International

Steve Suarez*

The Taxation of Mobile Activities

This article summarizes the discussion of the taxation of mobile activities in Seminar I of the 63rd Congress of the International Fiscal Association, held in Vancouver, Canada on 2 September 2009.

1. Introduction[1]

Mobile activities were acknowledged as being at the forefront of many highly topical tax issues. For example, by virtue of their inherent mobility, such activities can be relocated from one jurisdiction to another relatively easily, and, as such, are the subject of *tax competition* amongst different states seeking to tax the revenues from such activity. Relocation of mobile activities is also at the heart of the OECD's recent work on *business restructurings*, given the ability of taxpayers to move such activities from one country to another. The income from mobile activities also puts stress on traditional tax principles underlying *source-based taxation*, and creates a variety of *tax compliance* and *transfer pricing* issues for taxpayers and tax authorities.

The panel discussed a number of different activities which can be (or inherently are) mobile, in the sense of not needing to be (or in some cases inherently not being) located in any particular country in order to reach a particular customer. Specific examples discussed included international shipping (see 2.), financial services (see 3.), film and television production (see 4.), international sportsmen (see 5.), and intangibles (see 6.). Immobile activities, on the other hand, are those that can only be (or can only economically be) carried out in a particular place, such as local branch banking and land-based activities such as forestry, mining and tourism.

Globalization has resulted in the increasing mobility of economic activities due to various factors:
- technological advances;
- lowering of trade barriers;
- reduced travel and transportation costs; and
- increased financial sophistication.

The result is greater ability of (and pressure on) businesses to push down costs through relocation, and increased competition amongst states for tax revenues from business activity.

2. International Shipping

International shipping is a form of business activity that by its very nature is highly mobile because it is carried on largely outside the territory of any particular state. As a result, historically countries have found it very difficult to apply typical tax principles to this form of income, and the result has often been special rules in domestic legislation applicable to international shipping income.

Art. 8 of the OECD Model Tax Convention (the "OECD Model") reflects the approach taken by most countries, which is to limit taxation exclusively to the state where the place of effective management is located.[2] Source-based taxation is largely abandoned as being essentially unworkable for income from this form of mobile activity. Art. 8 of the OECD Model also applies to international shipping and air transportation, boats in inland waterways, and profits from the participation in a pool, joint business or international operating agency. This provision reflects the way in which historically countries came to accept the difficulties in apportioning income from international shipping and the risk that if they sought to tax residents of other countries on such income, their own residents would be treated similarly by other countries.

Canada's approach to international shipping is consistent with this view, for example. In its domestic income tax legislation, Canada effectively waives the right to tax non-residents of a particular country from profits on international shipping if that other country grants "substantially similar relief" to Canadian residents.[3] Canada's tax treaties generally include provisions similar to Art. 8 of the OECD Model (Canada also has a few specific shipping agreements with nations that do not have a full income tax convention with Canada). Moreover, Canada goes beyond renouncing source-based taxation. Canadian domestic law raises the threshold required in order for an international shipping company to be considered a resident of Canada so as to be taxable on its worldwide income. In a bid to retain the economic activity associated with head offices of international shipping companies, Canadian domestic law was amended to provide that international shipping compa-

* Partner, Osler, Hoskin & Harcourt LLP, Toronto. The author's summary is derived from and based on the original work product (both comments and written work) of the panellists, and it should not be assumed that the views stated can be attributed to a particular panellist. The author can be contacted at ssuarez@osler.com.

1. The members of the panel were Steve Suarez of Osler, Hoskin & Harcourt LLP (chair, Canada); Lucie Vorlickova of Leitner & Leitner (Czech Republic); Prof. Diane Ring of Boston College Law School (United States); Casey Plunket of Chapman Tripp (New Zealand); Jean-Emmanuel Dulière, Head of Sector, Coordination of Tax Policies and Harmful Tax Practices, European Union (Belgium); and Andrea Parolini of Maisto e Associati (Italy). The secretary of the panel was Daniel Lang of Borden Ladner Gervais (Canada). The original material prepared by the panel members was used extensively in the preparation of this summary, and the author acknowledges with appreciation the importance of these contributions from his co-panellists.
2. Art. 8(1) of the OECD Model states: "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated."
3. Para. 81(1)(c) Income Tax Act (Canada).

nies incorporated under non-Canadian law will not be considered to be residents of Canada, even if they maintain their head office in Canada.[4] Thus, Canada has effectively chosen to tax only income from purely domestic shipping and from Canadian-incorporated international shipping companies.

It was noted that in practice many treaties depart from Art. 8 of the OECD Model by not including inland waterways within the scope of their version of Art. 8. The merits of extending the principles of Art. 8 to rail and road transportation were also discussed, as many of the same sourcing and allocation problems exist on income from such activities. Finally, specific EU aspects of shipping were discussed, in particular various rules that acknowledge the unique nature of international shipping, which, as a result, impose relatively few restrictions on tax measures relating to this form of economic activity.

3. Financial Services

3.1. Introductory remarks

The panel next examined financial services as a mobile activity. It was observed that financial services had been identified as a mobile activity that could potentially give rise to tax competition as early as 1998, when the OECD released the report "Harmful Tax Competition: An Emerging Global Issue".[5] The OECD has noted banking, insurance and fund management as being principal elements of the financial services sector,[6] although it has been further subdivided into as many as 27 different subgroups in other OECD literature to include activities, such as financial leasing, debt collection and trustee services.[7] Group financing or holding activities might also be thought of as financial services, interpreted more broadly.

While not all financial services are necessarily mobile, among those that have been identified as constituting mobile activities are the following:
- offshore banking services to high net worth individuals;
- various tax-driven banking services (for example, securitizations, repos, etc.);
- investment funds and fund management;
- insurance services;
- holding activities; and
- group financing.

3.2. Case study: mobile banking services

An international bank seeking to expand its business into new markets without a local permanent establishment (PE) or subsidiary uses travelling employees and local independent agents to attract clients. Asset management transactions are carried out anywhere that the bank provides such services, for which the bank receives a fee. The client earns interest, income and capital gains on its invested funds.

General taxation principles would apply to this scenario. This means that the bank will not be subject to tax in the client's country as long as it is neither resident there nor rendering its services through a PE there. In this regard, even a representative office may not constitute a PE if it meets the conditions for the relevant exception in the PE definition in the applicable tax treaty. An agency PE could exist, if the people working on the bank's behalf in the local jurisdiction were dependent agents with the authority to conclude contracts on the bank's behalf. The manner in which client contracts are negotiated and approved is, therefore, very important. Recent developments in broadening the PE concept to deem a PE to exist on the basis of the amount of time services are rendered in the source state could also be relevant, depending on the terms of the applicable tax treaty (service PEs were the subject of extensive discussion in other panels at the 2009 Conference).

If a PE exists in this situation, it would then be necessary to determine how much income to attribute to it. The attribution of profit to PEs has of course itself been the subject of considerable recent work by the OECD, most particularly the 2008 report on profit attribution.[8] That document proposed a two-step approach to determine how much profit to attribute to a PE, and included a separate section for applying the OECD's approach to the PE of a bank.

The client itself would be subject to tax on a residence basis in its home country, unless the invested assets are held through an intermediate entity such as a foundation or trust. Foreign withholding taxes may also be exigible on whatever income or gains are earned on the invested capital. Local bank secrecy and exchange of information rules would also be relevant.

3.3. Case study: investment funds

An investment fund (Fund) is set up in Country F. The Fund may be created as a separate entity (for example, a trust, corporation or partnership) or alternatively as a simple pooling of funds without an independent legal character of its own. Administration of the Fund would depend on its legal form (for example, a trustee for a trust, a board of directors for a corporation, a general partner for a partnership). Investment decisions are made by a fund manager located in Country M. The Fund attracts invested capital from an investor in Country I. The funds may be invested in various countries.

In this scenario, the location of the Fund itself, the location of the fund management activities, and the jurisdiction(s) in which the investments are located are all highly mobile. Invested funds will likely be subject to

4. Subsec. 250(6) Income Tax Act (Canada).
5. Paris, 1998. OECD materials are generally available at www.oecd.org.
6. OECD, Consolidated Application Note, "Guidance in applying the 1998 report to preferential tax regimes", Paris, 2004.
7. OECD, "Indirect Tax Treatment of Financial Services and Instruments", Paris, 1998.
8. OECD, "Report on the Attribution of Profit to a Permanent Establishment", Paris, 2008.

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local withholding taxes in whatever jurisdictions the investments are located. This makes the tax treaty network of Country F a relevant factor in choosing that jurisdiction. The Fund itself may also be subject to tax in Country F, depending on whether it is fiscally transparent or not, although in many cases low or non-taxation of the Fund is an important factor in selecting its place of creation.

The Fund manager will potentially be subject to tax in Country M on the compensation it receives. Such compensation typically consists of a management fee and a carried interest in the profits of the Fund. These two forms of compensation may or may not be set up to be earned by the same entities and/or in the same home countries. For example, an advisor in one country may investigate and recommend investments to a decision-maker in a second country (often where the carried interest is held, which is usually a low-tax regime). The bifurcation of these services will be subject to transfer pricing and other attribution of profit principles, requiring a detailed factual analysis.

3.4. Discussion

Countries can and do compete to attract mobile financial services. Various forms of competition exist, such as low tax rates, preferential tax regimes (especially for trusts and foundations), banking secrecy, limits on exchange of information obligations, and reduced taxation for non-domiciled residents (for example, the United Kingdom). In some cases, these can amount to harmful tax competition that is discouraged by the OECD. Among the recommendations made by the OECD to counter harmful tax practices are the following:
- controlled foreign corporation (CFC) regimes;
- foreign investment fund rules;
- thin capitalization restrictions;
- the denial of deductions and similar tax preference items associated with tax haven transactions;
- the imposition of withholding taxes on residents of tax havens; and
- greater cooperation between tax authorities internationally.

The EU Code of Conduct is also a source of guidance in identifying potentially harmful tax measures.

Mobile banking services are likely to be affected by a number of initiatives. The expansion of the service PE concept will affect the taxation of mobile banking, and will, in turn, produce greater information exchange proceedings and profit determination and allocation issues. Among the most important administrative steps that have been taken are:
- the Savings Directive (information exchange on interest income, withholding taxes in Austria, Belgium and Luxembourg), and a draft directive to include trusts and foundations;[9]
- the draft EU directive on administrative cooperation on taxation;[10] and
- OECD efforts to improve information exchange and eliminate bank secrecy (see in particular recent developments in Switzerland).

4. Film Production

Film production is a highly mobile activity, with a variety of countries (many of which would not be thought of as low-tax jurisdictions, such as Canada, the Czech Republic, New Zealand and the United Kingdom) actively seeking to attract this form of economic activity. In many cases, the country seeking to attract the production is not especially interested in trying to tax the profits of the film production itself, but rather is primarily seeking to attract work for local residents who themselves will be taxed. The "source" country is, therefore, looking primarily for tax revenues that are residence-based.

To attract film production, the "source" country may be willing to give up some or all of its source-based rights to tax the film production, and may even offer positive incentives (through the tax system or otherwise). The nature of such tax incentives may also be driven by ensuring that no incremental tax burden is created for key personnel who can influence where the production will be shot. For example, Canada's domestic law includes a special tax regime for non-resident actors (but not other personnel) that imposes a 23% gross tax on Canadian-source activity, a rate selected on the basis that a resident of California should receive a full foreign tax credit in the United States and, hence, pay no incremental tax.[11] Consequently, attracting film production via tax measures may amount to competing against other potential "source" countries or competing with the country of residence for certain tax revenues.

Film production can be broken down into a number of discrete activities (for example, writing, acting, shooting, financing, editing and post-production), most of which are highly mobile and can be performed in separate countries if desired. The OECD Model, for example, treats actors differently from other film production personnel, giving source countries a largely unrestricted right to tax income from acting services in Art. 17. Off-screen personnel, on the other hand, generally fall under either Art, 7 as independent personal services (where source country taxation is premised on the existence of a PE), or under Art. 15 as dependent personal services. In the latter case, source country taxation typically requires either employment by a source country resident or physical presence in the source country for an extended period of time (for example, 183 days).

The film production itself will be subject to source country taxation only if it has a PE in that country. In many cases, this is avoided by using a local contract pro-

9. Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, 2003, L 157/42.
10. COM (2009) 29, Proposal for a Council Directive on administrative cooperation in the field of taxation.
11. Subsec. 212(5.1) Income Tax Act (Canada).

duction company to carry out many of the functions that require a source country presence.

5. Artistes and Sportsmen

International sporting events give rise to a variety of different forms of income for different persons. Consider, for example, an international sporting event where the following taxpayers may exist:

- an international organizing committee, located in State A. This entity is likely to earn fees from broadcasting rights, sponsorships and royalties;
- a national organizing committee in the host state, State B. This entity may share revenue earned by the international organizing committee;
- a participating team from a third country, State Y, that might earn a participation fee from the international organizing committee and perhaps sponsorship revenue;
- a player on the State Y team who is himself a national of State Y, but resident in State X, who may earn a salary or sponsorship revenue;[12]
- a company in State B making souvenirs for the event, earning souvenir sales revenue and paying a licensing fee to the organizing committees; and
- a soft drink manufacturer in State Z paying licensing fees to be associated with the event.

In theory, the athletes themselves are typically taxed by the source state (i.e. State B – the state in which the event is held) without limitation under Art. 17 of the OECD Model.[13] The international body organizing the event will typically also be subject to source country taxation, although the prevailing rule will usually be Art. 7, meaning that a PE must exist. There is also the potential for royalty income to be earned, in which case Art. 12 may apply (in practice there are several deviations). Obviously State B residents will be subject to tax in that country under normal principles.

The panel considered the extent to which some of these rules give rise to significant practical problems and are outdated in practice. For example, in many cases source states are effectively required to relinquish their right to tax as a condition of being granted the opportunity to host the event. Recent examples of this include Canada for the 2010 Winter Olympics, the United Kingdom for the 2012 Summer Olympics, Portugal for the 2004 UEFA Cup, and South Africa for the FIFA 2010 World Cup.[14]

It was also noted that where the source state does try to apply its right to tax foreign athletes, there are practical difficulties in apportioning the income, enforcing the source country's right to tax and producing the appropriate foreign tax credits in the state of residence. Further consideration should be given as to whether it continues to make sense to have a special rule for artistes and sportspeople such as is found in Art. 17.

6. Income from Intangibles

Intangible assets represent an important portion of the value of many businesses. Specific examples include software and related technology, patents, process intangibles, trademarks, know-how, and literary or artistic property.[15] Depending on the form of transaction, a variety of different kinds of income may be generated from intangibles.

Consider the case of a corporation (Development Co) that develops software and then sells it to a subsidiary (Low-Tax Co) resident in a low-tax jurisdiction. Low-Tax Co, in turn, licenses software to end-users in various different countries. Consequently:

- Development Co is likely not subject to any tax in Low-Tax Co's home country, since proceeds from a software sale are likely to be treated as a capital gain, which is generally not taxable in the purchaser's country unless connected to a local PE. However, it is likely to be taxed on the gain in its home country as a resident; and
- Low-Tax Co is likely to face little or no home country taxation on licensing income by virtue of being a resident of a low-tax country, and, if that country has a good tax treaty network, it may benefit from significantly reduced source country withholding rates on licensing payments from end-users. Indeed, source country withholding taxes may be the principal tax burden faced by Low-Tax Co.

The problem with a sale of the software to Low-Tax Co at full fair market value is that the future income represented by the intangible asset is effectively being taxed on an accelerated basis in a relatively high-tax jurisdiction if Development Co realizes a large gain. In order to reduce the home country tax faced by Development Co on gains from a sale to Low-Tax Co, Development Co could consider various options, all of which raise issues:

- a sale at a low price to Low-Tax Co will attract transfer pricing scrutiny;[16]
- a contribution of the software to Low-Tax Co will be treated as a deemed sale by many countries; and
- a cost-sharing agreement with Low-Tax Co to create a next-generation version of the software typically requires Development Co to bring the existing intangible into the arrangement in some way or another.

The current economic situation provides some scope for trying to effect a sale of the intangible to Low-Tax Co, as Development Co may have excess losses available

12. The example discussed was the Brazilian national football team, where only three players over 21 in a recent match were Brazilian residents.
13. The inclusion of a separate provision for the taxation of artistes and sportspeople is likely motivated by a concern of preventing the disproportionate erosion of source state tax base through high-remuneration activities occurring over a short period of time.
14. Germany attempted to retain source country taxation rights to some extent for the FIFA 2006 World Cup.
15. See Para. 6.2 of the OECD Transfer Pricing Guidelines, the most recent version of which is dated 15 September 2009.
16. See, in this regard, the IFA 2007 General Report on Transfer Pricing and Intangibles.

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to shelter the gain from the sale.[17] Thus, depending on the facts, an outright sale could be an option.

A cost-sharing agreement might take the form of a sharing in the rights of the intangibles created under the agreement, based on the respective contributions of the parties, but again will be subject to valuation scrutiny in Development Co's home country: arm's length parties would be unlikely to allow a rival to use their intangible assets for the purpose of creating a new, better, product without being very well compensated for doing so. Development Co will inevitably have an incentive to undervalue its contribution, and some evidence exists that this is occurring in practice.[18]

This, in turn, is likely to cause more subtle forms of intangibles transfers to take place. For example, Development Co might decide to contribute the services of its research team that developed the existing intangible, rather than the intangible itself. Another approach would be to minimize what constitutes a "cost" to be shared. A recent example of this is the *Xilinx* case in the United States,[19] involving the deduction of USD 177 million of stock option costs in connection with a cost-sharing arrangement between the taxpayer and a foreign subsidiary.

Business restructurings are another form of intangibles migration, whereby valuable intangibles are removed from a high-tax jurisdiction. In its work in this area, the OECD describes the two major issues involved as being (1) identifying whether any intangibles are being transferred, and (2) pricing any such intangibles for purposes of establishing the appropriate compensation.[20] The OECD Discussion Draft reviews a number of different intangibles restructuring scenarios, and reports that tax authorities might adopt two overriding positions in response to such transactions:

- some assets (so-called "crown jewels", such as trade names) may be so valuable to a seller that practically speaking they would not be sold, unless the seller was exiting the business or had no other option, making it impossible to determine an appropriate price; and
- some forms of business restructuring might be disregarded entirely by tax authorities.[21]

The migration of intangibles will continue to be a highly important issue for both taxpayers and tax authorities. The incentive on the part of taxpayers to shift intangibles to low-tax regimes will put tremendous pressure on the arm's length method of transfer pricing. This will be increasingly so if different countries move in different directions on transfer pricing, and ultimately countries may find themselves faced with fundamental (and highly interconnected) choices to make in order to defend their tax base, such as whether to adopt (or maintain) a territorial system, how much to depend on the corporate tax base for revenues, and how aggressively to cast their CFC regimes.

7. Concerns of Fiscal and Economic Authorities

Tax authorities around the world face a series of challenges as a result of the globalized economy and the mobility of business activities. In trying to design a fair, efficient and sustainable taxation system, a number of questions arise:

- how to meet domestic policy needs;
- how to achieve an appropriate balance between direct and indirect taxes;
- how to balance the need to raise revenue with other economic and social objectives;
- what kinds of competition amongst countries should be considered acceptable; and
- whether countries should adopt defensive measures, such as anti-abuse and CFC rules.

A discussion of tax competition ensued, in particular within the confines of the European Union and the EU Code of Conduct for business taxation and the OECD work on harmful tax practices. A number of important successes in this area were discussed. Good governance in the tax field was also reviewed, and acknowledged to include features such as transparency, fair tax competition and exchange of information. Recent examples of cooperation in good governance were identified, as was the utility of continuing international tax cooperation amongst countries.

8. Conclusions

The panel reached a number of general conclusions from its examination of different forms of mobile activities. First, it is clear that both the number and the value of the activities that can fairly be considered "mobile" is increasing. As globalization makes it possible to efficiently do more things in more places, relatively few activities will be incapable of being relocated from one jurisdiction to another at relatively low cost. Whereas perhaps 50 years ago international shipping might have been the only truly "mobile" activity, now financial services, film production, and sporting events are examples of activities that have very limited (if any) ties to any particular country. Intangibles are perhaps the most dramatic example of activities that have increased in value and importance to business and which can be located virtually anywhere: in many cases only the tax cost of moving them remains as an impediment to relocation. Some implications of this are (1) greater ability of taxpayers to choose where to carry on business,

17. Consideration might also be given as to whether or not the fair market value of the intangible has fallen in the current economic climate.
18. New US cost-sharing regulations issued in January 2009, using the investor model approach, are an example.
19. *Xilinx v. Commissioner*, Nos. 06-74246, 06-74269 (9th Circuit, 27 May 2009).
20. OECD, "Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment", 12 September 2008 to 19 February 2009, Paris (see, in particular, pp. 28-29).
21. The example cited in the Discussion Draft (at pp. 58-59) is the transfer of valuable brand names to a newly formed affiliate in exchange for a lump-sum payment, following which the seller continues to administer these brands for the buyer on a cost-plus basis.

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which will, in turn, result in greater tax competition among countries for such activities, and (2) a wider range of countries effectively able to compete to attract any particular business activity.

What is also clear is that it is becoming easier to separate a business into a number of discrete functions, which need not all be carried on in the same place. A business is not a homogenous whole, but is rather a number of related activities (often with very different characteristics and needs) carried on with a common purpose:
- a film production can be segmented into writing, financing, shooting, marketing and post-production, among other activities;
- an investment fund consists of soliciting clients, researching investments, making investments, back office administration, investor relations, and other functions; and
- the place in which intangibles are developed may be quite different from the place in which they are held or exploited.

This phenomenon makes it easier to restructure a business in order to advantageously locate particular functions in different jurisdictions, whether for tax reasons or otherwise. The fact that a business may have some functions that are relatively immobile is not an impediment to moving many or even most of the other functions of the business, which may represent a substantial portion of the value of the business. It is easier than ever to separate the moveable activities from the immoveable ones.

This same fact makes it possible for a country to seek to attract part but not all of a business. Countries like Canada and New Zealand are often able to attract the filming element of film and television productions without getting any of the other activity involved in the business. This, in turn, increases the amount of tax competition (and potentially harmful tax competition) that can be expected to be seen from different countries.

Furthermore, various devices are capable of being used to further segregate activities carried on in one country from those carried on elsewhere. Separate entities and special-purpose vehicles (SPVs) are often used to perform particular business functions (for example, intangible development versus licensing). In many cases these entities take advantage of differing tax characterization in one country versus another (i.e. hybrids). A business may also choose to use local independent agents (for example, local film production companies) in order to carry out a certain element of the business, rather than doing so itself.

The result is that the source country in which a particular activity is carried on has a diminished connection with other activities of the same business carried on elsewhere. This, in turn, places more stress on establishing the value of each business function as they become more subdivided into different entities and different countries, something that is often not easy to do, as continued struggles in the transfer pricing area attest.

The use of local entities (either arm's length or related) to perform discrete functions also changes the basis of taxation from one of source to one of residence, and in the case of related party entities brings home country CFC regimes into play. Indeed, mobile activities appear to be contributing to a diminution of source-based taxation, as local residents are often used to carry out particularly mobile functions. There is increasing evidence of source countries limiting or waiving their right to tax non-residents in order to attract economic activity, and being satisfied with tax revenue generated from their own residents involved in the particular activity. Where mobile activities are concerned, half a loaf is often better than none, and if the mobile activity is either being carried out partly by local residents themselves (for example, large portions of film production) or indirectly generating work for local service providers, such as lawyers, accountants and marketeers, there are still substantial incremental tax revenues for the source country even if taxation is limited or waived for non-residents.

Finally, the response of countries whose tax base is under threat from mobile activities is instructive. As noted, heightened tax competition for parts or all of mobile businesses is evident. As activities become more mobile, many jurisdictions are finding that attracting economic activity and then taxing their own residents on income they generate from that is much easier than trying to tax the profits of the activity itself. Countries are also aggressively defending their existing tax bases, as can be seen from recent US initiatives in cost-sharing agreements and CFC proposals. The broadening of the PE concept to include activities with a reduced source country nexus via service PEs also represents an attempt to defend the tax base in the face of an increasingly mobile business environment.

What the panel noted was the increasing extent to which general economic policy is taking precedence over tax policy, in the sense of deciding who should be taxed on which activities, and how much. Countries are being forced to think very hard about whether it is really in their interest (or practically within their power) to fully exercise taxing rights that are theoretically available to them, as businesses have more choices open to them than ever before. The practical limitations of countries over their tax base are being tested in ways not previously seen. The result has been a more pragmatic approach to taxation that must take into account the need to attract economic activity necessary to generate tax revenues, on the one hand, and a realistic understanding of the alternatives open to businesses and the limitations of tax compliance tools, apportionment devices, such as transfer pricing, and long-standing fundamental concepts, such as PEs, on the other.

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