JURISDICTION TO TAX AND THE CASE FOR THRESHOLD REFORM

KERRIE SADIQ

Kerrie Sadiq is a Senior Lecturer at the TC Beirne School of Law, University of Queensland and a Senior Research Fellow in the Taxation Law and Policy Research Institute at Monash University.

I INTRODUCTION

Currently, before a jurisdiction has the right to tax a multinational entity on a share of the income, a minimum threshold, in the form of residency or permanent establishment, must be established. To ascertain residency or permanent establishment the structure of the multinational entity is examined. A multinational entity may enter a market through foreign direct investment1 via one of three structures: a subsidiary, a branch, or a representative office.

This paper considers how the recognition of these structural forms is carried through to the current international tax regime. The purpose of examining the different structural forms, and how they are recognised in the international tax regime, is to argue that they do little in distributing the taxing rights between the relevant jurisdictions in an optimal manner according to economic activity. This paper suggests that, while the threshold tests of residency and permanent establishment are a necessary part of the traditional source and transfer pricing regime, they fail to take into account the unique nature of modern multinational entities.

This paper puts forward the notion that the traditional regime for taxing multinational entities is ‘one composed of legal concepts and constructs that no longer reflect the economic realities of international business.’2 In particular, it is argued that recognising the legal or structural form is the foundation of this lack of recognition of the economic reality of modern multinational entities.3

1 That is, operating as a multinational entity rather than simply an entity which deals internationally. Foreign direct investment is any investment by an entity over which they have ultimate control, with the activity consisting of four dimensions: a transfer of capital, a control investment, a source of funds for foreign operations, and a balance of payments flow. M V Eng, A L Francis and L J Mauer, Global Finance, (2nd 1998) 403.


3 Ibid 1417. Michael Graetz argues, ‘the continuing insistence of the international tax regime in treating different divisions of an integrated multinational business as separate entities, whenever their legal status implies such separation is but one illustration of the problem’—the problem being the legal concepts and constructs which compose the traditional regime.
The purpose of this paper is twofold. First, it is argued that the threshold tests of residency and permanent establishment are legal tests which have no place in a tax regime designed to allocate income based on economic activity. Second, it is argued that the principles contained in the traditional regime requiring the recognition of the different structures adopted, along with a legal distinction recognising the separate parts of the multinational entity, while inextricably tied to the current source and transfer pricing rules, are unnecessary, and therefore irrelevant, in determining the allocation of taxing rights to multinational entities where that allocation is based on economic activity.

There are four primary parts to this paper. First, the legal formalisms of the traditional legal regime, along with the interaction of the principles of residency and source, are considered. Second, the measurements of jurisdictional presence are examined. In this part of the paper the legal tests of residence and permanent establishment are considered in detail. Third, the conundrum of the component approach is examined to demonstrate first, that physical presence does not equate to economic activity, and second, that national boundaries should not be recognised for tax purposes. Fourth, an economically valid threshold test is considered within the framework of a unitary tax regime.

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4 A critique of the traditional residency regime is outside the scope of this chapter. There are further arguments for the abandonment of the residency principle. See, eg, John K Sweet, ‘Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles’ (1998) 146 University of Pennsylvania Law Review 1949, 1995. He states there are four fundamental problems with a residence-based regime: the difficulty in enforcing residence-based taxation on a taxpayer’s global income; the risk of ‘capital flight’; the reluctance by developing countries to submit to a residency-based regime; and the diminishing applicability of the ‘fixed place of business’ concept. Sijbren Cnossen suggests, ‘In view of the enforcement problems of residence-based capital income taxes, the choice may not be between residence-based and source-based taxation, but between source-based taxation and no tax at all.’ Sijbren Cnossen, ‘Tax Policy in the European Union: A review of Issues and Options’ (2001) Rotterdam: Erasmus University 19.

This paper concludes with a proposal for a unitary regime based on global formulary apportionment for multinational entities. A formulary apportionment regime removes both the need to distinguish between the various structural forms adopted as well as a threshold test based on physical presence. Changes in multinationals, and the emergence of new types of multinational entities, mean that ‘links between economic activity and a particular location, traditional tax concepts, such as “residence” and “source” become difficult to apply’. Formulary apportionment is a taxation model that alleviates these problems.

II LEGAL FORMALISMS OF THE TRADITIONAL REGIME

The aim of any international tax regime is to allocate the taxing rights to relevant jurisdictions. While a multinational entity may produce international business income, there is no one set of taxation principles to tax this income at a global level. Rather, taxation, or more concisely, jurisdiction to tax, is a matter for domestic law. In this sense, taxpayers have become global, tax authorities have not. At a global level, the international norms, or core concepts, which have been developed and embraced by most countries, apply. The two fundamental concepts—the norms of residency and source—which find their origins in a 1923 report submitted to the League of Nations and have been developed over the decades are the principles that apply to all multinational entities, whether traditional or modern. The effects, however, of globalisation mean that frictions now arise between current developments, such as the

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8 Although there is no such thing as an ‘international tax’. As David Williams explains “‘international tax” does not make logical or semantic sense, unless we find supranational taxing powers.’ Rather, it is the interactions that arise in respect of transnational aspects of national taxes, that we are concerned about: David Williams, Trends in International Taxation (1991) 8.

9 Richard Bird and Scott Wilkie suggest that ‘the most fundamental rule of international tax is that there are no rules of international taxation – just domestic rules applied to cross-border flows taking into account (or not) that such flows may be subject to taxation in more than one jurisdiction’. Richard M Bird and J Scott Wilkie, ‘Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?’ in Sijbren Cnossen (ed), Taxing Income in the European Union – Issues and Options for Reform (2000) 78, 91.


modern multinational entity, and the traditional principles which reflect outdated thinking.\textsuperscript{15}

The traditional principles are contained in both domestic law\textsuperscript{16} and international treaties.\textsuperscript{17} The application of these principles of residency and source to multinational enterprises involves a number of legal formalisms.\textsuperscript{18}

Generally, principles of residency and source are considered to be competing concepts, with the primary right to corporate taxation falling to the source jurisdiction.\textsuperscript{19} Each of the traditional concepts turns on the ability to establish a geographical physical presence in a particular country.\textsuperscript{20} The residual rights generally fall to the residence jurisdiction, with that country providing exemptions or credits for tax paid in the source country in order to avoid double taxation.


\textsuperscript{16} These concepts are first contended with in Division 6 of the Income Tax Assessment Act 1997 (Cth) (ITAA97). This Division provides that if you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year. See: ITAA97 s 6-5(2). Alternatively, if you are not an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all Australian sources during the income year; and other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source. See: ITAA97 s 6-5(3). These principles of residency and source apply equally to statutory income and income according to ordinary principles: s 6-5 of the ITAA97 includes ‘ordinary income’ in the assessable income of the taxpayer, while s 6-10 of the ITAA97 includes ‘statutory income’ in the assessable income of a taxpayer.

\textsuperscript{17} International Tax Agreements Act 1953 (Cth) s 4. The application of Australian domestic principles, without resort to international agreements, will not always present the optimal taxing result, as there is potential for double taxation or less than single taxation. Consequently the taxing position acquired through an application of those domestic principles is neither the final or legally correct result. Adjustments to the domestic principles are facilitated by the overriding effect of the ITAA53 which also addresses the key concepts of residency and source. The ITAA53 provides that the Income Tax Assessment Acts of 1936 and 1997 are incorporated into it and in the case of any inconsistency the former Act will prevail. All of Australia’s Double Tax Agreements are contained in Schedules to that Act, thus forming part of Australian domestic law and effecting the taxation position of multinational entities within Australia’s taxing jurisdiction. Like most economically sophisticated countries, Australia has entered into numerous comprehensive double tax agreements. The double tax agreements, generally based on the Organisation for Economic Co-Operation and Development (OECD) model treaty, serve two broad purposes: first, to avoid double taxation, and second, to prevent fiscal evasion. The avoidance of double taxation is achieved through mutual agreements as to the specific allocation of income to the jurisdictions, and exemptions or credits for tax paid. At this point it should be again emphasised that this paper is not suggesting that multinational entities are undertaking fiscal evasion. Rather, this paper considers whether the distribution of the right to tax multinational entities across relevant jurisdictions is optimal. Therefore, while the stated aims of the double tax agreements are to prevent fiscal evasion and double taxation, this paper does not examine whether that is, in fact, achieved. Rather this paper considers whether the distribution of taxing rights under the current law, both the ITAA97 and the relevant double tax agreements, achieves an optimal result, or one reflecting economic reality.

\textsuperscript{18} Green, above n 5, 24.


Table 1 summarises this position for multinational entities operating in Australia.\(^{21}\)

**Table 1- The general division of Tax Obligations under Australian Domestic Law**

<table>
<thead>
<tr>
<th>Australian Source Income</th>
<th>Australian Resident</th>
<th>Non-Australian Resident</th>
</tr>
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<tbody>
<tr>
<td>Australian Source Income</td>
<td>Jurisdiction to Tax</td>
<td>Jurisdiction to Tax</td>
</tr>
<tr>
<td>Foreign Source Income</td>
<td>Jurisdiction to Tax</td>
<td>No Jurisdiction to Tax</td>
</tr>
</tbody>
</table>

Residence and permanent establishment also have a secondary role.\(^{22}\) Where a multinational entity is the taxpayer in question, the residency principle is generally a threshold test in determining the right to tax. In this context, where the test of permanent establishment arises, it is essentially an artificial proxy for residency. ‘Strictly speaking, the permanent establishment concept establishes a threshold for taxing business profits rather than a source rule for such profits.’\(^{23}\) Where a multinational entity is deriving active income, these principles provide the threshold test for allowing a jurisdiction to exert their primary taxing right to that active income which is sourced within their boundaries. Under the traditional regime, the right of a jurisdiction to tax ‘is based on either formal residence or physical presence in a taxing jurisdiction’\(^{24}\). In broad terms, the residency requirement, whether it is used for the purposes of granting taxing rights per se, or as a threshold test, looks to the relationship between the taxpayer and the taxing jurisdiction whereby the residency status is dependent on the type of structure adopted by the taxpayer.

A parent-subsidiary relationship involves the establishment of separate enterprises under the domestic laws of the relevant jurisdictions and, as such, subsidiaries have residency. Conversely, a head office-branch type of relationship requires a consideration of the relevant double tax agreement, which is generally conclusive that branches are permanent establishments. Where a permanent establishment is shown to exist in a host country, taxing rights under domestic law may shift from the home jurisdiction to the jurisdiction of the host country with respect to any income connected to that permanent establishment. That is, the presence of a permanent establishment in a foreign jurisdiction, in accordance with the relevant double tax agreement accords that foreign jurisdiction the taxing rights to any income connected to the permanent establishment. This is based on the notion that an enterprise must have a sufficient presence through which it conducts business in the source country before it is subject to taxation in that country.\(^{25}\)

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\(^{21}\) This position is generally adopted globally.


\(^{23}\) Ibid.


\(^{25}\) Thorpe, above n 5, 654.
III MEASUREMENTS OF JURISDICTIONAL PRESENCE

In the framework of treaties based on the OECD Model Treaty, the rights of each state to tax the profits from global trading are determined by the presence of an enterprise within a jurisdiction and the extent to which profits are connected with that presence.\(^{26}\)

This statement of jurisdictional presence is essentially a statement about the necessary nexus between an enterprise and the taxing jurisdiction that is required for taxing rights to exist. These taxing rights arise where one of two measurements is satisfied. First, the existence of an enterprise of a contacting state according to the provisions of the domestic laws grants taxing rights to the relevant jurisdiction.\(^{27}\) This is simply a test of residency. Second, taxing rights are granted to a jurisdiction in which there is a permanent establishment of an enterprise of another jurisdiction.\(^{28}\) This test of permanent establishment is determined by virtue of the double tax agreements and generally looks for a fixed place of business.

Both of these measurements arise in the case of activities undertaken by multinational entities, as operations are conducted in both branch and subsidiary form. It is generally easy to determine whether the subsidiary is a resident of the relevant jurisdiction, just as it is generally easy to determine whether there are sufficient assets of a branch to determine the existence of a permanent establishment.\(^{29}\) However, issues may arise. For example, a difficulty arises in operations conducted through subsidiaries in determining whether a resident subsidiary is a dependent agent of a foreign subsidiary such that the foreign subsidiary has a permanent establishment in the contracting state.\(^{30}\) As Charles Plambeck explains, in practical terms this is often a distinction without a difference.\(^{31}\) However, it adds legal complexity where it is not warranted. Further, these tests are strict legal tests which adopt a form over substance approach.

It is outside the scope of this paper to discuss the merits of the residency requirement and the test of permanent establishment per se. The purpose, therefore, is to consider whether these legal tests allocate the rights to tax income from a multinational entity according to economic activity. Prior to a consideration of why these legal tests fail to allocate according to economic activity, it is necessary to consider what these tests entail. This is done below.

\(^{27}\) Ibid.
\(^{28}\) Ibid.
\(^{29}\) Ibid, 1150.
\(^{30}\) Ibid.
\(^{31}\) Ibid.
A The Multinational Entity Subsidiary

In the context of multinational entities, the test of residency has two broad implications. First, it is possible that a subsidiary of a foreign entity is also considered a resident in Australia, resulting in dual residence. Secondly, where an Australian entity operates through a subsidiary incorporated in a foreign jurisdiction, thereby ruling out the applicability of the test of incorporation, it is possible that residency occurs through either of the two residual residency tests. Such application of residency tests may result in the possibility of double taxation or less than single taxation through inconsistent application of domestic laws across jurisdictions.

It may be argued that the consequences of these results are twofold. First, unnecessary complexity is added to the regime in attempting to ensure there is not double taxation or less than single taxation. Secondly, and more importantly, splitting the jurisdiction to tax based on residency has little to do with economic activity and more to do with a physical presence. It is acknowledged that while the result under the current regime may be similar to that reached under an alternative tax regime, the process of determining residency and, if there is dual residency providing credits or exemptions to prevent double taxation, is an unnecessary process. Further, being mere legal tests, it is proposed that they fail to take into account the true location of income. If it is the case that economic activity does not marry with physical presence, the test of corporate residency is not an optimal measure of the right to tax. Overall it has been suggested that, ‘in the case of corporations … the idea of residence— an idea central to any discussion of principles and policies relating to international taxation of foreign direct investment—seems both outdated and unstable.’

Furthermore, flexibility in establishing a corporation’s residency is a universal phenomenon, which may be used to a taxpayer’s advantage.

The following discussion examines the three legal tests for establishing corporate residency to reveal both the purely legal (as opposed to economic) nature of these tests, along with the unnecessary complexity inherent.

The parent–subsidiary relationship, involves the foreign entity being a company in its own right. A resident Australian company is defined as a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

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32 Graetz, above n 2, 1422.
33 Ibid, 1423.
34 ‘Company’ is defined in s 995-1 of the ITAA97 as:
   (a) a body corporate; or
   (b) any other unincorporated association or body of persons;
   but does not include a partnership.
35 Section 6(1) ITAA36: ‘resident’ or ‘resident of Australia’ means:
   (a) a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia;
   The ITAA97 defines resident in terms of the definition of resident of Australia in the ITAA36. See: s 995-1 of the ITAA97.
Therefore, for a subsidiary to be considered a resident of Australia it must satisfy one of the three tests of residency.

The first statutory test, that of incorporation, replaces the common law proposition that incorporation is not decisive in the determination of residency of a company. By providing that incorporation determines residency it is assumed that the owners of a company generally incorporate in their own place of residence. An Australian subsidiary of a foreign entity will be incorporated in Australia and, as such, will satisfy the first statutory test and be considered an Australian resident company so defined. Consequently, application of the two residual tests will not be necessary to demonstrate that a locally incorporated subsidiary of a foreign entity is an Australian resident for tax purposes. As a resident of Australia, the Australian Taxation Office (ATO) may tax income from all sources earned by the subsidiary. Where another jurisdiction has the right to also tax the income of that subsidiary, resort to exemptions, credits, or double tax agreements are necessary to avoid double taxation.

The remaining two tests of residency are an adaptation of the common law, which provides that a company resides where its real business is carried on and its real business is carried on where its central management and control abides. As such, the common law provides valuable guidance when determining the residency of a company, particularly where incorporation is offshore.

The second and third statutory tests are applicable to multinational entities in two circumstances. First, where an Australian subsidiary of a foreign entity may also be considered a resident in the foreign jurisdiction, resulting in dual residence. Second, where an Australian entity operates through a subsidiary incorporated in a foreign jurisdiction, thereby ruling out the applicability of the test of incorporation, but making Australian residency possible through either of the two residual residency tests.

The first of these tests requires that for the company to be considered a resident of Australia, its central management and control must be in Australia. Unique problems may arise where the company in question is a subsidiary, due to the ability of the parent company to manage and control it from the foreign jurisdiction, or in the alternative, an Australian parent company manages and controls the foreign subsidiary. For example, a United States subsidiary of an Australian entity will clearly be a non-resident of Australia for Australian tax purposes through the operation of the statutory test. However, the question arises as to whether the subsidiary is a resident of Australia through the common law test of the place of ‘central management and control’. This leads to dual residence which would not occur under a unitary tax regime.

The second statutory test appears to contain two limbs: first, that the company carries on business in Australia; and second, that it has its central management and control in Australia. However, if there is proof of the company’s central management and control in Australia by

36 Todd v Egyptian Delta Land Investment Co Ltd (1929) AC 1.
37 De Beers Consolidated Mines Ltd v Howe (1906) AC 455. See also Cesena Sulphur Co Ltd v Nicholson (1876) 1 TC 88, San Paulo (Brazilian) Railway Co v Carter (1896) AC 31, American Thread Co v Joyce (1913) 108 LT 353, and Egyptian Delta Land & Investment Co Ltd v Todd (1929) AC 1.
38 Malayan Shipping Co Ltd v FCT (1946) 71 CLR 156. The Court in Malayan Shipping Co Ltd v FCT held that once it is established that a company’s central management and control is in Australia by
control in Australia it is sufficient to satisfy the second residency test. That is, a
foreign subsidiary of an Australian entity does not need to be carrying on business in
Australia in the strict sense. In determining what constitutes ‘central management and
control’ for the purposes of this test, it is prudent to consider the concept of
management separately to the concept of control despite historically being considered a
single concept.

The distinction between ‘management’ and ‘control’ was discussed—in the context of
the transfer pricing provisions of the ITAA36—in FCT v Commonwealth Aluminum Co
Ltd.\(^{39}\) Legislative history was utilised to indicate that control is the paramount test to
determine residency with the court clarifying that ‘the word “controlled”, when used
passively, in its ordinary meaning refers to de facto control rather than the capacity to
control’.\(^{40}\) In these circumstances, de facto control means actual control over the
business not the capacity to control the company. This type of control—actual
control—will usually be in the hands of the directors and management of the company,
thereby allowing management and control to be considered a single concept with the
place of management and control generally being the place of the meeting of directors.
There may be exceptional circumstances where control does not lie with the directors
thereby avoiding the application of the second residency test.\(^{41}\)

The necessity of ‘control’ to be de facto control is further supported by the mere
existence of the third test of residency, which requires that the company carries on
business in Australia and has its voting power controlled by Australian residents. As
the third test incorporates the capacity to control, regardless of whether it is actually
exercised, then by implication, the second test must be examining a separate issue,
namely actual control. The question of what constitutes actual control has been
considered in a number of cases dating back as far as 1946, when, in Malayan Shipping
Co Ltd v FCT\(^{42}\) the High Court held that the central management and control of the
company in question lay with an Australian resident despite the directors being non-
residents and meeting outside Australia.\(^{43}\) The judgment was based on the Australian
residents’ power to appoint and remove directors and veto any resolutions made by
them as well as the control over company business decisions and finances.\(^{44}\)


\(^{40}\) Ibid 4371, 4378.

\(^{41}\) It is suggested in R L Hamilton, RL Deutsch and JC Raneri, Guidebook to Australian International
Taxation, (6th ed, 1999) 2–16, that control may ‘not abide in the place where the directors meet, for
example because they have entered into an agreement that they will vote according to the wishes of
another or because they habitually follow the instructions of another without exercising independent
judgment’.

\(^{42}\) Malayan Shipping Co Ltd v FCT (1946) 71 CLR 156.

\(^{43}\) The House of Lords, in Unit Construction Co Ltd v Bullock (1959) 38 TC 712, also supported the view
that the question of control must be one of actual control. The question arose as to whether subsidiaries
of a United Kingdom Company were also residents of the UK. Despite the management and control of
the subsidiaries being vested in their directors it was held that the subsidiaries were residents of the UK
because of the director’s acquiescence in decisions made by the parent company.

\(^{44}\) Although Australia’s most notable case relating to the residency of a company is Esquire Nominees v
4,114; [1973] 129 CLR 204), where the question arose as to whether Esquire Nominees, a company
incorporated and holding its registered office in Norfolk Island, was a resident there for the purposes of
Decisions generally conclude the residence of one jurisdiction or the other. Case law, however, suggests that it is also possible, under this second test of residency, for the central management and control to be split between two jurisdictions resulting in dual residency. In *Koitaki Rubber Estates v FCT*45, Dixon J, at first instance, recognised the possibility of dual residency while, at the same time, cautioned against such a finding.

In summary, the second test of residency requires actual control of the company to be located in Australia and allows dual residency to be found where the central management and control exists in more than one jurisdiction. It has been suggested that factors to consider when determining the place of central management and control include the place of physical activities, the place where directors meet, and the place where important decisions are made.46

Clearly, under this test a foreign subsidiary of an Australian entity will usually also be a resident of Australia. As such, dual residency arises, as will the need for foreign tax credits or exemptions where there is double taxation. Again, this problem would not arise under a unitary tax regime.

The third test of residency, requiring the company to both carry on business in Australia and have its voting power controlled by persons who are residents of Australia, is a true two-limb test. First, it must be determined whether a business is being carried on for the purposes of Australian taxation law. Various factors influence a decision on whether a company is carrying on business in Australia. Repetition or intended repetition of transactions, continuity, and system in the organisation, commercial significance of activities, and profit motive are suggested as being indicative of a business being carried on in Australia.47 The courts have gone so far as to provide that a company, which merely invests in Australia, may be carrying on business in Australia.48 A diverging view, and one that does not attract the broad support of the courts, suggests that the dicta of Williams J in *Malayan Shipping Co Ltd*...
v FCT\(^{49}\) that ‘mere trading’ was not enough to find that a company was a resident, may be influential in the courts’ future interpretation of ‘carrying on business’.\(^{50}\) Despite the guidance such decisions provide us with, the fact remains that what constitutes carrying on business in Australia must be determined on a case-by-case basis.\(^{51}\)

Having established that the company is carrying on business in Australia, it is then necessary to satisfy the second limb of the test, that persons who are residents\(^{52}\) of Australia control the voting power. It would appear that ‘voting power’ includes not only the voting power attached to shares but also voting power attached to the holding of office.\(^{53}\) As to what constitutes ‘control’, it is suggested that it refers to de facto control of a general meeting rather than the mere capacity to control.\(^{54}\) The degree of control needed is that of a mere majority, that is, 50 per cent control over matters dealt with at a general meeting.\(^{55}\)

Subsidiaries can satisfy one of the three tests of residency to qualify for taxation by the ATO. The obvious problem of dual residency arises for a multinational entity when it is considered that they are a resident of more than one jurisdiction because of conflicting domestic tests of the relevant jurisdictions. This, in turn, leads to the double taxation of the income of the multinational entity.

To address the issue of dual residency and the resultant double taxation, Australia has generally adopted the ‘all or nothing approach’ of the OECD Model Tax Convention (OECD Convention). Based on the general principles of residency, Article 4 of the Convention attributes sole residence to one of the competing jurisdictions. The aim of Article 4 is stated as being ‘to define the meaning of the term “resident of a Contracting

\(^{49}\) Malayan Shipping Co Ltd v FCT (1946) 71 CLR 156, 159: ‘If, on the other hand, a company incorporated elsewhere is merely trading in Australia and its central management and control is abroad, it does not become a resident of Australia unless its voting power is controlled by shareholders who are residents of Australia.’

\(^{50}\) Hamilton et al, above n 41.

\(^{51}\) J Hill, in Evans v FC of T highlighted this need for a close consideration of the facts of the case when he cautioned against the reliance on any one case to establish the carrying on of a business. To this effect he stated that, ‘[t]he question of whether a particular activity constitutes a business is often a difficult one involving as it does questions of fact and degree. Although both parties referred me to comments made in decided cases, each of the cases depends upon its own facts and in the ultimate is unhelpful in the resolution of some other and different fact situations’. Evans v FCT 89 ATC 4540, 4554–4555.

\(^{52}\) Section 6(1) ITAA36: ‘resident’ or ‘resident of Australia’ means:

(a) a person, other than a company, who resides in Australia and includes a person:

(i) whose domicile is in Australia, unless the Commissioner is satisfied that his permanent place of abode is outside Australia;

(ii) who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied that his usual place of abode is outside Australia and that he does not intend to take up residence in Australia; or

(iii) who is:

(A) a member of the superannuation scheme established by deed under the Superannuation Act 1990; or

(B) an eligible employee for the purposes of the Superannuation Act 1976; or

(C) the spouse, or a child under 16, of a person covered by sub-subparagraph (A) or (B);

\(^{53}\) Kolotex Hosiery (Australia) Pty Ltd v FCT (1975) 75 ATC 4028; 132 CLR 535.

\(^{54}\) Hamilton et al, above n 41.

\(^{55}\) Mendes v Commissioner of Probate Duties (1967) 122 CLR 152.
State”, and to solve cases of double residence’.\(^{56}\) While Article 4 considers the
residency of both individuals and companies in relation to the residency of
multinational entities, only the principles relating to companies are relevant.

The OECD Article, in para 1,\(^{57}\) initially requires a consideration of domestic law to
establish residency. Australia’s double tax agreements are consistent with the OECD
Convention and generally provide that a taxpayer is a resident of a Contracting State
for the purposes of the double tax agreement if they are a resident of that State for the
purposes of domestic tax law. This, however, does not solve the issue of dual
residency.

The problem of dual residency is addressed in Article 4, para 3,\(^{58}\) of the OECD
Convention. It provides that a company’s residency shall be determined by reference
to ‘its effective place of management’, yet no guidance is given as to the meaning of
this phrase.\(^{59}\)

Therefore, according to the general principles of residency in Article 4 of the OECD
Convention, where, by application of the respective domestic laws, an entity is a
resident of more than one jurisdiction, para 3 of Article 4 declares that entity to be a
resident of only the jurisdiction in which its place of effective management is situated.
This provision excludes any pro rata allocation of taxation rights and excludes any
consideration as to where control of the entity is situated.

It can be seen from the above discussion that residence turns on legal concepts, rather
than what could be referred to as the true residence, that is, the location of economic
activity. In relation to the two residual tests Michael Graetz points out that:

> It is precarious to turn significant … tax consequences on the status of a
corporation as a resident or non-resident, given the difficulty of assessing the
‘true’ residence of corporations, except in the case of closely-held companies
where the residence of the owners easily can be determined. Linking corporate

Exceptions to the general adoption by Australia of Article 4 of the Convention are the United States and
Japan agreements, with neither providing tie-breaker rules for corporations.

\(^{57}\) Article 4(1) For the purposes of this Convention the term ‘resident of a Contracting State’ means any
person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence,
place of management or any other criterion of a similar nature, and also includes that State and any
political subdivision or local authority thereof. This term however does not include any person who is
liable to tax in that State in respect only of income from sources in that State or capital situated therein.

\(^{58}\) Article 4(3) Where by reason of the provisions of para 1 a person other than an individual is a resident
of both Contracting States, then it shall be deemed to be a resident of the State in which its place of
effective management is situated.

\(^{59}\) New Zealand’s judicial interpretation of this term ‘effective place of management’ is the ‘practical day
to day management, irrespective of where the overriding control is exercised’. Contrary to suggestions
by some commentators, this suggests that ‘effective place of management’ is not the same as the
domestic concept of ‘central management and control’. It is this author’s view that the two phrases have
different meanings as failure to conclude that there is a difference results in the continuing problem of
dual residency without resolution. Subsequently, with no guidance from the Australian judiciary as to
the meaning of ‘effective place of management’ necessitates acknowledgement of the interpretation
offered by the New Zealand judiciary. OECD, Model Tax Convention on Income and on Capital (1992)
(4)-7.
residence to the residence of its owners simply does not seem practical in the context of multtiered multnationals. On the other hand, insisting that a corporation’s residence is the same as that of its managers or officers seems difficult to justify.60

The problem of the residency requirement in a modern world can be summarised as follows: ‘in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties. It is no accident that we call corporations doing business around the world “multinationals”’.61 Similar issues arise when we consider the proxy for residency in the form of the test of permanent establishment.

B Permanent Establishment and Physical Presence

The permanent establishment concept is crucial to the taxing of multinational entities, as trading is often carried on in branch form62 (or through agents). The branch format is now the commonly adopted structure for some multinational entities, for example, multinational banks.63 The permanent establishment concept, contained in the treaty rules for taxing business profits, is also considered the international norm for determining the threshold right to tax,64 and therefore generally universally applied.

Double tax agreements introduce the concept of permanent establishment into the taxation of multinational entities, particularly in the context of the taxing rights attaching to them. As such, while the existence of a permanent establishment in a particular jurisdiction is not evidence of residency in the true sense, it is a precondition to the ability of a jurisdiction to tax an entity on certain income. In other words, the concept of the permanent establishment is a threshold test for source-based taxation,65 with a permanent establishment66 acting as a proxy for residence.67 Currently this

60 Graetz, above n 2, 1425.
61 Graetz, above n 2, 1422.
64 Sasseville, above n 22, 5:10.
65 Avi-Yonah, above n 24.
66 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishment (2001) 6(2). See: the importance of the permanent establishment concept can be seen from the following extract from para 1 of the Commentary on Article 7 of the OECD Model Tax Convention: ‘When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 of the OECD Model Tax Convention on Income and Capital (OECD Model Tax Convention) is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9 of the OECD Model Tax Convention’.
threshold is based on the historical notion that this presence is needed to conduct
significant business operations.

The concept of permanent establishment was introduced more than 100 years ago, with emphasis placed on permanence and physical presence. The current concept of the permanent establishment dates back to the League of Nations in 1927. The application of the concept is undertaken through Articles 5 and 7 of the OECD Convention. In understanding its origins, it has been suggested that the concept of the permanent establishment ‘has to be understood in the light of the second industrial revolution, which in this respect is characterised by relatively immobile production factors. Business enterprises on a national as well as international level were characterised by investments in fixed capital’. This emphasis remains today and, as such, a fundamental policy concern in the taxation of branches is whether the application of the traditional regime accurately reflects the economic income arising from the branch’s activities. The question is then asked whether these rules have become obsolete. To this extent, Michael McIntyre suggests that, ‘[t]he current permanent establishment rule is an anachronism, formulated in the heyday of the cross Atlantic steamer’.75

When the permanent establishment concept was introduced as a criterion for taxing income in the source jurisdiction the existence of a fixed place of business was seen as evidence of economic allegiance to the taxing jurisdiction. Increasingly, however, modern multinational entities are providing services and products which allow them to perform economically significant operations of a short duration, and with a flexible location.

As with the concept of residency, the concept of the permanent establishment is one which is inextricably tied to the current source and transfer pricing regime. However, it is one which again it is suggested is not an accurate reflection of the true location of the economic activity giving rise to the income. Further, it is only because of the recognition of the alternative legal structures adopted by multinational entities in the

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69 Skaar, above n 68, 70.

70 At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the OECD Model Tax Convention in 1963 and its revision in 1977.

71 Sasseville, above n 22, 5:3.

72 Skaar, above n 68, 69.


74 Sasseville, above n 22, 5:3.

75 McIntyre, above n 67, 788.

76 Thorpe, above n 5, 654.

77 Skaar, above n 68, 70.
current tax regime that the need to consider the existence of a permanent establishment arises.

Australia’s Business Profits articles in the double tax agreements to which they are a party generally follow Article 7 of the OECD Model. Paragraph 1 of that article provides:

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.78

There are essentially two ways in which a taxpayer may be declared to have a permanent establishment in a particular jurisdiction: first, by satisfying the test of a presence; and second, by having a dependent agent so defined. It is suggested that the permanent establishment requirement of the double tax agreements may be easily manipulated by multinational entities simply by satisfying or failing to satisfy the legal requirements, depending on which is more beneficial.

1 The Test of ‘Presence’

Article 5 of the OECD Convention provides the general definition of a permanent establishment. Australia has generally adopted this definition, subject to minor amendments. The Article states that for ‘the purposes of this Convention, the term permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on’.78 This twofold definition stipulates that in order for there to be a permanent establishment there must be first, an ‘enterprise’ of a Contracting State, and second, a ‘fixed place of business’.79

First, as to the requirement that there be an ‘enterprise’, neither the OECD Model Tax Convention, nor Australia’s double tax agreements, provides a definition of ‘enterprise’. Rather, it is left to judicial interpretation. The commentary to Article 3 of the OECD Model Tax Convention, containing the definition provisions, expressly excludes a definition of enterprise stating that, ‘the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No definition of the term ‘enterprise’ has therefore been attempted in this Article’.80

In 1990, the High Court of Australia, in *Thiel v FCT*81, was required to consider the term ‘enterprise’ for the purposes of Article 7 of the Australia–Switzerland double tax

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81 *Thiel v FCT* (1990) 90 ATC 4717.
The issues before the court were, first, whether Thiel’s activities and transactions were an ‘enterprise’ and second, whether these transactions constituted ‘carrying on business’. The High Court held that the expression ‘profits of an enterprise carried on by a resident of Switzerland’ should be construed to include profits arising out of an isolated commercial transaction and, as such, Article 7 of the double tax agreement protected the profits from taxation in Australia.\textsuperscript{83}

The second requirement of the definition of permanent establishment is that the business is ‘fixed’. At the crux of all weaknesses associated with the traditional taxation system is the difficulty associated with the concept of a ‘fixed place of business’, which has been described as ‘the most rooted of all in the physical world’\textsuperscript{84}. The concept of a permanent establishment is based essentially on the presence of a fixed place of business. ‘A crucial, perhaps the most crucial, part of the PE [permanent establishment] principle is the requirement of a qualified connection between the enterprise’s place of business and the soil … within the jurisdiction of the tax treaty.’\textsuperscript{85}

Article 5 of the OECD Model Tax Convention does not define a ‘fixed place of business’. It does however provide examples of what constitutes a permanent establishment. The term permanent establishment includes:

\begin{itemize}
\item[(a)] a place of management; \textsuperscript{86}
\item[(b)] a branch;
\item[(c)] an office;
\item[(d)] a factory;
\item[(e)] a workshop; and
\end{itemize}

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\textsuperscript{82} The appeal from the Full Federal Court was before Mason CJ, Brennan, Dawson, Gaudron, and McHugh JJ. The facts of the case, as described in McHugh J’s judgement ((1990) 90 ATC 4717 at 4725) involved the taxpayer Gunter Thiel, a resident of Switzerland. Since 1963, Thiel had operated a business in Switzerland as a distributor of earthmoving equipment. In 1983 the taxpayer began investigating the possibility of investing in Australia and in 1984 traveled to Perth at the suggestion of a Mr Kristensen, whom Thiel had known for many years. In January 1984, Thiel acquired an interest in a trust, of which Mr Kristensen was an executive. This acquisition of four units in the trust for a sum of $50 000 was made because of information provided that the trust was planning to make a public offer, which would create a profit for investors. On 25 May 1984 Thiel acquired a further two units in the trust at a cost of $100 000. The Trial judge found that one-quarter of the total purchase price of the six units was provided by a Swiss business account while the remainder was provided by way of loan from Thiel’s parents. On 22 October 1984, Energy Research Group Australia Ltd was incorporated with Thiel selling his six units to that company on 9 November 1984 at a price of $300 000. The $300 000 was satisfied by way of 600 000 fully paid ordinary shares of 50 cents each. Thiel gave instructions to his stockbrokers to sell his shareholding when the company became listed on the Australian Stock Exchange. In a one-month period between 7 February 1985 and 6 March 1985 Thiel sold 252 000 shares for a total of $566 307.30. The Australian Commissioner of Taxation assessed Thiel on the profits from the sales both of the units in the trust and the shares in the publicly listed company. The Commissioner contended that Thiel had made a profit which was assessable income pursuant to section 26AAA of the ITAA36. Thiel challenged the assessment on the basis that he was not liable to tax on the profits by reason of the Australia–Switzerland Double Tax Agreement. Thiel argued that Article 7 of the Agreement applied and that his activities constituted ‘an enterprise carried on by a resident of Switzerland’.

\textsuperscript{83} This interpretation of ‘enterprise carrying on business’ eliminates the Federal Court’s requirement that an enterprise must involve some level of continuity and permits isolated transactions to constitute an ‘enterprise carrying on business’.


\textsuperscript{85} Skaar, above n 68, 125.

\textsuperscript{86} OECD, Model Tax Convention on Income and on Capital (1992) Commentary (5)-5: A ‘place of management’ is mentioned separately because it is not necessarily an ‘office.'
(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.\(^{87}\)

Where a purported ‘fixed place of business’ does not fall within the examples provided it is necessary to consider the two elements of the term itself, ‘place of business’ and ‘fixed’.

First, ‘place of business’ is generally determined by reference to the OECD Model Tax Convention Commentary. This Commentary provides that the term is interpreted broadly to include any premises, facility or installation, where the enterprise carries on business, whether or not that use is exclusive. This broad interpretation means that the facility may be as simple as the provision of space for use, regardless of whether it is owned or rented by the enterprise.\(^{88}\) Various authors have suggested that the definition of ‘place of business’ should be more restrictive, including suggestions that a prerequisite to finding a place of business be the ‘production of income’, ‘some degree of entrepreneurial activity’ as a prerequisite to a finding that a facility is a permanent establishment’,\(^{89}\) or the existence of three characteristics: stability, productivity, and dependence.\(^{90}\) Despite such suggestions, neither the 1992 OECD Model Tax Convention, nor the 1977 OECD Model Tax Convention has implemented any restrictions on this definition thus accepting the broad interpretation.\(^{91}\)

Arvid Skaar believes that the concept of a ‘place of business’ can be defined as any substantial, physical object which is commercially suitable to serve as a basis of a business activity.\(^{92}\) This statement is qualified by the fact that while the term ‘place of business’ also encompasses separate parts of the enterprise such as foreign branches and places of management, an office or similar fixed premises must be presupposed.\(^{93}\) This leads to the second requirement of ‘fixed’.

For a ‘place of business’ to constitute a permanent establishment that place of business must be ‘fixed’. The OECD Commentary provides that this usually means that there is a link between the place of business and a geographical point, that is, the business takes place at one particular site.\(^{94}\) Further, there needs to be a degree of permanency with operations being conducted on a regular basis, that is, the place of business must not be of a temporary nature.\(^{95}\) However, so long as there is a degree of permanence present it is irrelevant that the permanent establishment only existed for a short period of time.

\(^{87}\) Ibid Article 5(2).
\(^{88}\) Ibid Commentary (5)-2. The OECD Model Tax Convention provides the example of a pitch in a market place or a permanently used area in a customs depot.
\(^{89}\) Hamilton et al, above n 41, 6–10.
\(^{92}\) Skaar, above n 68, 123.
\(^{93}\) Ibid, 123.
\(^{95}\) Ibid.
2 The Dependent Agent

An alteration to the general permanent establishment provision of Article 5(1) is the dependent agents’ inclusion in Article 5(5). This is a subordinated alternative to the basic rule, which replaces some but not all of the conditions for permanent establishment under the basic rule.  This alternative is particularly relevant to multinational entities where there is simply a representative or a representative office in a foreign jurisdiction.

It is not necessary for there to be physical presence where there is a dependent agent. Where there is no fixed place of business, and the entity falls outside of Article 5(1), but there is a person acting on behalf of the enterprise and concludes contracts for the enterprise (a dependent agent) it may be deemed to have a permanent establishment for the purposes of a double tax agreement. The Model Tax Convention provides:

Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - 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 a 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 essence, para 5 provides that where the enterprise has a person acting on its behalf who has the authority to conclude contracts in the name of the enterprise that enterprise is deemed to have a permanent establishment in respect of any of those activities except for activities excluded by para 4. Such persons, either individuals or corporations, acting on behalf of an enterprise are limited to persons who are not independent agents, that is, they do not fall within the scope of para 6 which specifically excludes brokers, general commission agents or any other agents of independent status. Therefore, the quintessential requirement in order for Article 5(5) to apply and to deem an entity to be a permanent establishment is the existence of a dependent agent.

The question of what constitutes a dependent agent as compared to an independent one arose in Case 23/93. The issue before the Administrative Appeals Tribunal was

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96 Skaar, above n 68, 471.
98 Ibid Article 5(6). This Article provides: ‘An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business’.
99 Case 23/93 (1993) 93 ATC 288. This case involved New Zealand husband and wife applicants who carried on the enterprise of share trading in Australia through a dealer. This dealer held the husband’s power of attorney, which allowed him to arrange contracts of sale and purchase, and also sign share transfer forms. Further, cash management accounts were opened by the dealer, in the applicants’ names which were used for the purposes of holding surplus funds, interest and dividends received. Evidence showed that the husband usually accepted the dealers’ advice in relation to purchases or sales, and, when busy, these transactions were executed without the husband’s knowledge. The wife’s investments were conducted on a more conservative basis, with her personally signing any documents.
whether the Australian dealer was a permanent establishment of the New Zealand taxpayers. The Commissioner argued that there was an enterprise being carried on through a permanent establishment in Australia. Consequentially the income was fully taxable in Australia without the limitations placed on dividends and interest income provided in the withholding tax provisions of the Australia–New Zealand double tax agreement.\textsuperscript{100} In support of this argument, the Commissioner relied on Article 4(5)\textsuperscript{101} of the relevant double tax agreement, while the applicants relied on Article 4(7)\textsuperscript{102} to argue that there was no permanent establishment.

The Administrative Appeals Tribunal rejected the applicant’s argument that the dealer was a broker, a general commission agent or any other agent of independent status on the basis that he worked substantially for one principal. On this basis, the Administrative Appeals Tribunal went on to consider whether Article 4(5) applied. In concluding that it did, the Administrative Appeals Tribunal stated, ‘the facts in these applications establish that the dealer habitually exercised in Australia an authority to conclude contracts on behalf of the applicants in their share trading activities. The dealer was little more than the Australian end of the applicants’ share trading enterprises. Although consulted by his principals, he habitually exercises his authority as an attorney and agent to conclude contracts on their behalf. The deeming effect of subsection (5) means that the business structure so created must be regarded as a permanent establishment in Australia’.\textsuperscript{103}

Even where a multinational entity has none of the three types of entry present in a jurisdiction the permanent establishment threshold may be met simply by having a representative present in the jurisdiction. Thus, the requirement may go from one of having an arm’s length price for the commissions paid to a sales location, to one where

\textsuperscript{100} Article 8:
(1) The Australian tax on dividends, being dividends paid by a company which is a resident of Australia for the purposes of Australian tax, derived and beneficially owned by a New Zealand resident, shall not exceed 15 per centum of the gross amount of the dividends.
(2) The New Zealand tax on dividends, being dividends paid by a company which is resident in New Zealand for the purposes of New Zealand Tax, derived and beneficially owned by an Australian resident, shall not exceed 15 per centum of the gross amount of the dividends.
(3) Paragraphs (1) and (2) of this Article shall not apply if the person who is the beneficial owner of the dividends, being a resident of a Contracting State, has in the other Contracting State a permanent establishment and the holding giving rise to the dividends is effectively connected with that permanent establishment.

Article 9:
(1) The tax of a Contracting State on interest derived and beneficially owned by a resident of the other Contracting State shall not exceed 10 per centum of the gross amount of the interest.
(2) Paragraph (1) of this Article shall not apply if the person who is the beneficial owner of the interest, being a resident of a Contracting State, has in the other Contracting State a permanent establishment and the indebtedness giving rise to the interest is effectively connected with that permanent establishment.

\textsuperscript{101} Article 4(5): A person acting in a Contracting State on behalf of an enterprise of the other Contracting State (other than an agent of independent status to whom paragraph (7) of this Article applies) shall be deemed to be a permanent establishment of that enterprise in the first-mentioned Contracting State if he has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.

\textsuperscript{102} Article 4(7): An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on trade or business in that other Contracting State through a broker, a general commission agent or any other agent of independent status, where such a person is acting in the ordinary course of his business as a broker, a general commission agent or other agent of independent status.

\textsuperscript{103} Case 23/93 (1993) 93 ATC 288, 297.
there is an agency of permanent establishment with an apportionment of the risk as well.\textsuperscript{104}

A further issue arises under the question of the agency threshold in the context of multinational entities. That is whether the activities of one enterprise constitute a permanent establishment of another enterprise. The question is, whether there is a dependent agent in existence so as to amount to a permanent establishment. The test for determining an agent’s status is whether they have the authority, in substance, to conclude contracts on behalf of the enterprise.\textsuperscript{105} Where the enterprise is undertaking business through a broker or agent of independent status there is no permanent establishment.

This issue arises in the following scenario. An enterprise may undertake activities in subsidiary form, with each subsidiary taking on separate roles such as trading activities, marketing activities and booking activities. Locations may then take on activities on another’s behalf thereby creating a permanent establishment. As the OECD suggests ‘the paradigm then changes from Article 9 to Article 7 (or to a combination of both)’.\textsuperscript{106} The result may potentially lead to double taxation because of the permanent establishment jurisdiction claiming a larger share of the tax base, as well as denying a deduction for internal payments.

3 Preparatory or Auxiliary Activities

Article 5(4) of the OECD Convention provides that a permanent establishment will not arise in certain circumstances. Two of those circumstances are where the activities are merely preparatory or auxiliary, or they relate to a mere purchase. Of particular interest is what is meant by ‘preparatory or auxiliary activities’. The OECD provides that where the activities form an essential and significant part of the activity of the enterprise as a whole then those activities are not considered preparatory or auxiliary.\textsuperscript{107} In this context, it has been questioned whether the activities of a branch rise to the level of a permanent establishment and may be taxed in that jurisdiction.\textsuperscript{108} It is suggested that the taxpayer may argue that the activities of branches are ‘merely preparatory, auxiliary activities’ or ‘mere purchases performed for another location’.\textsuperscript{109}

While it may not be possible to argue that a branch is merely performing preparatory or auxiliary tasks it may be possible to argue that a representative office does just that. The final structure by which foreign entities may enter the Australian market, the representative office, will not, under any statutory or common law test, be considered a resident of Australia for taxation purposes. While a representative office is physically located in the foreign jurisdiction, their role is usually one of information gathering and coordinating correspondent relationships. A representative office cannot conduct

\textsuperscript{106} Ibid 57(232).
\textsuperscript{109} Ibid 132.
business directly in the foreign jurisdiction, and as such, may be a precursor to the establishment of either a branch or subsidiary. Therefore, a taxpayer may argue that such a structure is merely preparatory or auxiliary, thereby circumventing its classification as a permanent establishment.

So far, this paper has considered the measurements of jurisdictional presence necessary to establish jurisdiction to tax. The next part of this paper considers the problem with this approach.

IV THE CONUNDRUM OF THE COMPONENT APPROACH

Professor Stanley S Surrey, writing a quarter of a century ago, could devote only two pages discussing what he called ‘jurisdictional allocation’ issues, i.e. source and residence based taxation, but over forty pages to ‘transactional allocation’ issues, i.e. those posed by the arm’s length method. A shift to a formulary apportion reverses the importance of the two categories. As US experience has shown, under formulary apportionment jurisdictional issues (in the sense of which state is entitled to how much) dominate and transactional issues are relegated to a relatively minor role.\textsuperscript{110}

The transactional allocation issues, which Professor Stanley Surrey refers to, are the arm’s length pricing requirements of the traditional transfer pricing regime. This method of transactional allocation focuses on the characteristics and nature of specific transactions between assumed distinct economic entities, each of which reports its taxable corporate income on a separate accounting basis,\textsuperscript{111} and relies on the traditional jurisdictional allocation principles. There is no attempt to allocate the overall profits of the multinational entity to the separate jurisdictions,\textsuperscript{112} rather each part of the multinational entity is treated as a separate entity. Hence, the reason why it is necessary to consider both the threshold tests and what is considered a separate entity per se. This paper suggests that this separate entity approach is incongruous with the unique attributes of the modern multinational entity.

It is not disputed that the concepts of residency and permanent establishment, (along with source), are usually easily applied to traditional transactions and designed for multinational entities undertaking these very types of transactions. These traditional concepts are ones that originated out of an era of trade in goods. The question that needs to be addressed is whether these concepts have been, or can be, moulded to adequately distribute the taxing rights among the relevant jurisdictions in the present era of trade in services and intangible goods. Where a traditional multinational entity is involved and there are physical goods being dealt in, identifying the relationship between income and the taxing jurisdiction is a relatively straightforward process. To this extent the traditional regime and international standards developed by the OECD


\textsuperscript{111}Richard M Bird, ‘The Interjurisdictional Allocation of Income’ (1986) 3 (3) \textit{Australian Tax Forum} 333, 337.

\textsuperscript{112}Ibid. It is, however, pointed out that such an allocation in effect results from the application of different rules to different classes of income and expenses.
have been ‘tolerably robust’. The application of the traditional concepts to traditional multinational entities, while not ideal, usually corresponds to some degree with the functions performed by the different parts of the traditional entity. Entities themselves may recognise these distinctions. It is also for this reason that a threshold test requiring physical presence does not appear to lead to a result less than ideal, or that the concept is irrelevant when applied to a traditional multinational entity. In essence, a regime recognising the structural variances of traditional multinational entities is often consistent with the economic rationale of the traditional firm.

However, when these concepts are applied to the modern multinational entity, identifying the relationship between income and jurisdiction becomes increasingly difficult, as does the logic of recognizing the different parts of the one entity under the concepts of residency and permanent establishment. The relevance of these traditional concepts is particularly diminished given the prevalence of modern transactions, which have increased dramatically with the expansion of the services industry and the advancement of technology.

In recognising the separate parts of the multinational entity as a precursor to the allocation of taxing rights, there is the potential for those rights to be allocated in a less than optimal manner. For example, source-based taxation of active income can be avoided by falling under the permanent establishment threshold. Alternatively, if a taxpayer wishes to be taxed in a jurisdiction it is simply a case of establishing a permanent establishment so defined within the jurisdictional boundaries.

Yaron Reich uses multinational banking as an example of where this happens. He states that under the current regime ‘[m]any tax systems subject a foreign bank to net income taxation only when the bank has a permanent establishment, or branch, in the taxing jurisdiction. Once this threshold is crossed, these tax systems generally treat the branch as a separate entity for the purposes of determining tax liability.’ It is suggested that because of the unique nature of modern multinational entities these threshold tests, taking into account the various legal forms adopted, fail to allocate the taxing rights to the relevant jurisdictions according to economic activity.

Vito Tanzi argues that there are fiscal termites gnawing at the very foundations of our tax systems causing a need to assess the ways in which current developments are affecting the traditional tax regime. He further proposes that an application of traditional principles may bear very little resemblance to economic realities. In this part of the paper, it is argued first, that physical presence is not an accurate measure of economic activity, and second that national boundaries do not need to be recognised in order to tax multinational entity income according to economic activity.

116 Ibid, above n5, 1263.
117 Ibid, 1278.
A Physical Presence as Opposed to Economic Activity

It has been suggested that ‘historical rules based on geographical source of income and nationality of taxpayers, and jurisprudential concepts that emerged in the early twentieth century, are simply not adequate in today’s world’. The existing rules were designed to divide income between jurisdictions in a fashion that roughly proxied economic activity. That is, physical presence in a jurisdiction meant that there was economic activity in the jurisdiction which should be taxed by that jurisdiction. However, today, many multinational entities are unique in the provision of services, potentially acting as intermediaries. Therefore, modern multinational entities do not fall within the traditional category for which the existing rules were designed to deal with. Modern multinational entities are not providing the same kinds of products and services as their traditional counterparts, that is, they do not offer any tangible outputs or acquire parts and supplies to rework into other products.

As such, it should not be taken for granted that these principles are suitable in the current economic climate. Today, fewer transactions conform to the conventional methods of commerce, which revolved around physical delivery. Further, there are shrinking geographical constraints to business activity generally. Internet businesses and multinational banks are clearly an example of where this is the case. In this sense, ‘the links between geography and residence have come unfastened. The integration of economies on a global scale, the mobility of capital and individuals, and new methods of doing business (electronically), make it more difficult to identify the residence of a taxpayer or the source of income’.

The concepts in the current domestic legislation and international treaties, largely conceived in the days of a ‘brick-and-mortar’ industrial economy, were based on the notion that a physical presence was required to conduct business operations in any substantive manner. This is certainly no longer the case with modern multinational entities. David Tillinghast provides:

While that economy still exists, not only has it evolved such that it is a substantial user of the e-commerce technological advances, as evidenced by the increasing prevalence of business-to-business alliances, in addition, it has been overshadowed by the newer information economy. The rapidly growing information economy is based on the technological revolution in communications and the provision of information. Rules designed to apply to the physical delivery of tangible goods or the provision of physical labour, for example, do not always work well when applied to the delivery of software or on-line services. At the same time, the use of derivative financial instruments to bundle or unbundle

119 Bird and Wilkie, above n 9, 93.
120 Klaus Vogel suggests that: ‘It has been taken for granted much too long that income taxes should be based on residence, and, in addition, on source’. Klaus Vogel, ‘Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part 1)’ (1988) Intertax 216.
121 Spence, above n 114, 143.
122 Zonana, above n 20, 1254.
economic interests, synthesize securities or confer the economic equivalent of the ownership of property without actually transferring that ownership raises treaty issues that require resolution.124

While the test of residency may pose questions as to its suitability as a threshold test, most of the issues lie with the threshold test of permanent establishment due to the capacity for easy manipulation. To this extent, the Australian Treasury Department has expressed concern as to whether the current definition of permanent establishment is still viable. It states:

it may also be necessary to examine the adequacy of the definition of permanent establishment in the domestic law, given that financial arrangements enable a significant level of economic activity to occur without creating a permanent establishment as currently defined. The traditional definition of permanent establishment is based on concepts of a fixed geographical place where business is carried on.125

Due to this highly mobile nature of services the traditional definition of permanent establishment may not be fulfilled and the ease of conducting significant levels of economic activity without creating a permanent establishment, as currently defined, questions the adequacy of the definition of permanent establishment.126 As stated, this is because of the need for a fixed geographical location in order for the definition of the permanent establishment to be satisfied.

The OECD is also clearly concerned about the definition of a permanent establishment. For example, in its 1998 discussion paper on the taxation issues relating to electronic commerce, prepared by the Committee on Fiscal Affairs, this issue was raised. It listed as one of the points of application of tax conventions requiring careful attention was the ‘definition of when a permanent establishment exists and what profits should be attributed to it’.127

The OECD went on to state:

It has been suggested that the concept of permanent establishment is ill adapted to electronic commerce. Those who take that position have argued that a rule based on physical presence is meaningless in the electronic commerce environment. Particular concerns have been expressed with respect to the allocation of tax revenues between source and residence countries and with respect to the use of tax havens.128

It is believed that ‘the future is likely to prove that the PE [permanent establishment] principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not. An enterprise’s connection to the soil, its PE, is no

124 Ibid.
126 Ibid 247.
longer a reliable evidence of economic allegiance’. Further, as Reuven Avi-Yonah explains, ‘the identity of multinationals as “domestic” or “foreign” based on their place of incorporation is becoming increasingly irrelevant. Multinationals recruit their executives and employees from a worldwide pool and locate their economic activities on the basis of economic, not national, considerations’.

**B The Fallacy of Recognising National Boundaries (and Separate Parts of the One Entity)**

It may be argued that where a multinational entity is dealing in modern services the entity itself does not recognise national boundaries. For example, multinational banks act as financial intermediaries negotiating deals between lenders and borrowers. By inserting themselves between the lenders (who deposit money into banks) and the borrowers, banks offer an intermediation service that operates seamlessly across borders, through a web of subsidiaries, branches, and representative offices. Where this is the case, recognising these separate parts for taxation purposes, where the entity in question is a multinational bank, fails to correlate with economic activity. Put simply, ‘reliance on geographical jurisdictions is inappropriate for new trading operations that fail to recognize national boundaries in their activities’.

The consequence of new multinational entities such as the multinational bank is that increasingly the relevance of these rules is being called into question. The reason for this questioning is that the ‘high-value intangible property and various manifestations of financial property or money increasingly dominate international economic flows, since the existence and exchange of such property is inherently difficult to tie to national territories either conceptually or in practice’.

By recognising national boundaries, it is suggested that activities are conducted in one jurisdiction by an entity located in that jurisdiction. Today, this seldom occurs. For example, the basic legal nature of the permanent establishment is that it is commercially separate from the head office, but is still a legally integrated entity of a business enterprise. The economic reality is somewhat different as it is frequently seen that the permanent establishment is also commercially integrated with head office, and sometimes performs the entire business of the head office.

It can be seen that it is relatively easy for a multinational entity to perform tasks in any location. This mobility then challenges taxing authorities. However, this is further compounded by the fact that these entities are becoming ‘more truly multinational in

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129 Skaar, above n 68, 572.
133 Bird and Wilkie, above n 9, 93.
134 Skaar, above n 68, 1-2.
135 Ibid.
their operations and revenue sources—that is, lacking any true “residence” in the traditional sense'. The consequence of these multinationals being managed as global, integrated enterprises makes attempts to tax them on a nation-by-nation, or subsidiary-by-subsidiary basis increasingly challenging and artificial.

By recognising national boundaries, the current regime requires an investigation into the legal form adopted by the multinational entity. This is done to attribute parts of the entity to those jurisdictions in which the entity has a physical presence. It has been recognised, however, that the tax consequences of the legal form adopted should be neutral. The current regime attempts to achieve this by essentially equating a subsidiary to a branch. It is suggested that by providing rules that recognise the organisational structure this neutrality is not achieved.

The fact that the tax consequences of the legal form of an entity should be neutral has been recognised in the literature. Klaus Vogel states: ‘The legal form imposed on the partial enterprise, whether it has been made a legally dependent or independent unit, a branch (permanent establishment), or a corporation (subsidiary), is immaterial, because the legal form does not affect the economic consequences’. As a footnote to this statement he adds that ‘[u]nless the taxation differs according to which legal form has been chosen. In such cases, however, the economic consequences flow from the legislative decision regarding taxation, not from the choice of legal form. It is generally acknowledged that taxation should be neutral with respect to the legal form of an enterprise’.  

Charles Plambeck, dealing specifically with the taxation of global trading, also makes this point:

Economic efficiency dictates that taxes be applied neutrally regardless of the location of operations (foreign versus domestic), the choice of entity (subsidiary versus branch), the form of intermediation (banking versus securities, for example), or type of financial product (swaps versus futures, for example). A coordinated approach also is necessary to prevent tax avoidance and evasion (such as where a book is passed through a tax haven), and to limit opportunities for tax arbitrage.

In order to attempt to achieve a neutral result under the traditional regime, an approach is adopted which treats a branch as if it were a hypothetical separate entity, that is, a subsidiary. This model is adopted in both domestic and treaty law, particularly for the purposes of applying the transfer pricing regime.

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137 Ibid.
139 Vogel, above n 139, 319.
140 Vogel, above n 139, 310, fn 128.
141 Plambeck, above n 26, 1155.
142 Income Tax Assessment Act 1936 (Cth) s 160ZZVA.
V AN ECONOMICALLY VALID THRESHOLD TEST

Any alternative proposal for allocating the right to tax the income of multinational entities needs to establish the degree of activity required in a jurisdiction before that jurisdiction can assert a right to tax. As part of a unitary tax regime, based on global formulary apportionment, there is potentially an inherent threshold test built in as the presence of factors in a jurisdiction represent activity in that jurisdiction. As Richard Pomp identifies, ‘[a] relationship, not always fully appreciated, exists between the development of an apportionment formula and the jurisdictional threshold rules’. In asking the question of whether there needs to be a threshold test at all, there are several reasons why a threshold test of some sort should be maintained:

- it would be unreasonable for a country to tax a business if that business did not have a sufficient link (nexus) with that country;
- it may be difficult to ensure proper compliance and collection of tax in the case of a foreign enterprise that does not have a presence in the country;
- the development of international trade and investment requires that enterprises that conclude a few isolated transactions in a jurisdiction where they have no business presence should not be overburdened by tax requirements in that jurisdiction; and
- the existence of a threshold that makes it relatively easy to determine which income should be taxed in a given country alleviates the fact that clear practical source rules for determining where business profits arise are not readily available.

In particular, there is concern with formulary apportionment that there may be an overreaching by jurisdictions where there is insufficient activity to reasonably assert a right to tax. Alternatively, the scenario could arise where no jurisdiction has the right to tax. Of course, there is the option of maintaining the permanent

143 Article 7 of the OECD Model Tax Convention on Income and on Capital and the accompanying documents, for example the OECD Discussion Draft on the Attribution of Profits to Permanent Establishment, OECD, Paris, 2001.
146 Sasseville, above n 22, 5:4.
147 Ibid.
148 Ibid.
149 Ibid.
151 McDaniel, above n 111, 297.
152 Ibid 297.
establishment threshold in a formulary apportionment regime. However, even then, it has been suggested that at the very least, modernisation of the permanent establishment concept seems essential. For example, modernisation could occur along the lines suggested by Michael McIntyre. He puts forward the notion that a corporation should be treated as having a permanent establishment in a country if it has apportionment factors in that country. This would appear to be a radical modernisation, which effectively does away with the permanent establishment concept—an approach which is suggested by this paper.

This paper maintains that the current threshold adds an unnecessary legalistic approach to the taxation of multinational entities and fails to allocate the taxing rights according to economic activity. As such, it is proposed that the concept of permanent establishment, as the threshold that is required for taxing jurisdiction to tax active income on a source basis, should be removed. Hence, the question that needs to be addressed is what should it be replaced with?

There needs to be a minimum threshold of business activity as a prerequisite to source-based taxation of business income. Within the context of the taxation of electronic commerce, Reuven Avi-Yonah suggests that the threshold test should not be linked to physical presence, rather that the threshold could be a de minimis amount of sales in a jurisdiction. Michael Graetz suggests that a threshold amount of sales, assets, labour, or research and development within a nation may better serve to establish both the source of business income and as a threshold for the imposition of tax. Where this is the case and source-based taxation is imposed on a uniform formulary apportionment of sales, assets, R & D, and labour costs, the need for the permanent establishment concept is eliminated. This would appear to be the most sound of the proposals. It is logical that a jurisdiction has the right to tax under a formulary apportionment regime where the factors are present.

Robert Peroni has put forth an alternative proposition. He advocates residency-based taxation, while at the same time arguing that formulary apportionment is superior to the arm’s length standard. As Stanley Langbein points out, this is a novel position.

154 McIntyre, above n 67, 789.
155 Reuven Avi-Yonah proposes that this is the first thing that needs to be changed. Avi-Yonah, above n 24, 510.
156 Graetz, above n 2, 1421.
157 Graetz, above n 2, 1421.
159 Graetz, above n 2, 1421.
160 Ibid, 1421.
162 Peroni, above n 5.
and one not normally adopted. However, he recognises that formulary apportionment
does require agreement on the international allocation of jurisdiction to tax. This
paper suggests that there are faults in the residency regime, which make it unsuitable as
a threshold test.

While the threshold chosen should be big enough to ensure that the tax collected is
greater than the compliance costs, a low threshold test avoids the necessity for anti-
avoidance techniques. The simplest threshold test to impose under a formulary
apportionment regime would simply be that of having formulary factors present in the
taxing jurisdiction. No matter what threshold test is chosen, it is essential that there is
international consensus in its application.

VI CONCLUSION

This paper suggests that the threshold tests of residency and permanent establishment
are legal tests which have no place in a tax regime designed to allocate income based
on economic activity. Further, it is suggested that the principles contained in the
traditional regime requiring the recognition of the different structures adopted, along
with a legal distinction recognising the separate parts of the multinational entity, are
unnecessary, and therefore irrelevant, in determining the allocation of taxing rights to
multinational entities where that allocation is based on economic activity.

If this is correct, then residency rules and the permanent establishment test have very
little effect on modern multinational entities and are easily manipulated by these
entities simply by establishing residency in a particular jurisdiction. Michael Graetz
suggests, "[L]egal constructs, which are largely elective and easily manipulated, play too
great a role in determining international tax consequences of business arrangements." Overall, residency and permanent establishment are legal tests, which would become
unnecessary with unitary taxation. As such, this paper concludes that an international
tax regime that does not contain either residency requirements, the permanent
establishment concept, or the recognition of structural variance, is congruent with an
optimal regime. However, with the source and transfer pricing rules, as they
currently apply, the principles of structure, residency, and permanent establishment are
inextricably linked.

Consequentially, if physical presence is not an accurate measure of economic activity,
and national boundaries do not need to be recognised in order to tax multinational
entity income according to economic activity, it is proposed that a move towards a
regime that encompasses these notions, should be made. Unitary taxation based on formulary apportionment is the suggested regime, as the formula unitary system eliminates a boundary that grows ever more difficult to sustain.

The unitary tax model, however, does still require an allocation based on source. Charles McLure asks the question ‘should source countries be allowed to tax income of foreign multinationals only if they have a physical presence in the country?’. Based on the conclusions of this paper it is suggested that the answer is no. However, by minimising the tax consequences dependent on an entity’s residence—which is the suggested approach—it is a robust source regime that is needed. The linkage to source should then be the location of the real economic activity, or factors such as sales, labour, property, and research and development. It was noted above that the current principles are connected in a way that would render a source regime alone ineffective. As such, it is also suggested that the current source regime fails to allocate income according to economic activity. However, the unitary tax regime would allocate based on source, but one that could stand alone and allocate income according to economic activity.

171 Paul McDaniel suggests that ‘[a] formulary system of taxing corporate income ignores entities and concentrates on determining the income of the unitary enterprise. It eliminated the distinction between business and investment income within the unitary enterprise by ignoring the form in which the enterprise is conducted - that is, legal entities and all intercompany payments are disregarded’. Paul McDaniel, ‘Reflections on International Taxation for the 21st Century’ (2000) 2000 World Tax Conference Report 20:1, 20:4.


173 Graetz, above n 2, 1426.

174 Ibid.