2008

Business Profits (Article 7 OECD Model Convention)

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Publication Information & Recommended Citation

Avi-Yonah, Reuven S., co-author. "Business Profits (Article 7 OECD Model Convention)." K. A. Clausing, co-author. In *Source versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives* , edited by M. Lang et al., 9-20. EUCOTAX Series on European Taxation, 20. Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2008.

KLUWER LAW INTERNATIONAL

EUCOTAX Series on European Taxation

Source versus Residence

Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives

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Wolters Kluwer
Law & Business

AUSTIN BOSTON CHICAGO NEW YORK THE NETHERLANDS

Chapter 2

Business Profits (Article 7 OECD Model Convention)

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1 INTRODUCTION

The general purpose of tax treaties is to implement the consensus underlying the international tax regime by shifting the right to tax passive income from the source to the residence country, and by limiting the ability of source countries to tax active income to income attributable to a permanent establishment.[1] Article 7 of the OECD MC implements this latter function by stating that a Contracting State may not tax business profits arising therein unless they are attributable to a permanent establishment (PE, as defined in Article 5 OECD MC).

A priori, one would expect Article 7 not to play a very important role in modern treaty practice, because most cross-border business profits are earned by multinational enterprises (MNEs), and MNEs generally operate in host countries

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1. See generally Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (2007).

Michael Lang, *Source versus Residence*, pp. 9–20.

via subsidiaries, rather than via branches. Thus, one would expect that most practical issues in the allocation of business income would be governed by Article 9 OECD MC, which addresses parent-subsidiary transactions, rather than by Article 7.

However, a series of recent developments have led to a renewed emphasis on Article 7, as evidenced by the publication last year of a major OECD report on the attribution of profits to permanent establishments.[2] These developments include the rise of electronic commerce, which has made it easier to sell products into countries without using a subsidiary or a PE; the increasing importance of financial services and global trading, which is frequently conducted via branches; and the proliferation of tax planning using PE structures, such as US planning relying on check the box. In addition, various countries have taken aggressive approaches to finding that a PE exists, such as recent cases that find that a subsidiary is in fact a dependent agent PE.[3]

In reaction to these developments, the OECD Report advocates an 'authorized OECD approach' to the interpretation of Article 7, which incorporates by analogy the concepts developed under Article 9 and the Transfer Pricing Guidelines:

> [T]he authorized OECD approach is that the profits to be attributed to are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2).[4]

As Richard Vann has pointed out, the problem with this approach is that it assumes that the Article 9/Transfer Pricing Guidelines are working well, and therefore treating PEs as if they were subsidiaries would solve the problem.[5] However, an extensive literature has established that the Transfer Pricing Guidelines are not working well, and are in need of reform.[6] Thus, we believe that the Article 7 problem must be reconsidered from first principles.

2 WHAT IS THE RIGHT WAY TO TAX MNEs AT SOURCE?

The OECD Report states that its recommendation 'was not constrained by either the original intent or by the historical practice and interpretation of Article 7'.[7]

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2. OECD, *Report on the Attribution of Profits to Permanent Establishments* (December 2006), (hereafter, the 'OECD Report').
3. LeGall, 'When Is a Subsidiary a Permanent Establishment of Its Parent?' *Tillinghast Lecture*, New York University (2006), (forthcoming in *Tax Law Review*).
4. OECD Report, 12.
5. Vann, *Problems in the International Division of the Business Income Tax Base* (2007); Vann, 'Tax Treaties: The Secret Agent's Secrets', *British Tax Review* 345 (2006).
6. See, e.g., Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *Virginia Tax Review* 15 (1995): 89; updated version in *Finance and Tax Law Review* 9 (2006): 310.
7. OECD Report, 8.

Moreover, the report recommends a redrafting of both the article itself and the commentary.[8] Given this, it seems appropriate to begin by asking: If we were working on a clean slate, what would be the best way to tax MNEs at source in the light of 21st century business practices?

The beginning point has to be that a modern MNE does not operate as if its constituent units, either subsidiaries or branches, deal with each other as if they were separate enterprises. Instead, a modern MNE is generally a single, unified enterprise, managed from a central location by managers who are responsible to their shareholders for the results of the MNE as a whole.

The current approach to taxing MNEs at source is based on separate accounting (SA), or treating each entity within the MNE as a separate taxpayer. This approach is problematic for a variety of reasons. First, the system is not suited to the global nature of international business. In particular, international production processes make the SA system of assigning profit to specific geographic destinations inherently arbitrary. Further, the very nature of multinational firm operations generates additional profit over what would occur with strictly arm's-length transactions between unaffiliated entities. Theories of multinational firms emphasize that they arise in part due to organizational and internalization advantages relative to purely domestic firms; such advantages imply that profit is generated in part by internalizing transactions within the firm. Thus, with firms that are truly integrated across borders, holding related entities to an 'arm's-length' standard for the pricing of intra-company transactions does not make sense, nor does allocating income and expenses on a country-by-country basis.

Also, the current system is based on an artificial distinction among legal entities. For example, companies are taxed differently based on whether they employ subsidiaries or branches; as one example, deferral of taxation on unrepatriated profits is allowed for the former but not the later. Recently, there has been an increasingly common use of hybrid entities (treated as subsidiaries by one country and branches by another) to achieve double non-taxation.

Another related problem is that the current system is based on an increasingly artificial distinction between MNEs whose parent is incorporated in a residence country and those whose parent is incorporated elsewhere. The former, but not the latter, are frequently subject to world-wide taxation with its attendant complexities (primarily the foreign tax credit and CFC rules). But in today's world, this distinction is less and less meaningful as the sources of capital, location of research and development (R&D), location of production, and location of distribution of MNEs become increasingly globalized. The current distinction has led to a spate of inversion transactions, in which US-based MNEs formally shift the location of incorporation of their parent offshore without changing the location of any of their real business activities.

Second, the current system of international taxation creates an artificial tax incentive to locate profits in low-tax countries, both by locating real economic

8. OECD Report, 9.

activities in such countries and by shifting profits toward more lightly taxed locations. It is apparent that US multinational firms, for example, book disproportionate amounts of profit in low-tax locations. Figure 1 shows the top ten profit locations for US multinational firms in 2003, based on the share of worldwide (non-US) profits earned in each location. While some of the countries are places with a large US presence in terms of economic activity (the United Kingdom, Canada, Germany, Japan), seven of the top-ten profit countries are locations with very low effective tax rates.

The literature has consistently found that multinational firms are sensitive to corporate tax rate differences across countries in their financial decisions. Estimates from the literature suggest that the tax base responds to changes in the corporate tax rate with an average semi-elasticity of about −2; thus, countries with high corporate tax rates are likely to gain revenue by lowering their tax rate.[9] One recent study suggests that corporate income tax revenues in the United States were approximately 35% lower due to income shifting in 2002.[10]

Third, the current system is absurdly complex. As Taylor notes, observers have described the system as 'a cumbersome creation of stupefying complexity' with 'rules that lack coherence and often work at cross purposes'.[11] Altshuler and Ackerman note that observers testifying before the President's Advisory Panel on Federal Tax Reform found the system 'deeply, deeply flawed', noting that 'It is difficult to overstate the crisis in the administration of the international tax system of the United States'.[12]

A large part of this crisis results from applying the current Transfer Pricing Guidelines. The current regime consumes a disproportionate share of both IRS and private sector resources. For example, several recent Ernst and Young surveys of multinational firms have concluded that 'transfer pricing continues to be, and will remain, the most important international tax issue facing MNEs'.[13] Seventy per cent of their respondents feel that transfer pricing documentation has become more important in recent years, and 63% of respondents report transfer pricing audit activity in the previous three years.

Opinions in transfer pricing cases run to hundreds of pages each, and litigation involves billions of dollars in proposed deficiencies, such as the recently settled *Glaxo* case (9 billion dollars [USD] in proposed deficiency, settled for USD 3.4

9. See de Mooij, 'Will Corporate Income Taxation Survive?' *De Economist* 153 (2005): 277, for an overview of this literature.
10. This estimate is from Clausing, 'Multinational Firm Tax Avoidance and U.S. Government Revenue' (2007), working paper. The calculation is based on a regression of US multinational firm affiliate profit rates on tax rate differences across countries.
11. Taylor, Testimony before the President's Advisory Panel on Federal Tax Reform, 31 March 2005; *Tax Notes* (4 April 2005), Doc. 2005-6654.
12. Altshuler/Ackerman, 'International Aspects of Recommendations from the President's Advisory Panel on Federal Tax Reform', *International Tax Policy Forum Presentation* (2 December 2005).
13. Ernst and Young, '2005–2006 Global Transfer Pricing Surveys'. Available on-line at <www.ey.com/transferpricingsurvey>, accessed 4 Jan 2007.

billion) or the Aramco advantage case (litigated and lost by the Internal Revenue Service, which asserted deficiencies of over USD 9 billion). There is no indication that the 1994 regulations under IRC section 482 have abated this trend.[14] While there have been fewer decided cases than under the pre-1994 regulations, this is because both taxpayers and the IRS have been devoting enormous resources to settling these controversies in the appeals process, in litigation or through advance pricing agreements, while both sides have been wary of losing a major court case.

The contemporaneous documentation rule adopted by Congress, which requires taxpayers to develop documentation of their transfer pricing methods at the time the transactions are undertaken rather than when they are challenged on audit, as well as the complexity of the new SA methods (such as the Comparable Profits Method, or CPM), have led the major accounting firms to develop huge databases and expertise in preparing transfer pricing documentation for clients. This imposes large costs on major US multinational corporations.[15] Meanwhile, small and medium businesses, which cannot afford the major accounting firms, are left to fend for themselves and are frequently targeted for audits in which the IRS can employ more sophisticated methods than the taxpayer because only the IRS and the large accounting firms have the necessary data to apply CPM. Thus, while the IRS continues to lose transfer prices cases against major MNEs under the 1994 regulations (for example, *Xilinx*) or has to settle for less than half the proposed deficiency in *Glaxo*, it is able to win cases against small and medium firms on the basis of superior resources, rather than greater substantive justification of its position.

Thus, we believe that if we were designing the system from scratch, we would adopt as our starting point not SA, but formulary apportionment (FA). FA has several advantages over SA. First, FA aligns the international corporate tax system with the reality of a truly global world economy. In a world where most major corporations are MNEs, where 70% of US international trade is done by multinational firms, and where many opportunities for tax avoidance have an international dimension, the current system of corporate taxation is obsolete. In particular, SA systems treat each affiliate of a multinational firm as a distinct entity with its own costs and incomes. Allocating income and expenses across countries is both complex and conceptually unsatisfactory, given that worldwide income is generated by interactions between affiliates across countries. Multinational firms exist in large part because these interactions generate more income than would separate domestic firms interacting at arms-length; thus, requiring firms to allocate this additional income among domestic tax bases is necessarily artificial and arbitrary, because it would by definition disappear if the related entities operated at arm's length. Further, such allocation generates ample opportunity for multinational firms to reduce worldwide tax burdens by shifting income to more lightly taxed jurisdictions.

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14. Avi-Yonah, *Finance and Tax Law Review* (2006): 310.
15. Durst/Culbertson, 'Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today', *Tax Law Review* 57 (2003): 37.

Under an FA system, tax liabilities are instead based on a multinational firm's global income, and the share that is taxed by the national jurisdiction depends on the fraction of a firm's economic activity that occurs in a particular country.[16] Thus, while a truly precise definition and measurement of economic value is likely unattainable, FA provides a reasonable, administrable, and conceptually satisfying compromise that suits the nature of the global economy. Further, a FA system does not create an artificial legal distinction among types of firms, and whether multinational entities are organized as subsidiaries, branches, or hybrid entities. Nor does an FA system rely on an artificial distinction between MNEs whose parent is incorporated in a particular residence jurisdiction and MNEs whose parent is incorporated elsewhere.

The second advantage associated with the proposal is that it eliminates the tax incentive to shift income to low-tax countries. As income shifting incentives are an important part of the overall tax incentive for locating operations in low-tax countries, removing this incentive will also result in less tax-distorted decisions regarding the location of economic activity. Under FA, firms are taxed based on their global income. Thus, accounting for the income earned in each country is no longer necessary, and there is no way to lighten global tax burdens by manipulating this accounting for tax purposes.

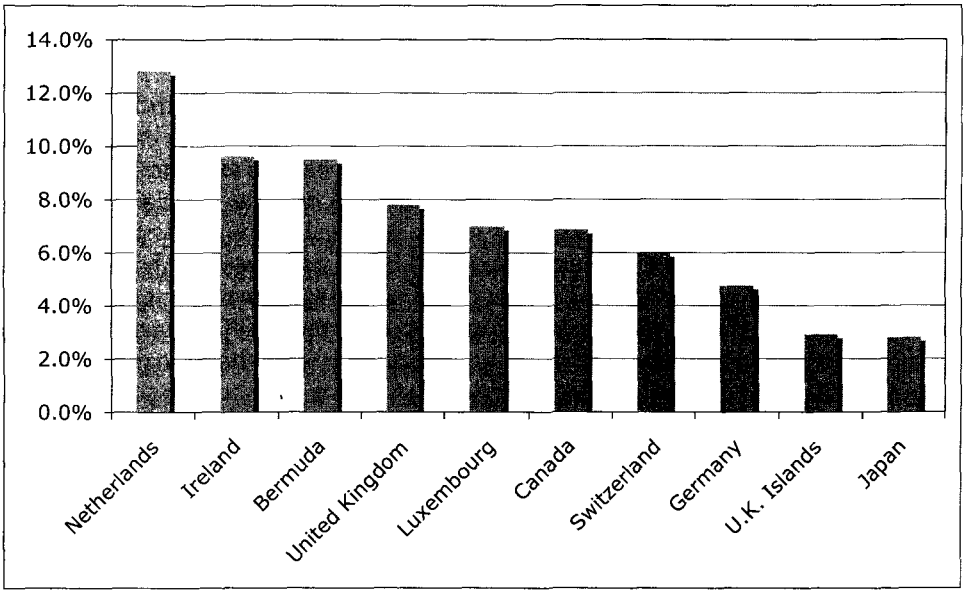
Under FA, there is no reason for the sort of profit distortions that are so clearly visible in Figure 1. In addition, when firms consider the tax advantages associated with operating in low-tax countries, these advantages will be based simply on the lower tax associated with their operations in such countries, rather than additional advantages conferred due to the fact that real operations in low-tax countries facilitate tax avoidance. Thus, the adoption of FA should vastly reduce tax distortions to multinational firm decision making.

Such changes in the taxation of international income ultimately help governments set their tax policies more independently. The wishes of voters in each government influence the ideal size of government, required revenue needs, and the allocation of the tax burden among subgroups within society. Under FA, governments would be able to choose their own corporate tax rate based on their assessment of these sorts of policy goals, rather than the pressures of tax competition for an increasingly mobile capital income tax base.

The third advantage associated with the proposal is the massive increase in simplicity that this would enable for the international tax system. To determine tax liability, there would be no need to allocate income or expenses among countries, resulting in far lighter compliance burden for firms. CFC rules and the foreign tax credit, which are both hugely complicated and a major source of transaction costs for MNEs, are no longer necessary, since there is no deferral under this system (which is essentially territorial and treats all MNEs alike).

16. How this fraction is determined depends on the formula, discussed below.

Figure 1: Where Were the Profits in 2003?
(profits as a percentage of the worldwide total)



Country	*Effective Tax Rate*
Netherlands	5.3%
Ireland	6.1%
Bermuda	1.7%
United Kingdom	20.1%
Luxembourg	−1.8%
Canada	23.5%
Switzerland	4.5%
Germany	8.2%
U.K. Islands	1.3%
Japan	36.9%

Notes: In 2003, majority-owned affiliates of US multinational firms earned USD 326 billion of net income. This figure shows percentages of the worldwide (non-US) total net income occurring in each of the top-ten income countries. Thus, each percentage point translates into approximately USD 3.3 billion of net income. Effective tax rates are calculated as foreign income taxes paid relative to net (pre-tax) income. Data are from the Bureau of Economic Analysis (BEA) web page; 2003 is the most recent year with revised data available. The Bureau of Economic Analysis conducts annual surveys of *Operations of U.S. Parent Companies and Their Foreign Affiliates.*

Further, the likely administrative savings from abandoning the current cumbersome transfer pricing regime are huge. By contrast to the current regime, FA is relatively simple since all that it requires is:

(1) establishing which businesses are unitary and
(2) establishing destination of arm's-length sales of goods or services.[17]

Once these two elements are established, the resulting formula permits both taxpayers and the tax authorities to determine to correct tax liability to each jurisdiction that uses FA. This means that there is no longer a need to allocate or apportion expenses (a source of major complexity in the current rules, as the US 861 regulations indicate), because all a business needs is to calculate its world-wide net income (worldwide gross income minus worldwide expenses). This net income is then allocated to various jurisdictions based on a single formula, the tax rate of each jurisdiction is applied to the allocated income, and the tax is paid.

For small and medium businesses in particular, FA results in major cost savings as well as the likelihood of paying less tax (since such businesses are rarely in a position to take on the IRS under SA). For major multinational firms, FA also offers the prospect of avoiding the costs of contemporaneous documentation, and while some firms may pay more tax than under SA, many would welcome the opportunity of paying a single, low rate to each jurisdiction they do business in (especially if the adoption of FA is coupled with a reduction in the corporate rate), instead of having to cope with the complexities and costs of SA.

3 PROGRESS TOWARD FA, 1995–2007

But, it will be argued right away, we are not working on a clean slate: SA is the international norm, and FA is anathema to the OECD. Thus, we must work within the confines of SA, whatever its disadvantages.

But is this really still true? We would argue that developments since the adoption of the revised Transfer Pricing Guidelines in 1995 have made a consensual shift to FA much more likely.

First, one needs to recognize that the Transfer Pricing Guidelines themselves represent a crucial step forward because they adopt two methods (TNMM and profit split) that are not based on strictly defined comparables. As we have argued elsewhere, once strict comparability is abandoned, the term 'arm's length' can be applied to any transfer pricing method, including FA.[18] That is because in the absence of comparables, no one can know what unrelated parties would have done, and thus any result is an arm's length result. Thus, as stated in 1993 by senior officials of the United States Treasury, the United Kingdom Inland

17. For a specific statutory proposal on how to deal with these issues in the context of a sales-based formula see Durst, 'A Statutory Proposal for U.S. Transfer Pricing Reform', *Tax Notes Int'l* (2007): 1041.
18. Avi-Yonah, *Virginia Tax Rev.* (1995).

Revenue, the Fiscal Affairs Division of the OECD and the Japanese National Tax Administration:

> [T]he arm's length principle and formulary apportionment should not be seen as polar extremes; rather, they should be viewed as part of a continuum of methods ranging from CUP to predetermined formulas. It is not clear where the arm's length principle ceases and formulary apportionment begins, and it is counterproductive and unimportant to attempt to apply labels to the methods.[19]

Second, recent developments in the EU (which now represents a majority in the OECD) have cast doubt about the opposition of certain traditional opponents of FA to that method. In particular, the work on the Common Consolidated Corporate Tax Base (CCCTB), which is scheduled to lead to a concrete proposal by 2010, is based on FA.[20] Of course, the CCCTB proposal faces difficult political obstacles, is only intended to apply within the EU, and is currently voluntary. However, the work so far shows that a significant portion of EU Member States, including some traditional opponents of FA like Germany, now believe that FA is the direction of future development.

Third, the US has been at the forefront of adopting formulary methods, both in the context of allocating expenses (for example, the interest allocation regulations) and income (for example, the global trading regulations). Moreover, the US approach to transfer pricing has since 1995 been closer in practice to FA (the CPM is more formulary than TNMM, and the US profit split is equivalent in practice to FA with the location of R&D determining the formula). Recent policy work by the Hamilton Project, the major Democratic think tank for the 2008 election, has supported FA, which has gained adherents such as former Treasury Secretaries Robert Rubin and Larry Summers.[21]

Thus, we believe that if the OECD were to shift course and start working on an FA proposal for Article 7, this could have the support of both the US and a large number of EU members. That is particularly true if the proposal could be implemented within the existing language of Article 7.

4 IS FA COMPATIBLE WITH THE OECD MODEL CONVENTION?

Some have argued that tax treaties will need modification with adoption of FA. However, it is not clear to us that existing tax treaties will have to be renegotiated. Transfer pricing is currently governed by Article 9 of the treaties, which assumes

19. Arnold/McDonnell, 'Report on the Invitational Conference on Transfer Pricing: the Allocation of Income and Expenses among Countries', *Tax Notes* (1993): 1377.
20. European Commission, 'The Mechanism for Sharing the CCCTB,'< CCCTB/WP/047/doc/en> (2006); Spengel, *The Common Consolidated Corporate Tax Base* (2007).
21. See Avi-Yonah/Clausing, *The Hamilton Project* (2007).

the SA method because it addresses the commercial or financial relations between associated enterprises. If FA were adopted, Article 9 would become irrelevant in those situations to which FA applies (that is where a unitary business is found to exist) because FA ignores the transactions between related parties, and treats them instead as part of a single enterprise.

Instead, FA would be governed by Article 7. Under Article 5(7):

> The fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State... shall not constitute either company a permanent establishment of the other.

However, it is well established that a dependent agent can be a permanent establishment (see Article 5(5)), and whether an agent is dependent is based on whether the principal exercises legal and economic control over the agent:

> An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.[22]

In the case of a modern, integrated MNE that operates as a unitary business, a strong argument can be made that the parent of the MNE exercises both legal and economic control over the operations of the subsidiaries, especially where the subsidiaries bear no real risk of loss and acquire goods and services exclusively or near exclusively from the parent or other related corporations. In that case, the subsidiaries should be regarded as dependent agents of the parent. Such a finding is in fact made with increasing frequency in both developed and developing countries.[23]

If the subsidiary is an agent of the parent, Article 7(2) of the treaties requires the attribution of the same profits to the subsidiary:

> that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

Arguably, the application of FA satisfies this arm's length condition because in the absence of precise comparables (which almost never exist) it is not possible to determine exactly what profits would have been attributable to the subsidiary under SA.

When the US adopted CPM and profit split in the 1994 transfer pricing regulations, some countries objected that it was violating the treaties because these methods did not rely on exact comparables to find the arm's length price. However, these objections soon subsided, and even the OECD endorsed similar methods in its transfer pricing guidelines. The US always maintained that both CPM and profit

22. U.S. Treasury, *Technical Explanation of United States Model Income Tax Convention*, (Washington, D.C.: Government Printing Office, 2006) Art. 5(6).
23. LeGall, *Tillinghast Lecture* (2006).

split satisfy the arm's length standard despite the lack of precise comparables (and in the case of profit split, using no comparables at all to allocate any residual profits). Similarly, the US has maintained that the 'super-royalty rule' of IRC section 482 (which requires royalties to be 'commensurate with the income' from an intangible, and therefore subject to periodic adjustment) is consistent with the arm's length standard, even though no comparables can be found to show that such adjustments are ever made by unrelated parties.

In addition, if OECD members were to adopt FA, they could argue that this is compatible with the language of OECD MC Article 7(4):

> Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be necessary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

This language is found in many existing tax treaties based on the OECD and UN models, and it can be used by OECD members as a basis for applying FA under their domestic law, without resort to a treaty override.

5 CONCLUSION: TOWARD A NEW MECHANISM FOR TAXING BUSINESS PROFITS AT SOURCE

We thus believe that rather than finalizing the current OECD Report, the OECD should abandon its effort to apply obsolete Article 9 SA concepts to PEs. Instead, it should work on designing a workable FA approach within the context of current Article 7. Article 9 can be left to apply only to those situations in which a business is not unitary.

Adopting FA requires resolution of difficult issues. First, the OECD would need to define a unitary business. We believe that relying on the current treaty language of legal and economic dependency, plus a test based on control (>50% of vote or value) and a *de minimis* threshold of related party transactions would be adequate in most cases.

Second, the common tax base to be apportioned needs to be agreed on. The EU work on the CCCTB and progress toward international adoption of IFRS both can help in this regard.

Third and most importantly, the formula needs to be determined. We have advocated a sales-based formula because of the likelihood that countries can adopt it without coordination, like destination basis for VAT.[24] Sales are also less susceptible to tax-motivated shifting than assets or payroll (the other elements in the

24. See Avi-Yonah/Clausing, *The Hamilton Project* (2007).

traditional US state formula). But within the OECD there is scope for negotiations on other formulas, including functional analysis based on personnel, assets and sales (as in the global trading regulations and the OECD Report).

Finally, we believe that in the future the text of Article 5 needs to be revamped so that it fits modern business realities. In particular, we would advocate a numerical threshold, rather than one based on a physical PE.[25] But that is a topic for another day.

25. See Avi-Yonah, 'International Taxation of Electronic Commerce', *Tax Law Review* 52 (1997), 507; Arnold, 'Threshold Requirements for Taxing Profits under Tax Treaties', in *The Taxation of Business Profits under Tax Treaties*, eds Arnold/Sasseville/Zolt (2003); Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', *Bulletin for Int'l Taxation* 60 (2006): 206.