

KEY ASPECTS ABOUT THE SUBSIDIARY IN THE CONCEPT OF PERMANENT ESTABLISHMENT

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Abstract: The article deals with one of the cases when permanent establishment (PE) is not usually formed – the provision of Art. 5, para.7 of the Model Tax Convention on Income and Capital of Organisation for Economic Co-operation and Development (OECD). The main aim of the study is to outline its legal nature, focusing on the key points in it. Although it is not distinguished by particular challenges of theoretical and practical nature, there are certain aspects that need special attention, as they can be interpreted as an exception to what is written on it.

Keywords: permanent establishment, subsidiary, treaties for avoidance of double taxation.

JEL: K22, K33, K34.

Introduction

The concept of permanent establishment (PE) in international tax law is outlined in Art.5 of the Model Tax Convention on Income and Capital of Organisation for Economic Co-operation and Development (MTCIC). It is an important regulator in the conclusion of Treaties for Avoidance of Double Taxation (TADT) among countries and is reflected in their domestic

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legislation. In Bulgaria, PE is defined in § 1, item 5 of Additional provisions of Tax and Social Insurance Procedure Code (TSIPC).²

Art. 5 of the Model Tax Convention on Income and Capital of Organisation for Economic Co-operation and Development consists of several paragraphs which over the years have been the subject of numerous discussions due to their significance of theoretical and practical nature. The dynamic trade relations nowadays also reflect on the legal nature of permanent establishment (PE), determining the need for regular research on its development.

For the purpose of the present work of interest is the provision of Art.5, para.7 of the Model Tax Convention on Income and Capital of Organisation for Economic Co-operation and Development of 2017³, which considers the hypothesis of non-formation of PE.⁴ Structurally, the study begins with the legal nature of the provision by deriving its main elements. It

² "Permanent establishment" shall be:

- a) a definite place (owned, rented or used on another ground), through which the foreign person implements fully or partially an economic activity in the country, for example: place of management, branch, trade representative office registered in the country; office; chamber; studio; factory; workshop (factory); shop; storehouse for trade; service shop; installation site; construction site; mine; quarry; drill; petrol or gas well; spring or another site for deriving natural resource;
- b) the implementation of activity in the country by persons, authorized to conclude contracts on behalf of foreign persons, except for the activity of the representative with independent statute under chapter six of the Commerce Act;
- c) durable implementation of commercial transactions with place of fulfilment in the country, even when the foreign person has no a permanent representative or a definite place.

³Art.5, para.7 of the Model Tax Convention on Income and Capital of Organisation for Economic Co-operation and Development is textually identical to Art5, para. 8 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (MOOH), therefore the latter will not be the subject of separate study.

⁴ As the MTCIC of 2017 is the latest official version and due to the lack of an official translation into Bulgarian, the Bulgarian version of the MTCIC of 2010 is cited due to the identity in the texts. This is also applicable to the other provisions cited in the study by the MTCIC in Bulgarian. Art. 5, para. 7 of MTCIC: "The fact that a company which is a resident of a contracting state controls or is controlled by a company which is a resident of the other contracting state or which carries on business in that other state (by place of business or otherwise), does not in itself make any of the companies a place of business of the other".

continues with an analysis of the relevant international practice, followed by a comparison of the concluded Tax and Social Insurance Procedure Code (TSIPC) between Bulgaria and other countries on this issue. In the conclusion, a summary of the results is made and the author's position is shared.

1. Key points in the provision of Art. 5, para. 7 of the MTCIC

The text of Art. 5, para. 7 of the MTCIC is already listed in the first MTCIC from 1963, remaining unchanged over the years, including the last one from 2017. On the one hand, this shows its significant and unchanging role in the concept of permanent establishment (PE). On the other hand, it gives rise to the question whether the lack of change is proof of the absence of theoretical and practical challenges.

In this connection, it is necessary to examine the key elements of the provision. Art. 5, para 7 of the MTCIC begins with the term "company" which is conceptually derived in Art. 3, para. 1, b of the MTCIC.⁵ After careful reading, it is necessary to understand that the concept of a company has a wide scope. According Klaus Vogel, sole shareholders also fall within the definition (Reimer & Rust, 2015). This is a kind of upgrade of its legal nature according to the trade regulations for the purposes of taxation.

The 'company' is found in several places in the MTCIC. Except in Art. 5, para. 7 and para. 8 of the MTCIC, it also appears in the text of Art. 16 "Directors' remuneration (fees)" and Art. 29 "Entitlement to benefits". It can be understood that the company does not determine the existence of serious challenges in its interpretation, covering the diversity of its manifestations.

In relation to the company, a comparison of the legal nature between the subsidiary and the branch should be made through the prism of the PE concept. The latter is one of the possible forms of the PE according to Art. 5, para. 2, b. "b" of the MTCIC. While the subsidiary is an independent legal entity, a separate body corporate, the branch is a non-independent legal

⁵ Art. 3, para. 1, b. "b" MTCIC: "the term 'company' means any body corporate or any other taxable unit that is treated as a body corporate for the purposes of the tax law".

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entity from a commercial point of view. In this regard, there is a constant practice of the Supreme Courts of the Republic of Bulgaria.⁶ On the other hand, for tax purposes the branch can be defined “as a relatively independent entity with its own facilities/equipment, forming a certain place of activity, with separate accounting and registration” (Dulevski, 2018). However, it is economically subordinate to the parent company. Through the prism of the concept of PE, it can be generally concluded that the subsidiary does not form PE, while the branch is one of its most common forms. An essential element for their differentiation is the degree of their dependence.

With regard to the criteria for determining ‘resident’, which conceptually appears in Art. 5, para. 7 of the MTCIC, Art. 4 of the MTCIC is applicable. This is significant in order to determine the location of the taxation of the person concerned as the holder of the relevant rights and obligations in the particular country. Due to their comprehensiveness, as well as the different aim of the present work, they are not subject to analysis. The established international postulates, as well as the relevant rules in the domestic legislation in determining which person is ‘resident’ are also applicable to Art. 5, Para. 7 of the MTCIC.

In analysing the provision, another key point is the control that one company exerts on another. There is no explicit definition in the MTCIC of what is meant by ‘control’. In Tax and Social Insurance Procedure Code (TSIPC) § 1, item 4 of Supplementary Provisions, divided into five alternative hypothesis, the answer to this question is given from the Bulgarian point of

⁶ “There is no dispute in legal theory and consistent court practice that the branch of the company is not a legal entity and does not have the status of a legal entity.” (Judgement № 119 of 01.09.2017 on item № 1056/2016 of The Supreme Court of Cassation); “According to Art. 17a, para.1 of the Commercial Act, a foreign person, registered with the right to carry out commercial activity according to its national law, may register a branch in the Republic of Bulgaria, as the branch shall be entered in the commercial register. However, the entry in question does not give rise to a new legal entity and in this sense it is not an independent legal entity.” (Judgement № 13182 of 10.10.2013 under Administrative Case № 10228/2013 of the Supreme Administrative Court); “The branch of a commercial company under 17a of the CA is a legal - Organisational form for carrying out economic activity, in which the trader by relative differentiation of his activity carries it out on the territory of a state, different from the one in which headquarters is located. This justifies the conclusion that the branch of the company is not a legal entity.” (Judgment №3015 of 08.03.2010 under Administrative Case № 1055/2010 of the Supreme Administrative Court).

view.⁷ Evidently, control has various manifestations, and all its cases cannot be covered in detail in the definition. In this regard, we share the position that control does not need to be exercised (Reimer & Rust, 2015). In general, control is the right or authority to significantly influence the business activity of the other company, which reflects the legal and economic dependence between the two companies – controlled and controlling.

Economic activity is a characteristic feature of the formation of PE, which is also part of its name in the Bulgarian translation. It is characterised by productivity and a variety of cases and is inexhaustibly set out in Art. 3, para. 1, b, “z” MTCIC (Slavcheva & Stefanov, 2012).⁸

Regarding the concept of PE in the Bulgarian and international tax literature, there are detailed studies. The comprehensiveness of the matter does not determine the need to analyse what is meant by PE in this article, as it focuses only on the provision of Art. 5, para.7 of the MTCIC.

The use of the expression “in another way” as a second alternative form for carrying out the economic activity according to Art. 5, para. 7 of the MTCIC, implies the possibility of a broad interpretation depending on the respective country and case. For instance, this may be a permanent

⁷ "Control" shall be in effect where the controlling party:

(a) holds, either directly or indirectly or by virtue of an agreement with another person, more than one-half of the

voting rights in the General Meeting of another person, or

(b) has a possibility to designate, whether directly or indirectly, more than one-half of the members of the management body or the supervisory body of another person, or

(c) has a possibility to manage the activity of another person, including through or together with a subsidiary, by virtue of articles of association or a contract, or

(d) as a shareholder or partner in one company, controls independently, by virtue of a transaction with other partners

or shareholders in the same company, more than one-half of the number of voting rights in the General Meeting of the company, or

(e) may in any other way exercise a dominant influence over decision-making in connection with the activity of the company.

⁸ Art. 3, para. 1, 10.2 of MTCIC: “the term “business” includes the performance of professional services and of other activities of an independent character”.

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establishment within the meaning of § 1, item 10 of the Additional Provisions of Value Added Tax Act (VAT), when it does not meet the criteria for PE.⁹

2. Practical international cases in the application of Art. 5, para.7 of the MTCIC

In this item of the study, some decisions from the practice of different countries related to Art. 5, para.7 of the MTCIC are analysed.

In the early 90s, the German Federal Tax Court dealt with a similar issue in its case-law (Judgment of 14 September 1994 of the German Federal Tax Court). The American company A-company, Akron has an English subsidiary that sells the products of the parent company in Europe. At the same time, a German company, which is also part of the American group and is a subsidiary of it, maintains a warehouse in Germany where it sells and delivers the products of the English company. In this connection, the German company provides services in advertising and promoting them. At the same time, the German company sells products from another manufacturer and performs repair and maintenance of vehicles. Based on specific factual situation, the question is whether the German company is not a dependent representative under Art. 5, para.7 of the MTCIC of the English company and thus to form PE for it in Germany.

The German Federal Tax Court proceeds from the understanding that the acceptance and observance of instructions by the German company is not an authoritative criterion for determining definitively whether there is a dependence on the English one. On the contrary, in order to have independence, it is necessary to study it in two directions – legal and economic.

⁹ "Fixed establishment" shall be a representative office, a branch, an office, a bureau, a studio, a plant, a workshop (factory), a retail shop, a wholesale storage facility, an after-sales service establishment, an assembly project, a construction site, a mine, quarry, prospecting drill, oil or gas well, a water spring or any other place of extraction of natural resources, a fixed place (whether owned, rented, or allocated for use) or a fixed base wherethrough a person carries out economic activity within the territory of a country, whether wholly or partly.

The German company is an independent body corporate under domestic law. It only sells and produces goods in its normal business, as well as it provides additional services (e.g. repair services). Although it is part of a group, this does not automatically reflect on the dependency criterion. Moreover, the German subsidiary continues to carry on its normal business in the specific factual situation. It executes orders for the English company, but this in no way affects the other business operations it carries out. Therefore, it cannot be defined as a dependent representative and form PE.

The Phillip Morris case is crucial not only from an Italian point of view, but also reflects on the MTCIC by placing a new paragraph in Art. 5 in the Commentary to the MTCIC (Commentary) of 2005 (Judgment of 7 Mart 2002 of the Italian Court of Cassation). The latter is a proper means of interpretation in the application of Treaties for Avoidance of Double Taxation (TADT).

The Italian company Intertaba Spa, part of the Phillip Morris group, is engaged in the production and distribution of cigarettes for Italy and other countries. At the same time, it supervises the production and distribution of cigarettes between foreign companies, part of the same group, and the Italian Tobacco Administration, as well as other activities.

The Italian Court of Cassation, contrary to the lower courts, concluded that the company could be a PE for several foreign companies that are part of a group. It advocates that the existence of ancillary/preparatory activity should be examined at the level of the whole group. In this regard, the supervision or control of the performance of a contract cannot be defined as ancillary activities within the meaning of Art. 5, para. 4 of the MTCIC and therefore not to form an PE. The participation in the negotiations by representatives of the Italian company, despite the formal implementation by foreign companies, may lead to the existence of a dependent representation, as this is not a normal activity for the Italian company. It is also possible for the assignment of the business management of the foreign company to Intertaba Spa to form a PE.

It is noteworthy that in assessing the existence of PE, the Italian Court of Cassation follows the so-called substance over form approach, thus limiting the purely formalistic interpretation of the facts. Its judgments are reflected in the Commentary in para. 33, 41 and 42 to Art. 5 of the MTCIC of

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2005 but in the opposite direction, distinguishing when PE can be formed and when not in similar cases.

A subsidiary may be the PE for the foreign parent company according to the Italian Regional Council of Veneto (Rossi, 2006). In the present case, a German company has an Italian subsidiary, and a distribution and license agreement has been concluded between them. The license itself is non-transferable and concerns the production and distribution of equipment, which is subsequently sold to Italian customers. In this regard, almost all the economic activity of the subsidiary is focused on the performance of the contract with the parent company.

The Italian Regional Tax Commission considers that the subsidiary forms an PE for the German one. Proof of this view is that the Italian company cannot change the equipment sold, the conditions for its sale and the quality standards without the explicit consent of the parent company. Therefore, it stands hierarchically in a dependent subordinate position.

In 2010, the French Supreme Administrative Court expressed an interesting position on this issue (Judgment of 31 March 2010 of the French Supreme Tax Court). The English company Zimmer Ltd sells orthopedic products through its French subsidiary Zimmer SAS under a sales contract concluded between them. Subsequently, the French company became a commission agent acting for Zimmer Ltd. The administrative court of appeal of Paris considers that Zimmer SAS is PE of the English company, since it binds the latter through its commercial activities. Examining the contractual clauses, the court found that the commission agent entered into contracts on behalf of Zimmer Ltd with clients, prepared offers, provided discounts and other activities without the express consent of the English company. All this proves that it is controlled by the parent company and cannot be defined as an independent representative.

In another position, however, is the French Supreme Administrative Court. First of all, analysing the contract between the two companies and observing the French Commercial Code, it found that there was no legal relationship between the two parties to determine the existence of dependence. An argument in this regard is that the commission agent is responsible for the performance of the contract to the clients, as the principal is not bound by his actions, although the former acts on his behalf. There is

another view that if the formation of PE was accepted, this would put foreign parent companies at a disadvantage compared to French ones, which will reflect to a different tax treatment. From these judgments, it can be concluded that a subsidiary is a PE if it legally binds the parent company.

Relevant decisions in connection with Art. 5, para. 7 of the MTCIC can also be found in Indian practice. The Finnish company Nokia assigns to its Indian subsidiary Nokia India Private Limited contracts for the installation of GSM equipment with customers, the latter also concludes contracts for technical support with them (Judgment of 5 June 2018 of the Income Tax Appellate Tribunal, New Delhi). For this purpose, an interesting analysis of the possible tax treatment of the subsidiary through the prism of PE was made.

Firstly, the existence of a certain place of activity according to Art. 5, para. 1 of the MTCIC due to the presence of employees of the Finnish company in India was examined. It has been established that the use of telephone and fax by them cannot determine the premises of the subsidiary for PE.

Secondly, a position has been expressed on dependent representation. The Indian company does not assist in the supply of goods and bears its own risk, therefore it does not fall into this hypothesis. The impossibility to apply one of the two possible forms of PE in this case proves its non-formation.

Another Indian decision confirmed the existence of a PE through a subsidiary (Judgment of 30 August 2011 of the Supreme Court of Delhi). The British company Rolls Royce PLC supplies aircraft engines and spare parts to Indian Government Organisations. It enters into a contract with its Indian subsidiary "Rolls Royce India Limited" for services such as administrative services, conference organisation and others, which take place in the latter's office.

In connection with the specific factual situation, the formation of PE was confirmed simultaneously under the basic rule according to Art. 5, para. 1 of the MTCIC and the dependent representation under Art. 5, para 5 of the MTCIC. With regard to Art. 5, para. 1 of the MTCIC, it was found that the premises of the Indian company were accessible to all employees of the parent company in connection with their business activities. Regarding the

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dependent representation, customer orders are addressed to the subsidiary, which then redirects them to the parent company. The independence in carrying out the activity proves its dependence.

From the analysed practice of the respective countries, it can be concluded that there are opposite decisions regarding the formation of the PE. The majority of them confirm the international view regarding the provision of Art. 5, para. 7 of the MTCIC, that in principle the subsidiary is not a PE for the parent company only due to the existence of control. However, the opposite practice should also be taken into account, as in some countries (e.g. Italy) it may even be a decisive and authoritative criterion on this issue.

It is noteworthy that the point of discussion on this issue is the correct definition of the boundaries of in/dependent representation, which is reflected in the non/formation of PE. Dependence should be considered from a legal and economic point of view and it is present even in cases of independent representation. Less common are the hypotheses according to the general rule under Art. 5, para. 1 of the MTCIC. It should be noted that in the present study no case has been considered through the prism of the so-called "PE for services", which due to its specificity may raise subsequent questions in this matter.

Proceeding from the concept of PE and those pursued in Art. 5, para. 7 of the MTCIC objectives, we consider that in very specific cases and after a precise analysis of the facts, it can be assumed that the subsidiary may be a PE for the parent company. Otherwise, this unconditionally expands the scope of art. 5 of the MTCIC and makes the existence of such a paragraph meaningless. It may also lead to uncertainty for foreign companies regarding the criteria for setting up an PE in the country concerned.

3. The meaning of Art. 5, para. 7 of the MTCIC in the TADT concluded among Bulgaria and other countries

There are no significant differences in the concluded TADT between Bulgaria and other countries, which theoretically and practically reflect the studied provision. In this regard, Bulgaria adheres to the postulates

established in the MTCIC. It is irrelevant that in some concluded TADTs this provision is placed in another paragraph or article (e.g. in Art. 5, para. 10 of the TADT with the Islamic Republic of Pakistan; Art. 5, para. 6 of the TADT with the Russian Federation; Art. 4, para. 6 of the TADT with the Republic of France; Art. 4, para. 7 of the TADT with the Republic of Italy and the Republic of Zimbabwe and Art. 4, para. 8 of the TADT with the Kingdom of Spain).

There is no such text in the TADT with the Kingdom of Belgium, the Republic of Finland and the Kingdom of Sweden. We believe that in this case, each individual hypothesis should be examined to determine whether it leads to formation or non-formation of the PE.

In the TADT with the Italian Republic, the provision is divided into two alternative sub-items, which are similar in meaning to the idea set out in the MTCIC.¹⁰ Regarding b. "b" the expression "otherwise" is replaced by "no". The same approach is observed in the TADT with the Grand Duchy of Luxembourg and Japan. Probably its idea is similar to the one set in Art. 5, para. 7 of the MTCIC, but we are of the opinion that its placement does not lead to a definite understanding of a broad interpretation similar to the original text of the MTCIC.

Regarding the subjective criterion, the following differences are observed. In the TADT with Japan, the term "legal entity" is used instead of "company". In the TADT with the Republic of India the term "enterprise - a resident of a Contracting State" is used, which has a separate definition in Art. 3, para. 1, p. "g" of it.¹¹ However, unlike the MTCIC, there is no explicit definition for an "enterprise".¹² The concept is associated with the

¹⁰Art. 4, para. 7 of the TADT with Italy: The fact that a company which is a resident of a contracting country:

a) holds a share in a company which is a resident of the other contracting country (or the latter company holds a share in the first one);

b) or carries on its business in the other contracting country (regardless of whether this activity is carried out through a place of business or not) it is not sufficient in itself to assume that either company is the permanent establishment of the other".

¹¹ Art. 3, para. 1. b. (g) from the TADT with the Republic of India: the terms "enterprise of one Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of one Contracting State and an enterprise carried on by a resident of the other Contracting State '.

¹² Art. 3, para. 1, b. "b" of the MTCIC "term" enterprise "applies to the carrying on of any business"

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performance of economic activity and should comply with the domestic legislation of the country (Tabakov, Tabakov & Hubenov, 2013). In Bulgarian legislation, definitions of "enterprise" are found in several regulations - the Labour Law, the Law on Protection of Competition, the Law on Small and Medium Enterprises, the Ordinance on business trips and specialisations abroad. Therefore, the question remains which is the closest for tax purposes through the prism of domestic law on this matter.

In the TADT with the Kingdom of Denmark, the Republic of Zimbabwe, the Kingdom of Spain, the French Republic, "controls or is controlled" is replaced by "participates" / "has a participation", which should be defined as synonymous in this case. A similar approach has been applied in the TADT with the People's Republic of China through the expression "share in the property". Upon reading Art. 21 "Property" shows that there is no specific definition of 'property' due to its diverse manifestations.

It can be summarised that the concluded TADTs between Bulgaria and other countries do not distinguished by serious differences on this issue, which should not cause theoretical and practical problems. The specifics in some of them are the result of negotiations with the respective country and are rather exceptions.

Conclusion

The provision of Art. 5, para. 7 of the MTCIC considers a specific case from the concept of the PE regarding its non-formation. Although the text does not create opportunities for ambiguous interpretation, there are certain challenges in this regard and in particular regarding the relationship to other paragraphs of Art. 5 of the MTCIC (e.g. para. 1 and para. 5).

After the analysis of the main items of the provision, there are no discussion issues from a theoretical point of view. Cases in different countries sometimes lead to a deviation from the general international understanding of non-formation of PEs. However, they are rather dictated by national needs and cannot be perceived as a constant practice. It should be borne in mind, however, that there are cases where PEs may be formed

under this paragraph, but they are exceptions and need to be subject to individual analysis.

The TADTs concluded between Bulgaria and other countries do not outline serious deviations from the text set out in the MTCIC, and the differences have a limited scope compared to the respective TADT.

Art. 5, para. 7 of the MTCIC is a relatively clearly defined provision in comparison with other paragraphs of Art. 5 of the MTCIC. However, non-formation of a PE through a subsidiary is not applicable in all cases, especially when intentional abuse of rights is intended. Future international cases on this subject will outline the development of the studied provision.

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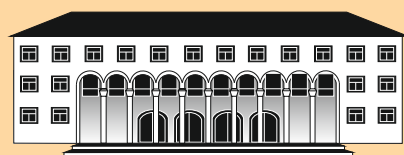
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