy, as explicated in Ring, *supra* n. 33, p. 19. At the same time, we share the view expressed by Freedman that legal scholars should not circumvent the underlying technical law in making policy suggestions. *See* J. Freedman, *Tax Research as Legal Research*, in: *Taxation an interdisciplinary approach to research* p. 14 (M. Lamb et al. eds., Oxford University Press 2005).

52. *See* chapters written by Van Hoecke, Hage and Mackor in M. van Hoecke, *Methodologies of Legal Research: Which Kind of Method for What Kind of Discipline?* (Hart Publishing 2011).

53. *See* Smits, *supra* n. 50, pp. 41-48.

54. Id., p. 58.

55. Id., p. 59.

56. *See*, in detail, id., pp. 76-81. *Compare also* the ideas on the interaction between positive and normative legal analysis laid out in P. Arginelli, *Multilingual Tax Treaties: Interpretation, Semantic Analysis and Legal Theory* sec. 1.1.2. (IBFD 2015), Online Books IBFD.

57. Douma, *supra* n. 33, pp. 43-44.

economy"[58] – it provides for a fruitful, multidisciplinary area of research.[59] Undeniably, one can approach the research question posed in this book from a purely economic perspective, searching for the most efficient, best-world outcomes.[60] One can also take an international political economy perspective, explaining the structure of the current framework using the vast array of interdisciplinary tools.[61] We share the view that this and other possible approaches are to be encouraged as they can greatly expand our knowledge on the subject.

On the other hand, one must be aware that every discipline operates in a distinctive linguistic network, hence leading to the emergence of differing "discourses" on taxation (e.g. economic, legal, moral and political discourse).[62] Tax policy discourse is where other discourses face one another, putting forward arguments to the policymakers on the proper course of action in tax matters.[63] It ensues from the research question and the methodology of this book – as presented above – that our purpose is to provide policy solutions, thus entering the battlefield of policy discourse, but starting from the concepts internal to the legal discourse, e.g. the concept of tax jurisdiction. Elements external to the legal discourse are the normative benchmarks we use in the evaluation framework, grounded either in ethics (e.g. tax equity) or in economics (e.g. tax efficiency and tax simplicity).[64] As noted by Ring, there is a long tradition in tax law scholarship to internalize normative concepts, primarily borrowing it from economists and streamlining them, with a consideration for legal norms and institutions, in order to provide "guidance to the real-world".[65] As Vann puts it in the introduction of his article on

58. S. Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* p. xi (Quorum Books 1992). *Compare also* K. Tipke & J. Lang, *Steuerrecht* p. 1 (Otto Schmidt 1996).
59. For a brief overview, *see* M. Lamb, *Interdisciplinary Taxation Research – An Introduction*, in: M. Lamb et al. eds., *supra* n. 51, p. 3.
60. That is in the tradition of the welfarist approach to social policies. *See*, e.g., L. Kaplow & S. Shavell, *Fairness versus Welfare* (Harvard University Press 2002).
61. For a masterful example of this approach to international taxation, *see* T. Rixen, *The Political Economy of International Tax Governance* (Palgrave Macmillan 2008).
62. I. Roxan, *Limits to Globalisation – Some Implications for Taxation, Tax Policy, and the Developing World*, LSE Law, Society and Economy Working Papers, pp. 10-11 (2012), available at http://papers.ssrn.com/sol3/Delivery.cfm?abstractid=1995633.
63. Id., pp. 11-14.
64. For a similar approach, *see* R.J. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation* p. 4 et seq. (Kluwer Law International 1999); M.F. de Wilde, "*Sharing the Pie": Taxing Multinationals in a Global Market* (Erasmus University Rotterdam 2015).
65. Ring, *supra* n. 33, p. 4. *Compare also* ideas laid out in Freedman, *supra* n. 51, pp. 28-30.

international tax allocation: "[A]n important role for legal academics is to investigate how policy prescriptions can be made operational".[66]

Further limitations of the present study pertain to a number of specific legal issues arising in the context of a discussion on proper nexus rules that are not examined. Firstly, the research is focused only on the business income of non-resident persons. Therefore, a very important and often-debated question – especially with regard to legal entities as taxpayers – on the appropriateness of fiscal residence as a connecting factor legitimizing the state's income tax jurisdiction, is not examined in the book.[67] Fiscal residence is used only in the context of explicating the fundamentals of income tax jurisdiction set by public international law. Consequently, we highlight its resemblance with the PE concept and other factors used to denote the "source of income", as possible manifestations of the state's territorial sovereignty.[68] Additionally, some recent contributions dealing with the tax policy aspects of (corporate) residence may justify this delimitation.[69]

Secondly, the book examines only nexus rules regulating the taxation of active (business) income, i.e. income to which article 7 of the OECD Model Convention applies as *lex generalis*.[70] Items traditionally classified as passive (or investment) income, like interests, dividends and royalties, are left out of the analysis. The choice can be justified by the important differences in the allocation of the taxing rights with respect to these two broad income categories. The derivation of cross-border passive income – particularly from portfolio investments – usually entails minimal physical presence in the other, presumed source country. It seems that this was the cause for a fundamentally different approach in creating pertinent nexus rules, ever since the formative years of international tax coordination and the creation of the first model tax treaties (1920s). That is, the mere fact that the payer of passive income has its fiscal residence in a country is used as a factor legitimizing the taxing claim of that country. Against this backdrop, nexus rules

66. R.J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 World Tax J. 3, p. 292 (2010), Journals IBFD.
67. For a persuasive critique of the concept of corporate residence as a starting point for international income tax allocation, *see* Graetz, *supra* n. 47, p. 299.
68. *See*, in particular, sec. 2.2.7.2.
69. We particularly refer to the comprehensive study on corporate residence written by Robert Couzin, who, although specifying in the preface that his book is not a "tax policy text", heavily explores tax policy issues in the final chapter. *See* R. Couzin, *Corporate Residence and International Taxation* (IBFD 2002). *Compare also* Brian Arnold's commentary of Couzin's analysis in B.J. Arnold, *A Tax Policy Perspective on Corporate Residence*, 51 Canadian Tax Journal 4 (2003). For a more recent contribution, *see*, e.g., O. Marian, *Jurisdiction to Tax Corporations*, 54 Boston College Law Review 4 (2013).
70. *See*, for a detailed explanation of this relationship, sec. 4.2.

for passive income will be referred to in the book only in analogy with those types of cross-border business income that can be derived without the need for a non-resident's significant physical presence in the market state.[71] A similar approach is undertaken in the book with respect to items of business income that are governed by specific distributive rules of tax treaties, e.g. income related to international shipping and air traffic, the income of artistes and sportsmen, etc.[72] Therefore, these distributive rules will be used simply to demonstrate which factors may signify the existence of a sufficient link between a non-resident's business income and the territory of the presumed source state. It should be emphasized that this delimitation is based on the assumption that the system for taxing rights allocation will continue to follow the schedular approach, i.e. the compartmentalization of a taxpayer's total income into different income categories.[73] This approach – attributed largely to the prevalence of schedular income tax systems in European countries during the "formative years"[74] – may seem hard to swallow from a theoretical perspective, but it is well entrenched in the system and unlikely to be reformed in the near future.[75]

Thirdly, issues of the attribution of income are also left out of the scope of this book. Admittedly, due to the inextricable connection between the issue of jurisdiction to tax (subjective tax liability) and the apportionment of income/expenses (objective tax liability), a few references to possible approaches to profit attribution – both existing and proposed – are made throughout the book. From a theoretical perspective, however, these issues can be considered to be separate.[76]

71. *Compare also* the discussion on the difference in the allocation of the rights to tax active/passive income in R.S. Avi-Yonah, N. Sartori & O. Marian, *Global Perspectives on Income Taxation Law* pp. 156-158 (Oxford University Press 2011).
72. *See* sec. 4.7.
73. *See* P.A. Harris & D. Oliver, *International Commercial Tax* pp. 71-76 (Cambridge University Press 2010).
74. K. Vogel, *The Schedular Structure of Tax Treaties*, 56 Bulletin for International Fiscal Documentation 260, p. 260 (2002). *See also* B.J. Arnold, J. Sasseville & E. Zolt, *Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century*, 50 Canadian Tax Journal 1, pp. 77-78 (2002). For a detailed account of the developments of income tax legislation in European countries before World War I, *see* P.A. Harris, *Corporate-Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* pp. 288-293 (IBFD 1996).
75. Similarly, *see* Arnold, *supra* n. 22, pp. 58-60.
76. *See* id., pp. 67-68. Further clarification on this issue is given by Skaar, who distinguishes the issue of whether a state has a tax jurisdiction, under the PE norm, from the issue of apportionment of income and expenses to that PE. *See* Skaar, *supra* n. 28, pp. 4-5. Arguably, one should note Brauner's criticism on the separation of the PE issues

Finally, several general assumptions from which the book departs must be noted. First and foremost, in analysing the system of allocation of the right to tax income, we depart from the paradigm of state sovereignty. We acknowledge the fact that most of the contemporary tax policy problems are a result of the natural tension between the Westphalian paradigm of nation states' sovereignty in tax matters, on the one side, and the processes of globalization, on the other. In other words, when economic activity is increasingly turning global, taxes are increasingly losing their local (nation-state) character. On the other hand, this is primarily a book on the limits of states' tax jurisdiction, and tax jurisdiction is but one expression of state sovereignty. The world still seems to be very far from the creation of an "international tax organization", upon which states' taxing powers would be conferred. The term "international tax coordination" still effectively describes the collaboration between sovereign states. We also assume that current domestic tax structures will remain largely unchanged, in the sense that income taxes will continue to play an important role in the raising of public revenues.[77] Therefore, the inquiry into the problems of income tax jurisdiction seems both highly relevant and justified. Furthermore, we also assume that, in the foreseeable future, there will not be any radical reforms to the system of integration of company/shareholder taxation, i.e. that countries will continue to levy both individual and corporate income taxes, concurrently using various methods of integration of the two.[78] This point is important since most of the cross-border business income is derived through legal entities. Finally, we assume that there will not be a radical change in the norms that govern the apportionment of income and expenses stemming from intra-firm transactions and dealings.[79] That is, the often-criticized arm's length principle is assumed to keep its status as the general norm.[80] Arguably, much of the analysis in this book could also be used in

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(BEPS Action Item 7) with the attribution of profits issue (BEPS Action Items 8-10) in the BEPS Action Plan. *See* Y. Brauner, *BEPS : An Interim Evaluation*, 6 World Tax J. 1, p. 29 (2014), Journals IBFD.

77. *See* sec. 2.2.3.
78. *See* Schön, *supra* n. 12, pp. 89-90.
79. Similarly, *see* Arnold, *supra* n. 22, pp. 57-58.
80. Among the abundant supply of literature on the topic of "arm's length vs formulary apportionment", we only refer to those contributions that are focused on the latest trends, in the light of the BEPS Project. *See*, e.g., Y. Brauner, *Transfer Pricing in BEPS: First Round – Business Interests Win (But, Not in Knock-Out)*, 43 Intertax 1 (2015); G. Kofler, *The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressure?*, British Tax Review 5 (2013); A. de Graaf, P. de Haan & M.F. de Wilde, *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS*, 42 Intertax 5 (2014).

the case of the transition to the alternative system of formula apportionment, which also employs thresholds in the allocation of tax revenues.[81]

1.6. Outline of the book

This book is divided into eight parts. Chapter 1 provides a short general introduction to the issues that will be analysed herein. It lays down the aim, hypotheses and methodology of the research. Chapter 2 examines the legal fundamentals of states' income tax jurisdiction, in the light of the doctrine of state sovereignty. Chapter 3 contains a comparative analysis, exploring different approaches states take in regulating the nexus issue on a domestic level. Chapter 4 provides an analysis of nexus requirements for taxing non-residents' business income that are embodied in tax treaties. Particular emphasis is placed on the analysis of the permanent establishment concept. Chapter 5 outlines the framework construed for the analysis *lex lata* of nexus from a normative perspective. In this respect, we depart from the general tax policy principles, such as tax equity, tax efficiency and administrability, and then adapt these abstract standards to the problem at hand. Chapter 6 explores the ways in which the global economic environment challenges the application of existing nexus norms of international tax law. Chapter 7 provides a normative evaluation of nexus norms *de lege lata*, as well as some prominent reform proposals. A proposal *de lege ferenda* is construed against the backdrop of the main findings of this evaluation. Finally, chapter 8 summarizes the most important conclusions of the book and tests the hypotheses laid down at the outset of the research.

1.7. Terminology

Before proceeding, it seems necessary to briefly present some of the most important terms used consistently throughout the book. This may help readers to avoid potential misinterpretation of our line of reasoning.

First, the term "international tax law" is used extensively throughout the entire book. This term signifies the entire collection of domestic legal

81. For example, the original proposal of the European Commission to introduce the so-called common consolidated corporate tax base model (CCCTB) relied on the PE concept in the allocation of tax revenues. *See* European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121/4. For a discussion on this topic, *see* S. Mayer, *Formulary Apportionment for the Internal Market* p. 202 (IBFD 2009).

provisions governing the taxation of cross-border economic activity, complemented by the provisions of double tax treaties.[82] Or, in the words of Knechtle, who ascribes the widest possible sense to the notion of "international fiscal law", it is "the sum total of international and national conflict rules and of substantive rules which are applied to international fiscal facts".[83] This view is prevalent in modern tax scholarship.[84]

Since chapter 2 draws heavily on the terminology of public international law, which is essential to understanding the notion of tax jurisdiction, some concepts that are not necessarily part of "international tax language" are used throughout the book when discussing jurisdictional issues. At various occasions, we refer to the dichotomy between general international law and particular international law. *General international law* is a *terminus technicus* used to denote a category of norms of international law that are binding *erga omnes*, i.e. a subcategory of international law that applies to all states as primary subjects of international law.[85] In contrast, *particular international law* has a narrower, subjective scope of application, signifying a category of norms binding *inter partes*, i.e. among limited number of states. As will be demonstrated below, this differentiation is intertwined with the differentiation between main sources of international law, as norms of general international law are in most cases of a customary nature, and norms of particular international law, in most cases, stem from the treaties.[86]

82. The notion and legal effects of double tax treaties is explained in detail in sec. 4.1.1.
83. *See* Knechtle, *supra* n. 15, pp. 15-16.
84. *See* e.g. Arnold & McIntyre, *supra* n. 10, p. 2; K. Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application* p. 2 (IBFD 2007); Kobetsky, *supra* n. 10, p. 42; E. Reimer, *Permanent Establishment in the OECD Model Tax Convention*, in: *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* p. 14 (E. Reimer, N. Urban & S. Schmid eds., Kluwer Law International 2012); O. Lončarić-Horvat & H. Arbutina, *Osnove međunarodnog poreznog prava* pp. 3-4 (Narodne Novine 2007).
85. For a detailed discussion on the meaning of general international law from a normative scope-type perspective, *see* A. Gourgourinis, *General/Particular International Law and Primary/Secondary Rules: Unitary Terminology of a Fragmented System*, 22 European Journal of International Law 4, pp. 1010-1016 (2011).
86. *See* the discussion in id., pp. 1012-1013; *compare also* T. Treves, *Customary International Law*, Max Planck Encyclopedia of Public International Law, available at http://opil.ouplaw.com/view/10.1093/law:epil/9780199231690/law-9780199231690-e1393?rskey=vlKjuK&result=1&prd=EPIL, (noting that "while customary international law rules normally apply to all States, and the expression 'general international law' can be used as synonymous with 'customary international law', in some cases the existence of particular (in general regional or local) customary international rules may be ascertained through the practice of a limited number of States (even of two)"); G.I. Tunkin, *Is General International Law Customary Law Only?*, 4 European Journal of International Law 4 (1993).

Furthermore, when the term "territoriality principle" is used, we ascribe to it the meaning it has under public international law, denoting a generally recognized legal basis of state jurisdiction based on a link existing between a relevant set of facts and the territory of a state.[87] Against this backdrop, both the fiscal residence of the taxpayer and source of income signify different criteria by which the territoriality principle unfolds itself in income tax matters.[88] It should be noted that some other meanings are often ascribed to the term "territoriality principle" (*Territorialitätsprinzip*) in tax scholarship.[89] Most notably, it is widely used to describe the practice of states on the level of determining the quantitative extent of a taxpayer's income tax liability, by which only domestic-source income is being taxed.[90] However, we have opted for limiting the meaning of territoriality only in relation to the justification of the state's right to tax, from a public international law perspective.

Another term that deserves special explanation here is the term "market state". The term will be used to connote the state in which the taxpayer sells his/her goods and/or services. Put differently, the market state is the state where a taxpayer's customer base is located. This term is preferred to the term "destination state" – used by some authors to denote the same thing[91] – in order to avoid confusion with the so-called "destination principle", which is a jurisdictional concept specific to the area of value added tax.[92]

87. For more on the meaning of territoriality principle, *see* sec. 2.1.4.
88. For more on this, *see* sec. 2.2.7.2.
89. For an overview, *see* F.A. Garcia Prats, *Source, Residence and Nationality in Income Tax Matters: Between International Tax Rules and EU Law*, Rivista di Diritto Tributario Internazionale 2, pp. 44-47 (2013).
90. *See*, e.g., M. Lang, *Introduction to the Law of Double Taxation Conventions* pp. 23-24 (Linde 2010); G. Brähler, *Internationales Steuerrecht Grundlagen für Studium und Steuerberaterprüfung* p. 6 (Gabler Verlag 2010); Lončarić-Horvat & Arbutina, *supra* n. 84, p. 22. *Compare also* the discussion on the meaning of territoriality principle provided in the IBFD Glossary: *Territoriality Principle* in *International Tax Glossary*, Glossary IBFD (accessed 9 Dec. 2015).
91. *See*, e.g., M.F. de Wilde, *Tax Jurisdiction in a Digitalizing Economy: Why "Online Profits" Are So Hard to Pin Down*, 43 Intertax 12 (2015).
92. For more on the VAT destination principle, *see* sec. 7.3.4.1.

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