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# Problems Involving Permanent Establishments: Overview of Relevant Issues in Today's International Economy

Leonardo F.M. Castro  
*Milbank, Tweed, Hadley & McCloy*

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# PROBLEMS INVOLVING PERMANENT ESTABLISHMENTS: OVERVIEW OF RELEVANT ISSUES IN TODAY’S INTERNATIONAL ECONOMY

LEONARDO F.M. CASTRO<sup>†</sup>

## ABSTRACT

*The present article analyzes the most common problems related to the Permanent Establishment (PE) concept in International Tax in current modern economy, after the booming of e-commerce, the consolidation of the globalization process, and the new attempts to update and improve such concept in double tax treaties.*

*For that purpose, this article addresses the structure of Article 5 of the OECD Model Tax Convention and gives readers an overview of the concepts, definitions, and problems arising from each of the Article 5 paragraphs of such Model Convention.*

*After such overview, it examines the hottest topics in today’s international economy that are creating new PE problems, like e-commerce, attribution of profits under new Transfer Pricing methods, and the Service PE rule.*

*Lastly, it analyzes the recent OECD discussion draft on interpretation and application of Article 5 of the OECD Model Convention and its developments to current problems.*

*It concludes with reference to the most known issues on each PE topic, and an opinion on what should be improved in each sub-area of the Permanent Establishment article in tax treaties.*

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## I. INTRODUCTION

“Permanent Establishment” (PE) is a tax concept that indicates a particular level of business activity in the Source State (i.e., the state other than the residence state of the person carrying on the business concerned).<sup>1</sup> The concept of PE is particularly important for Article 7 (Business Profits) of the Organisation for Economic Co-Operation and Development Model Tax Convention (OECD MC).<sup>2</sup> Additionally, it is also relevant to various other treaty provisions (including Articles 10 [Dividends],<sup>3</sup>

<sup>1</sup> See generally OECD, COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND CAPITAL: CONDENSED VERSION, art. 7, at 26-27 (July 2010), available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010\\_mtc\\_cond-2010-en](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en) [hereinafter OECD MODEL CONVENTION].

<sup>2</sup> See generally *id.* art. 7, at 26-27.

<sup>3</sup> See *id.* art. 10, ¶ 4, at 28.

11 [Interest],<sup>4</sup> and 15 [Employment income]<sup>5</sup>). Nonetheless, greater importance might be reserved to Article 7 since, for purposes of interaction with such provision, Article 5 defines the threshold above which the Source State may tax business profits earned in that State by a resident of the other treaty State.<sup>6</sup>

In the 2000 update to the OECD MC, Article 14 (Independent Personal Services)—which dealt specifically with income from professional services—was deleted.<sup>7</sup> It employed the notion of “fixed base” as a threshold for Source State taxation.<sup>8</sup> As the precise difference between “fixed base” and “permanent establishment” was never fully clear, not even for some scholars, it was decided in 2000 to merge Article 14 into Article 7,<sup>9</sup> ending this dual treatment for individuals and companies. Since that time, the term “business profits” includes income from professional services and from other activities of an independent character.<sup>10</sup>

Article 5 of the OECD MC defines in seven paragraphs the terms, conditions and requirements for a PE.<sup>11</sup> Paragraph 1 defines the archetypal “physical” PE.<sup>12</sup> The second paragraph provides a rather useless list of examples which are not *a priori* cases of physical PEs (i.e., in each instance one must check whether a given establishment meets the requirements of Article 5(1)).<sup>13</sup> Paragraph 3 deals with “project PEs”—building sites and construction or installation projects.<sup>14</sup> In paragraph 4, *de minimis* exceptions are provided for the PE definitions of paragraphs 1, 3 and 5.<sup>15</sup> Paragraphs 5 and 6 define a third type of PE called an “agency PE.”<sup>16</sup> Finally, paragraph 7 explains that a subsidiary is not by itself a PE of its parent company and vice versa.<sup>17</sup>

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<sup>4</sup> See *id.* art. 11, ¶ 4, at 29.

<sup>5</sup> See *id.* art. 15, ¶ 2(c), at 31.

<sup>6</sup> See generally *id.* art. 5, at 24-25.

<sup>7</sup> See OECD, COMMITTEE ON FISCAL AFFAIRS, COMMENTARY ON ARTICLE 5 CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT, ¶ 1.1, at 92 (July 2010), available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010\\_mtc\\_cond-2010-en](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en) [hereinafter COMMENTARY ON ARTICLE 5].

<sup>8</sup> Christoph Trzaskalik & Marion Petri, *Administrative Provisions in Taxation Law*, in INT’L TAX L. 99, 166-67 (Andrea Amatucci & Christoph Trzaskalik eds., 2006).

<sup>9</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 1.1, at 92.

<sup>10</sup> OECD MODEL CONVENTION, *supra* note 1, art. 3, ¶ 1(h), at 23; see also COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 1.1, at 92.

<sup>11</sup> See generally OECD MODEL CONVENTION, *supra* note 1, art. 5, at 24-25.

<sup>12</sup> *Id.* art. 5, ¶ 1, at 24.

<sup>13</sup> *Id.* art. 5, ¶ 2, at 24.

<sup>14</sup> *Id.* art. 5, ¶ 3, at 24.

<sup>15</sup> *Id.* art. 5, ¶ 4, at 24.

<sup>16</sup> *Id.* art. 5, ¶¶ 5-6, at 24.

<sup>17</sup> *Id.* art. 5, ¶ 7, at 24.

This article analyzes the concept of PE, the requirements, conditions and different types of PEs existing in the OECD Model Convention (and mostly reflected in UN and U.S. Model Conventions)<sup>18</sup> in order to determine whether, after several decades since the concept of PE was originally created, the current wording and Commentaries remain sufficient to establish the proper allocation of taxing powers between the Source State (state of the PE) and the Residence State (state of the head office of the company itself).

Due to the undeniable importance of the PE provision in a cross-border transaction—meaning that, if there is a PE, the Source State may impose tax on income, and if there is not a PE, only the Residence State may tax the income—it is very important to go through all the items, requirements and relevant discussions related to the PE article and examine them to spot the trouble issues, the unclear concepts, and the points that need further analysis, new wording or additional attention in the Model Convention and in the Commentaries.

The objective of this study is to contribute to the development and improvement of the PE provision. Its practical applicability in this new era of intangible assets, fast movement of capital and services, and competitive economy is crucial for international tax purposes, particularly when determining whether a transnational investment or cross-border transaction is feasible or not.

## II. PERMANENT ESTABLISHMENT IN DOUBLE TAX TREATIES: AN OVERVIEW

International tax treaties to avoid double taxation (also known as “double tax treaties” or just “tax treaties”) use residence criteria to establish the minimum nexus for taxing a person or an entity in its own territorial limits.<sup>19</sup> The subsistence of an effective place of management or headquarters within the jurisdictional boundaries of that State—the criteria used to determine if a company resides in a contracting state—is often considered to be a sufficient factor that demonstrates the economic and social importance inherent to the relation of sovereignty between a State and that specific subject.<sup>20</sup> Consequently, the income generated within the State may be directly imputed to the enterprise established therein and, hence, directly subject to taxation on profits. However, where such genuine link (residence) fails to exist, a

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<sup>18</sup> See generally UNITED NATIONS MODEL CONVENTION FOR TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (1980), available at <http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf> [hereinafter UN MODEL CONVENTION]; U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION OF NOV. 15, 2006 (2006), available at <http://www.irs.gov/pub/irs-trty/model006.pdf> [hereinafter U.S. MODEL CONVENTION].

<sup>19</sup> See generally OECD MODEL CONVENTION, *supra* note 1, art. 4, at 24. The first paragraph of Article 4 of the OECD Model Convention, which defines “residents,” reads as follows:

For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. *Id.* art. 4, ¶ 1, at 24.

<sup>20</sup> See generally *id.*

State may only tax a foreign taxpayer if it is determined that a substantial economic interest or engagement within the life of the country still exists.

On the opposite side, though, whenever two or more States expand their tax capacity to a higher international degree in order to include foreign taxpayers, they are also further enhancing the risk that one of those subjects may become susceptible to overlapping taxation by more than one tax jurisdiction. As a response, some legal instruments, assuming the form of internationally binding bilateral agreements (mainly the OECD Model Tax Convention<sup>21</sup> and the United Nations Model Convention for Tax Treaties between Developed and Developing Countries,<sup>22</sup> but also the United States Model Income Tax Convention<sup>23</sup>), were created under a pre-negotiated standard structure,<sup>24</sup> which helps prevent circumstances where different States would concurrently levy taxes on the same economic earnings.

Holding a central role in such exercise, the concept of PE becomes, in itself, a basic requirement to be met before any taxation on business profits may occur under a bilateral treaty based on the OECD MC.<sup>25</sup> However, even though such definition is made by the OECD, UN and U.S. Model Conventions, the broad meaning of the terms used in such concepts—the fulfillment of the requirements and the facts and circumstances of each case—make it extremely complex, difficult and debatable for taxpayers and tax authorities to precisely determine when a “permanent establishment” actually exists for a certain enterprise. For this reason, the subject of permanent establishments continues to be one of the most fascinating, important and intricate topics of international taxation. Specifically under tax treaties, it is crucial to explore its definitions, problems and implications under current cross-border transactions and multinational business activities.

### III. THE PERMANENT ESTABLISHMENT CONCEPT

#### A. *The OECD Model Code Definition of a Permanent Establishment*

The idea of a Permanent Establishment (PE) is inherent to treaties against double taxation (e.g., “tax treaties”). As mentioned, the existence of a PE is a minimum threshold required for a country to tax non-residents’ business profits derived from sources in that jurisdiction where they are carrying on business.<sup>26</sup> It is often referred to as a legal fiction that enables one State to widen its taxation capacity over a non-

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<sup>21</sup> OECD MODEL CONVENTION, *supra* note 1.

<sup>22</sup> UN MODEL CONVENTION, *supra* note 18.

<sup>23</sup> U.S. MODEL CONVENTION, *supra* note 18.

<sup>24</sup> KLAUS VOGEL ET AL., KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS: A COMMENTARY TO THE OECD, UN AND U.S. MODEL CONVENTIONS FOR THE AVOIDANCE OF DOUBLE TAXATION ON INCOME AND CAPITAL, WITH PARTICULAR REFERENCE TO GERMAN TREATY PRACTICE 15-19 (3d ed. 1997).

<sup>25</sup> Ekkehart Reimer, *Permanent Establishment in the Model Tax Convention*, in PERMANENT ESTABLISHMENTS: A DOMESTIC TAXATION, BILATERAL TAX TREATY AND OECD PERSPECTIVE 187 (Ekkehart Reimer, Stefan Schmid, & Nathalie Urban eds., 2011).

<sup>26</sup> See Cormac Kelleher, *Problems with Permanent Establishments 1*, TTN-TAXATION.NET, available at <http://www.ttn-taxation.net/pdfs/prizes/CormacKelleherEssay.pdf> (last visited Feb. 22, 2012).

resident legal entity which would not otherwise be normally considered subject to an income tax in that State, and where no further connection to the territory is provided.<sup>27</sup> Essentially, the PE definition determines the right of a contracting State to tax the profits of an enterprise of the other contracting State. Thus, according to Article 7 of the OECD Model Convention, a country may not tax business profits of an enterprise unless that enterprise has a PE in that State.<sup>28</sup>

The OECD Model Tax Convention is the framework typically used by developed countries when negotiating tax treaties.<sup>29</sup> According to Article 5 of the OECD MC, there are two general types of PEs in the OECD MC: (1) the fixed place of business PE<sup>30</sup> and (2) the agency PE.<sup>31</sup> The relationship between Articles 5(1) and 5(5) shows that a Contracting State obtains taxing rights over a non-resident entity only if that enterprise first has a fixed place of business, either through management of assets of the non-resident entity located in the Contracting State, or through the acts in the Contracting State of individual employees with the non-resident entity, or a dependent agent, which involves the an individual or company to act on behalf of the non-resident entity in the Contracting State.<sup>32</sup>

Klaus Vogel recognizes a simple method of applying PE requirements in order to verify if a PE is present in a cross-border business, basically by verifying if there is a PE under paragraphs 1 or 3.<sup>33</sup> After that analysis, there is no need to determine whether there is also a PE under paragraphs 5 and 6, since in the first analysis these last types of PE would already be covered.

### B. “Fixed Place” Permanent Establishments

#### 1. The Definition of “Fixed Place of Business”

A fixed place of business PE exists where an enterprise carries on business in a country through a fixed location, such as an office or store, its definition codified in Article 5(1) of the OECD Model Convention, which provides that “[f]or the purposes of this Convention, the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”<sup>34</sup>

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<sup>27</sup> See U.N. Dep’t of Eco. & Soc. Aff., Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries ¶ 11, at 3 (2003), available at <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan008579.pdf> [hereinafter UN Manual].

<sup>28</sup> OECD MODEL CONVENTION, *supra* note 1, art. 7, ¶ 1, at 26.

<sup>29</sup> UN MANUAL, *supra* note 27, ¶ 11, at 3.

<sup>30</sup> See OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 1, at 24.

<sup>31</sup> See *id.* art. 5, ¶ 5, at 25.

<sup>32</sup> See generally OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶¶ 1, 5, at 24-25. See also Guy A. Kersch, *Comments on Definition of Permanent Establishment in the OECD Model Tax Convention*, ALLBUSINESS.COM, at 3, available at <http://www.allbusiness.com/accounting/3605358-1.html> (last visited Feb. 22, 2012).

<sup>33</sup> VOGEL, *supra* note 24, at 281.

<sup>34</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 1, at 24. In *McDermott Industries (Aust) Pty Ltd. v. Commissioner of Taxation*, it was argued that subsequent provisions should

The definition put forward in the UN Model Convention is essentially similar to the one above.<sup>35</sup> This apparently relatively straightforward definition encapsulates three requirements in order for a PE to be present, notably: (1) the existence of a “place of business” at the disposal of the enterprise; (2) the place of business must be of a “fixed” nature (geographical and temporal permanence); and (3) the enterprise being carried on is required to be “carried on through” the fixed place of business.<sup>36</sup>

The term “fixed place” seems to redirect the concept towards the indispensable existence of a physical location where the business is situated; it demands, therefore, a specific *situs*, a tangible element, which can be translated into an effective geographical requirement.<sup>37</sup>

In spite of the fact that the OECD MC does not have a definition of the term “place,” the Commentary proposes that attention should be paid to the tangible assets used for carrying on the business.<sup>38</sup> Therefore, a “place of business” shall include all physical objects, including the premises, equipment and accessories used by the taxpayer, that are necessary for carrying on a businesses with a certain degree of permanence.<sup>39</sup> Regarding such matter, the Italian tax authorities have concluded that a Swiss company maintaining a piece of railway and a railway station in Italy had a PE under the Italian domestic laws.<sup>40</sup>

However, no physical attachment to the soil is absolutely necessary.<sup>41</sup> For that purpose, tangible assets themselves can be regarded as “places.”<sup>42</sup> This may be pertinent where such properties are connected to a certain site, as may be the case with floating-restaurants or ship-museums.<sup>43</sup>

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be construed having regard to the general definition clause since they elaborate and elucidate (but not “vastly” expand) the concept of substantial business expressed in the general definition provision of Permanent Establishment. However, such approach was posterior rejected by the Australian Full Federal Court. *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation* (2005) 142 FCR 134; [2005] FCAFC 67, ¶ 57, 71.

<sup>35</sup> UN MODEL CONVENTION, *supra* note 18, art. 5, ¶ 1, at 10.

<sup>36</sup> Tiiu Albin, *Problems with Permanent Establishments: Problems in Determining Permanent Establishment on the Basis of Article 5(1) OECD MC 2*, TTN-TAXATION.NET, <http://www.ttn-taxation.net/pdfs/prizes/TiiuAlbinEssay.pdf> (last visited Jan. 31, 2012).

<sup>37</sup> See OECD CTR. FOR TAX POL’Y AND ADMIN., PUBLIC DISCUSSION DRAFT: ARE THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS APPROPRIATE FOR E-COMMERCE?, ¶ 12, at 7 (Nov. 26, 2003), <http://www.oecd.org/dataoecd/2/38/20655083.pdf> [hereinafter CURRENT TREATY RULES]. See also COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 2, at 90.

<sup>38</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 4.1, at 93. See also Andrew Hamad, *Rationalising the “Permanent Establishment,”* 35 AUSTRAL. TAX REV. 52, 62 (2006).

<sup>39</sup> See COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 2, at 92. See also Arvid A Skaar, *Commentary on Article 5 of the Model Treaty: The Concept of Permanent Establishment*, IBFD, at 13 (Amsterdam 2005).

<sup>40</sup> Raffaele Russo & Edoardo Pedrazzini, *Permanent Establishments under Italian Tax Law: An Overview*, 47 EUR. TAX’N 389, 393 (2007).

<sup>41</sup> See COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 5, at 94.

<sup>42</sup> *Id.* ¶ 8, at 96-97.

<sup>43</sup> Albin, *supra* note 36, at 2.



## 2. What Constitutes a “Fixed Place of Business”

In order to complement the general definition, Article 5(2) of the OECD MC sets forth a positive list (though not exhaustive) of what a permanent establishment actually consists of, including: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; and (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.<sup>44</sup> The provision of these examples reinforces the belief that a physical facility is required in order for a PE to be present, provided there is a sufficient nexus with a specific geographical point.<sup>45</sup>

In this sense, the doubt that remains is whether the expression “fixed place” should be understood as envisaging the feasibility of locating, identifying or pointing out a certain place which is stationary and not moving.<sup>46</sup> Unexpectedly, in *Fugro Engineers BV v. ACIT*,<sup>47</sup> the Indian court concluded that a company engaged in carrying out activities onboard an Indian vessel belonging to three different clients would still give rise to the existence of a PE.<sup>48</sup>

According to Arvid Skaar, any geographical area that commercially or economically constitutes an entity may be considered a fixed place of business; this is true even where the taxpayer’s activities are dispersed among the district.<sup>49</sup> The Dutch Supreme Court confirmed such view by stating that the mobility of a fixed place of business (in the case, a circus tent) did not prevent it from being treated as a PE.<sup>50</sup>

The length of time a non-resident has been operating in a contracting state is generally accepted as being irrelevant. In the majority of cases, it should be apparent whether a physical presence exists or not. Hence, the distinction between “temporary” and “permanent” is made based on the intention of the non-resident (a subjective factor). Accordingly, if a taxpayer plans to exercise its operating activities through the fixed place of business for an indefinite period of time, a PE

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<sup>44</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 2, at 24.

<sup>45</sup> VOGEL, *supra* note 24, at 286.

<sup>46</sup> See Har Govind, *Business Connection and Permanent Establishment*, 7 ASIA-PACIFIC TAX BULL. 190, 195 (2001).

<sup>47</sup> *Fugro Engineering B.V. v. ACIT* [2008] 122 TJJ 655 (Del).

<sup>48</sup> See review of *Fugro Engineering*, KPMG.COM (Sept. 29, 2011), available at <http://www.kpmg.com/IN/en/WhatWeDo/Tax/FlashNews/KPMG-Flash-News-GIL-Mauritius-Holdings-Ltd.pdf>. India, a non-OECD Member State, has the position that, even if there is no commercial coherence between different places where the business by a non-resident is carried on, a PE is still established. See OECD, COMMITTEE ON FISCAL AFFAIRS, NON-OECD’S ECONOMIES’ POSITIONS ON THE OECD MODEL TAX CONVENTION, POSITIONS ON ARTICLE 5 (PERMANENT ESTABLISHMENT) AND ITS COMMENTARY, ¶ 25, at 437 (2010), available at [http://www.keepeek.com/Digital-Asset-Management/ocd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010\\_mtc\\_cond-2010-en](http://www.keepeek.com/Digital-Asset-Management/ocd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en) [hereinafter POSITIONS ON ARTICLE 5].

<sup>49</sup> See Skaar, *supra* note 39, at 19.

<sup>50</sup> Hans Pijl, *The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with Special Reference to Dutch Case Law*, 56 BULL. FOR INT’L FISCAL DOCUMENTATION 554, 555 (2002).

would be regarded as existing in the Source State regardless of whether its intentions were not, in fact, realized.<sup>51</sup>

Another possible PE existence can occur even when the taxpayer does not intend to have a permanent place of business in the Source State. This happens when a taxpayer wants to use a place of business for a short period, but for objective reasons, the usage has become constant. If this is the case, the subjective inquiry is irrelevant, and a PE will be considered to have been established retroactively, as from the first day the enterprise was carried out.<sup>52</sup> It should also be pointed out that, due to the fact that the examples set out in Article 5(2) hanker to an era comprised of manufacturing and retailing businesses, the concept of a fixed place of business is not in keeping with modern businesses such as those in the service industry, e-commerce, or development of intangible products (discussed subsequently).

The examples provided in Article 5(2) refer to mines, oil wells, and similar business activities.<sup>53</sup> As a general rule, these enterprises often span a large geographic area, making it difficult to determine a single place of business.<sup>54</sup> However, it is largely held that mining over a such an area should constitute a single place of business, and the work is considered to be taking place in a particular geographical location, giving rise to the existence of only one, not multiple, PE.<sup>55</sup>

In addition to the general definition of PE stated in Article 5(1), paragraph 4 of the same article contains a list of what does not constitute a PE under the Model Convention. The list mainly covers any activity that holds a mere preparatory or accessorial character to the main business activity. The excluded activities mentioned in Article 5(4) include:

- a) [T]he use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business

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<sup>51</sup> Skaar, *supra* note 39, at 34.

<sup>52</sup> See COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 6.3, at 96.

<sup>53</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 2, at 24.

<sup>54</sup> See Kelleher, *supra* note 26, at 2.

<sup>55</sup> See *id.*

resulting from this combination is of a preparatory or auxiliary character.<sup>56</sup>

Generally, a place of business means any location used to carry on the activities of the enterprise, though such facilities are not necessarily used exclusively by the business, and it is possible for a place of business to exist without the presence of premises or facilities.<sup>57</sup> Interestingly, it is not necessary to have a formal legal entitlement to usage of the premises or facilities (i.e., formal right to use acquired by law, contract or other lawful formalized agreement, whether in the form of ownership, commercial or residential lease, deposit, pledge or other relationship), since the substance-over-form approach is often adopted according to evidence from facts and circumstances.<sup>58</sup> Additionally, the OECD Commentary is clear in confirming that there is no need for formal legal entitlement, pointing out that even illegal presence may constitute a PE.<sup>59</sup> For this reason, implicit authorization (i.e., factual right to use) and the like are not prerequisites since the actual control over a place is not sufficient to satisfy the disposition requirement.

In this sense, the material presence of the non-resident is also necessary, although it is not always enough, as mentioned by several OECD Commentary examples.<sup>60</sup> The Supreme Court of Canada has held that “where there [is] no person in the office with capacity to contract on behalf of the non-resident and the conduct and control originated outside Canada, there [is] no permanent establishment in Canada despite the fact that a company related to the nonresident [makes] an office in Canada available to the nonresident.”<sup>61</sup> For this reason, it is hard to determine if there is a place of business when the facilities are not at the disposal of the enterprise. This is likely to occur where, for example, the sales staff of the non-resident entity concludes contracts at the offices of its customers.

As to the meaning of the term “disposition,” as extracted from the OECD Commentary, it can be understood as occurring when the taxpayer has the power or liberty to control the place and, hence, the right to determine the conditions according to its needs.<sup>62</sup> Conversely, an example of a narrow—and more uncommon—interpretation is found in the Austrian Treaty for the Prevention of

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<sup>56</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 4, at 25.

<sup>57</sup> *See* Kelleher, *supra* note 26, at 1.

<sup>58</sup> *See* Ministry of Finance (Tax Office) v. Philip Morris GmbH, 4 INT'L TAX L. REP. 903 (Italy 2002) (holding that “substance over form” was considered one of the five principles applicable to the Permanent Establishment definition).

<sup>59</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 4.1, at 93.

<sup>60</sup> *Id.* ¶¶ 4.2-4.5, at 93-94.

<sup>61</sup> Richard G. Tremblay, *Permanent Establishments in Canada*, 2 J. INT'L TAX 305, 308 (1992).

<sup>62</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 4.1, at 93.

Double Taxation,<sup>63</sup> under which the accessibility of a key or an office desk is sufficient.<sup>64</sup>

### 3. Time Required to Create a Permanent Establishment

Domestic courts diverge when it comes to determining the minimum period of time needed to establish a PE. For instance, for Dutch general practice purposes, a six-month period is regarded as satisfactory to create a PE for taxation determinations.<sup>65</sup> Alternatively, in Portugal, an enterprise may be treated as having a permanent establishment if it “carries on an activity consisting of planning, supervising, consulting, any auxiliary work or any other activity in connection with a building site or construction or installation project lasting more than six months, if such activities or work also last more than six months.”<sup>66</sup>

Nonetheless, isolated activities will not, generally, give rise to a PE, since they lack the criteria of regularity, continuity and minimum time period for a business enterprise to have a genuine link or economical connection to the Source State.<sup>67</sup> Even so, depending on the nature of the activity, exceptions may occur, mostly on a case-by-case analysis (for instance, a daily sale like milk cannot be compared to sales of a sugar factory).<sup>68</sup>

### 4. Problems Concerning “Fixed Place of Business”

As demonstrated in this topic, the difficulty concerning the general definition of a “permanent establishment” is that the OECD Convention does not define “fixed place of business,” which is the elementary point in determining whether a non-resident’s activities in a Source State are sufficient to create a permanent establishment.<sup>69</sup> Thus, the term “fixed place of business” has been applied according to legal doctrine, case law, and the OECD Commentary since its origination,<sup>70</sup> but still varies considerably among countries worldwide.

In Belgium, for instance, the Tribunal of Ghent decided in 2003 that the material “fixed place” need not necessarily be associated with a personal “permanent

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<sup>63</sup> Austria is a signatory to a Treaty for the Prevention of Double Taxation of which there are 83 signatories, including Germany and the United States. See Austria Double Taxation Prevention Treaties, WORLDWIDE-TAX.COM, available at [http://www.worldwide-tax.com/austria/aus\\_double.asp](http://www.worldwide-tax.com/austria/aus_double.asp) (last visited Feb. 20, 2012).

<sup>64</sup> Albin, *supra* note 36, at 10-11 (citing Dietmar Herbrich, *The Future of Taxing Business Profits*, in TAX TREATY POL’Y & DEV. 336 (Markus Stefaner & Mario Züger eds., 2005)).

<sup>65</sup> See Pijl, *supra* note 50, at 557.

<sup>66</sup> POSITIONS ON ARTICLE 5, *supra* note 48, ¶ 64, at 127.

<sup>67</sup> Skaar, *supra* note 39, at 36.

<sup>68</sup> For more information on whether isolated activities could be regarded as continuous activities in the U.S. courts, see generally *Consolidated Premium Iron Ores, Ltd. v. Comm’r*, 265 F.2d 320 (6th Cir. 1959); see also *De Amodio v. Commissioner*, 34 T.C. 894 (1960).

<sup>69</sup> Benjamin Hoffart, *Permanent Establishment in the Digital Age: Improving and Stimulating Debate through an Access to Markets Proxy Approach*, 6 NW. J. TECH & INTELL. PROP. 106, ¶ 3 (2007).

<sup>70</sup> *Id.*

establishment.”<sup>71</sup> In that case, a Luxemburg company engaged in the management of a real estate asset was considered to have a professionally profitable activity (i.e., a business activity) which fell within the framework of a “permanent establishment” even though there was no representation to contract.<sup>72</sup> Under Belgian domestic law, a Belgian business enterprise is no longer required to tax foreign real estate owners leasing Belgian property directly to Belgian persons or enterprises.<sup>73</sup> The presence of a PE may only be significant where head office expenses are attributed to the lease under Article 7 of the OECD.<sup>74</sup>

Nevertheless, the notion of PEs still leads to different interpretations among countries and subsequently continues to cause confusion in treaty interpretation. A wide range of jurisprudence can be found explaining the terminology within Article 5 of the Model Treaty, varying from country to country, but without considerable harmonization until today.

### C. Project Permanent Establishments

Various scholars have taken the position that the PE defined in Article 5(3) (what is known as a “Project PE”) is different from the physical PE in Article 5(1).<sup>75</sup> In the 2003 update to the Commentary, the definition of a paragraph 1 PE was broadened to comprise also the paragraph 3 definition of a “Project PE.”<sup>76</sup> There is disagreement whether in view of the text of Article 5 the changed Commentary has the intended effect.<sup>77</sup>

The “fixed” requirement mentioned in Article 5(1) connotes that a certain quality of permanence is also mandatory.<sup>78</sup> This view of the fixed requirement and permanence consubstantiates into an effective time requirement. A “permanence

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<sup>71</sup> Hof van Beroep [HvB] [Court of Appeal] Antwerpen, Apr. 1, 2003, RECHTSKUNDIG WEEKBLAD [RW] 2003 (Belg.), published in FISCOLOG 2003, no. 237, at 4. See generally Patrick Cauwenbergh & André Claes, *Definition of ‘Permanent Establishment’: Part 1*, 39 DELOITTE BELG. TAX Q. (Jan. 2010), available at [http://www.deloitte.com/view/en\\_BE/be/insights/newsletters/tax-quarterly/issue-39-january-2009/544fddf413246210VgnVCM200000bb42f00aRCRD.htm](http://www.deloitte.com/view/en_BE/be/insights/newsletters/tax-quarterly/issue-39-january-2009/544fddf413246210VgnVCM200000bb42f00aRCRD.htm) [hereinafter Cauwenbergh & Claes, *Permanent Establishment, Part 1*]; see also Patrick Cauwenbergh & André Claes, *Definition of ‘Permanent Establishment’: Part 2*, 40 DELOITTE BELG. TAX Q. (May 2010), [http://www.deloitte.com/view/en\\_BE/be/insights/newsletters/tax-quarterly/issue40-may2010/057a7315d0278210VgnVCM200000bb42f00aRCRD.htm](http://www.deloitte.com/view/en_BE/be/insights/newsletters/tax-quarterly/issue40-may2010/057a7315d0278210VgnVCM200000bb42f00aRCRD.htm).

<sup>72</sup> Cauwenbergh & Claes, *Permanent Establishment, Part 1*, *supra* note 71.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*; Com.DTC, No. 5/238.

<sup>75</sup> See João Sérgio Ribeiro, *Outline of Article 5 of the OECD Model Convention*, 1(115) JURISPRUDENCIJA 295, 300 (2009), available at [http://www.mruni.eu/en/mokslo\\_darbai/jurisprudencija/archyvas/?l=75234](http://www.mruni.eu/en/mokslo_darbai/jurisprudencija/archyvas/?l=75234).

<sup>76</sup> See COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 5.1, at 94.

<sup>77</sup> Hans Pijl, *The Relationship between Article 5, Paragraphs 1 and 3 of the OECD Model Convention*, 33 INT’L TAX REV., no. 4, 189-93 (2005).

<sup>78</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 1, at 24.

test” is often conducted through a *contrario sensu* judgment method: a place of business is considered to be permanent “if it is not of a merely temporary nature.”<sup>79</sup>

Nevertheless, the OECD and UN Model Conventions provide further enlightenment on this matter by ruling that, wherever in presence of a “building site or construction or installation project,” a PE is only constituted if any of the previous figures lasts for more than twelve months in the OECD MC,<sup>80</sup> or six months in the UN Model Convention.<sup>81</sup> The twelve-month duration will apply to each individual project. Difficulties may arise in determining if a project is within the twelve-month timescale, given that it may be challenging to identify when the project commenced. It is understood that the term starts when the contractor begins his or her preparatory work in the foreign jurisdiction.<sup>82</sup>

Once work commences, the project is considered to be enduring until activity ceases.<sup>83</sup> It shall be stressed that the project term will not be considered to cease where there are periods of temporary abatements, even due to factors beyond contractors’ control (e.g., weather conditions, third party agencies or industrial disputes).<sup>84</sup>

In order to evade the twelve-month standard, contractors may attempt to subcontract portions of the project to third parties.<sup>85</sup> Despite subcontracting parts of the work, the principal contractor may still have a foreign PE, since the time spent by the sub-contractors is taken into account in determining if the principal has a PE, according to the OECD Commentary.<sup>86</sup>

The twelve-month test applies to each individual project or situs.<sup>87</sup> In establishing the length of each project, work spent on projects unrelated to the one being examined is not taken into account.<sup>88</sup> However, a project may be considered as a single endeavor because of its commercial and geographical links, regardless of the number of contracts involved.<sup>89</sup> Because entities often attempted to skirt the

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<sup>79</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 6, at 95.

<sup>80</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 3, at 25.

<sup>81</sup> UN MODEL CONVENTION, *supra* note 18, at 10.

<sup>82</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 19, at 100. *See also* Kelleher, *supra* note 26, at 3.

<sup>83</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 19, at 100. *See also* Kelleher, *supra* note 26, at 3.

<sup>84</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 19, at 100.

<sup>85</sup> *Id.* ¶ 18, at 100.

<sup>86</sup> *Id.* ¶ 19, at 100.

<sup>87</sup> *Id.* ¶ 18, at 100. India, Morocco, and Vietnam have voiced their reservations about the 12-month test applying to each individual site where a project is held, stating that “a series of consecutive short-term sites or projects operated by a contractor would give rise to the existence of a permanent establishment in the country concerned.” POSITIONS ON ARTICLE 5, *supra* note 48, ¶ 20, at 437.

<sup>88</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 18, at 100.

<sup>89</sup> *See id.*

twelve-month provision by compartmentalizing contracts amongst multiple connected parties, this operation by taxpayers is no longer effective.<sup>90</sup>

Though seemingly simple, the OECD twelve-month test comes with its own difficulties. It has been noted that because there is no provision for temporary absences due to weather, for instance, a PE can still arise, leading to unfair taxation standards.<sup>91</sup> Actually, this does not seem to be the spirit of the tax treaties. While it may be difficult to monitor and enforce this, it would be advisable to have an exception for the twelve-month provision to cover such abnormal circumstances, such as involuntary interruption of construction work due to floods, earthquakes, currency or monetary crisis, strikes and others.

It is relevant to state that Article 5(3) of the OECD MC is one of the most modified articles when Contracting States initiate tax treaty negotiations, especially considering the duration of time in order to configure a construction site or building PE, which can be reduced from twelve to as little as three months, depending on the treaty.

#### *D. Agency Permanent Establishments*

An agency PE exists under the OECD MC Article 5(5) when an agent acts on behalf of a foreign principal and habitually exercises authority to conclude contracts in the name of the principal.<sup>92</sup>

The OECD MC provides an exception for an independent agent acting in the ordinary course of its business,<sup>93</sup> since in this case it is obvious that there is no binding contract between the foreign company (non-resident) and the independent agent (resident). Thus, it would be impossible for the foreign company to have a PE regarding the enterprise of a third party (the independent agent).

##### 1. Dependent Agents and Permanent Establishments

The type of agent that can create a PE on behalf of an enterprise is referred to as a “dependent agent.”<sup>94</sup> A dependent agent can be classified as such whether or not the agent is an employee of the enterprise; it may also be either an individual or a corporation.<sup>95</sup> In other words, an enterprise should be considered to have a PE in a foreign jurisdiction where it is carrying on business through an agent who is acting in the ordinary course of business. This “acting in the ordinary course of their

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<sup>90</sup> *See id.*

<sup>91</sup> *See Kelleher, supra* note 26, at 3.

<sup>92</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 5, at 25. Article 5(5) states, in relevant part:

[W]here a person . . . is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise . . . .  
*Id.*

<sup>93</sup> *Id.* art. 5, ¶ 6, at 25.

<sup>94</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 10, at 97.

<sup>95</sup> *Id.* ¶ 32, at 105.

business” test has been the source of much uncertainty and criticism.<sup>96</sup> While the OECD Commentary endeavors to illuminate the situation, much still rests on the legal system in each jurisdiction.<sup>97</sup>

Also, under Article 5(5), the existence of the authority to conclude contracts should be the determining factor in whether an agency PE is found to exist.<sup>98</sup> Merely being present at the negotiations cannot, in and of itself, be sufficient justification for finding a PE under paragraph 5.<sup>99</sup> Consequently, in order for an agent’s activity to give rise to a PE, the agent is required to have sufficient authority, habitually exercised in the Source State, to negotiate and conclude contracts on behalf of the foreign organization.<sup>100</sup> Moreover, it is expressly stated in Article 5(6) that a broker, general commission agent or any other agent of an independent status are not considered a permanent establishment in a Contracting State, “provided that such persons are acting in the ordinary course of their business.”<sup>101</sup>

Perhaps paragraph 32 of the Commentary on Article 5(5) should be clarified to include an express mention that the mere attendance at or participation by a person acting on behalf of an enterprise in business negotiations of the enterprise will not, in and of itself, comprise sufficient evidence that the person has or habitually exercises an authority to conclude contracts in the name of the enterprise.<sup>102</sup>

In general, many treaties adopt the definitions stated above in determining whether an agency results in a PE situation. However, certain treaties provide alternatives which allow for negotiations and conclusion of contracts related to the agency PE, on their own specific wording to clarify future issues among the Contracting States.<sup>103</sup>

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<sup>96</sup> See Kelleher, *supra* note 26, at 4. See generally Tan How Teck, *Some Aspects of a Permanent Establishment in Australia*, 1(2) J. OF AUSTL. TAX’N 151, § 3.9.1 (1998), available at <http://www.austlii.edu.au/au/journals/JATax/1998/12.html#Heading170>.

<sup>97</sup> See Kelleher, *supra* note 26, at 4.

<sup>98</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 5, at 25.

<sup>99</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 33, at 106.

<sup>100</sup> *Id.*

<sup>101</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 6, at 25.

<sup>102</sup> It has also been suggested that the OECD Article 5 Commentary be refined to confirm that dependent agents in agency PEs use business judgment in the formation of the contract, and that “persons whose only role is to receive and acknowledge a customer’s acceptance of a foreign enterprise’s offer to sell a product or service on terms and conditions pre-set by the foreign principal should not be treated as a person with contract concluding authority within the meaning of Article 5(5).” Gary D. Sprague & Rachel Hersey, *Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, 38 GA. L. REV. 299, 328-29 (2003).

<sup>103</sup> See, e.g., Convention between Ireland and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Ir.-Japan, Jan. 18, 1974, available at <http://www.revenue.ie/en/practitioner/law/double/japan.html>.



## 2. Income Allocation in Agency Permanent Establishments

Income allocation is the problem of an agency PE, since the PE shall be treated as a separate entity for purposes of allocation of profits.<sup>104</sup> For example, if the agent receives a commission for selling property in the host State, and an independent contractor sells the apartment for a higher amount, when treating the arm's-length price of an agent, the income attributable to that agency PE will suffer modifications, considering the cost of the real estate and the sale price and the commission received. Thus, the agency PE is very imprecise due to the fact you have to determine which part of the whole business price is attributable to the agent; sometimes this is not an easy task.

It should be clearly understood that whether there is or is not an agency PE is a matter of tax liability of the principal (on whose behalf the agent acts) and not of the agent himself.<sup>105</sup> It is therefore preferable to refer to activities as carried on through an "agency PE" rather than through an "agent."

### *E. The "Carried on Through" Expression*

It is necessary to reaffirm that the concept of PE under Article 5(1) requires that the business activity is carried on through the fixed place.<sup>106</sup> However, it is not required that the entire business be conducted by means of the fixed place of business, but that only a fraction has been effectively carried on that way; this condition is met by satisfying what is known as the "business activities test."<sup>107</sup> Thus, in order for a place of business to constitute a PE, it is necessary for the enterprise to carry on its business activities wholly or partly through it. The activity is not required to be of a permanent nature.<sup>108</sup> However, it is considered necessary for the activity to be carried on on a regular basis, and not only once.<sup>109</sup>

This conclusion is extracted from "carry on," a phrase which strongly suggests continuity and regularity. In this sense, only income derived from active trade or business can be the basis for the existence of a PE (i.e., only income that would fall within OECD MC Article 7 scope can be included as PE income or active business income).<sup>110</sup> Consequently, all other types of income (especially passive income, such as dividends, interests and royalties) fall under other articles of the OECD MC and cannot be attributed to the PE.<sup>111</sup>

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<sup>104</sup> See OECD MODEL CONVENTION, *supra* note 1, art. 7, ¶ 2, at 26.

<sup>105</sup> The agent's tax liability in the State where he acts as an agent depends on the agent's residence. If the agent is a resident of that state, the fee earned by him as an agent is taxed to him as part of his worldwide income. If the agent is a non-resident, it depends on whether the agent's fee is taxable by the source country under the pertinent treaty rules. See generally OECD MODEL CONVENTION, *supra* note 1, arts. 7, 15, at 26-27, 31.

<sup>106</sup> *Id.* art. 5, ¶ 1, at 24.

<sup>107</sup> See generally COMMENTARY ON ARTICLE 5, *supra* note 7, ¶¶ 2-4.2, at 92-93.

<sup>108</sup> *Id.* ¶ 6, at 95-96.

<sup>109</sup> See *id.*

<sup>110</sup> See generally OECD MODEL CONVENTION, *supra* note 1, art. 7, ¶ 2, at 26-27.

<sup>111</sup> See generally *id.* arts. 10-12, at 28-30.

It is relevant to mention that the OECD Model Treaty 2008 version is the one that included the term “through.”<sup>112</sup> As previously indicated, the 2008 definition of PE is: “. . . a fixed place of business *through* which the business of an enterprise is wholly or partly carried on.”<sup>113</sup> This definition differs from its forerunner 1963 version, which provided that a PE was: “. . . a fixed place of business *in* which the business or enterprise is wholly or partly carried on.”<sup>114</sup> The 2008 revised definition results in a wider application of the concept of a PE, making it theoretically possible for the definition to apply to any situation where business activities are carried on at a particular location that could be used by the organization.<sup>115</sup>

The word “through” in the definition of permanent establishments charges that activities of the business must take place in the fixed place.<sup>116</sup> Therefore, most links between the fixed place and business activity will fulfill the requirements of permanent establishments.<sup>117</sup> Apparently, the determination of whether the foreign entity business is being carried on through a PE will be made by reference to the domestic laws of the foreign jurisdiction. Each jurisdiction will have its own criteria for determining what constitutes the “carrying on” of business in the region.

For that reason, the OECD’s new concept of a place of business, together with the domestic definition of “carried on,” often leads to the existence of a PE even if the activities have mainly or nothing but expenditures.<sup>118</sup> Alternatively, previous Model Conventions, such as those of Mexico and London,<sup>119</sup> proffered that establishments used merely for the purposes of services having no precise link with the profits generated by the business entity should not entitle the site State to retain taxation rights.<sup>120</sup> However, this is not the current scenario created by the OECD and UN definitions of PE.

Finally, recent discussions are making this requirement more difficult to be duly and unanimously answered. One such example is raised by Professor Kees van Raad, regarding whether a road may constitute a permanent establishment for an

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<sup>112</sup> See generally OECD, COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND CAPITAL: CONDENSED VERSION (July 2008), available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2008\\_mtc\\_cond-2008-en](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2008_mtc_cond-2008-en) [hereinafter OECD 2008 MODEL CONVENTION] (emphasis added).

<sup>113</sup> *Id.* art. 5, ¶ 1, at 24.

<sup>114</sup> OECD, COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND CAPITAL: DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL, art. 5, ¶ 1, at 3 (1963), available at [http://faculty.law.wayne.edu/tad/Documents/Tax\\_treaties/oecd\\_1963.pdf](http://faculty.law.wayne.edu/tad/Documents/Tax_treaties/oecd_1963.pdf) (emphasis added).

<sup>115</sup> See Albin, *supra* note 36, at 3.

<sup>116</sup> See *id.* at 13.

<sup>117</sup> See *id.*

<sup>118</sup> Andrew Hamad, *Rationalising the “Permanent Establishment,”* 35 AUSTN. TAX REV. 52, 66 (2006).

<sup>119</sup> See generally League of Nations, Fiscal Committee, London and Mexico Model Tax Conventions: Commentary and Text, Official No.: C.88.M.1946.II.A. (1946).

<sup>120</sup> Albin, *supra* note 36, at 13.

internationally operating trucking company.<sup>121</sup> The same issue arises with regard to railroad companies that make use of tracks in other countries and also for internationally operating bus companies.<sup>122</sup> To verify if there is a PE in this case, the main question is whether the road is at the disposal of the trucking company.<sup>123</sup> According to the author, the answer is positive; the trucking company has the road at its disposal and, thus, it makes rise to a railroad PE.<sup>124</sup>

*F. A Group Company as the Permanent Establish of another Group Company*

Paragraph 7, the last paragraph of Article 5, states:

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 (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.<sup>125</sup>

In this sense, a company resident in one state cannot be a PE of a company resident in another state simply because the latter controls or is controlled by the former; each company is a separate legal entity. However, if one company can be considered a dependent agent of the other company under Article 5(5), then an agency PE will exist.<sup>126</sup>

The 2005 changes to the Commentary clarify that, in the case of a group of companies, the existence of a PE under paragraphs 1 or 5 must be ascertained separately for each company of the group and not for the group as a whole.<sup>127</sup> In addition, it is specified that no PE exists where a group company provides services to another group company, while using its own personnel, as part of its business carried on on its premises that are not those of the recipient of the services.<sup>128</sup>

As the OECD felt that the Italian Supreme Court had misinterpreted the PE notion in the Italian Philip Morris decision,<sup>129</sup> it clarified the existing Commentary by making some additions to the Article 5 Commentary, stressing that one must look

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<sup>121</sup> See generally Kees Van Raad, *New Sources of Tax Revenue for (Rail)road Transit Countries?* (April 2011) (unpublished paper) (on file with author).

<sup>122</sup> See *id.*

<sup>123</sup> See *id.*

<sup>124</sup> See *id.*

<sup>125</sup> OECD MODEL CONVENTION, *supra* note 1, art. 5, ¶ 7, at 25.

<sup>126</sup> See *id.* art. 5, ¶ 5, at 25.

<sup>127</sup> OECD, THE 2005 UPDATE TO THE MODEL TAX CONVENTION: PUBLIC DISCUSSION DRAFT, ¶ 41.1, at 6 (Mar. 15, 2004), available at <http://www.oecd.org/dataoecd/54/24/34576874.pdf> [hereinafter OECD 2005 UPDATE].

<sup>128</sup> See *id.* ¶ 42, at 6.

<sup>129</sup> Ministry of Finance (Tax Office of Italy) v. Philip Morris GmbH, 4 INT'L TAX L. REP. 903 (Italy 2002). See also Raffaele Russo, *The 2005 OECD Model Convention and Commentary*, 12 EUR. TAX'N 560 (2005) (providing a brief discussion of the 2002 Italian Philip Morris decision).

separately at each company of the group and not at the group as a whole.<sup>130</sup> Modifications to the Commentary include the following:

1. Participation by a local group company in negotiations between a foreign enterprise and a local client does not by itself create an Agency PE—;<sup>131</sup>
2. A subsidiary may create a PE for its parent only if the premises of the subsidiary are at the disposal of the parent and that constitutes a fixed place of business through which the parent carries on its business, or the subsidiary acts as an agent of the parent, habitually carrying on business in the name of the parent;<sup>132</sup>
3. Determining whether a PE exists will be accomplished for each company of the group individually;<sup>133</sup>
4. If one multinational group company provides services to or manufactures products for another group company on its own premises and with its own personnel, the former company does not constitute a PE of the latter company.<sup>134</sup> The economic benefits the latter company receives from such service or manufacturing does not imply the existence of a PE.<sup>135</sup>

#### IV. ATTRIBUTION OF PROFITS AND TRANSFER PRICING RULES

When the rule of Permanent Establishment is mentioned, it is indubitable that Article 7 (Business Profits) of the OECD Model Convention will be brought up as well.<sup>136</sup> The Commentary on Article 7 states the generally accepted principle of

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<sup>130</sup> OECD 2005 UPDATE, ¶ 41.1, at 6.

<sup>131</sup> *Id.* ¶ 33, at 5.

<sup>132</sup> *Id.* ¶ 41, at 6.

<sup>133</sup> *Id.* ¶ 41.1, at 6.

<sup>134</sup> *Id.* ¶ 42, at 6.

<sup>135</sup> *Id.*

<sup>136</sup> *See generally* OECD MODEL CONVENTION, *supra* note 1, art. 7, at 26-27. Article 7, “Business Profits,” reads as follows:

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

double taxation conventions: “profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”<sup>137</sup> In the absence of a PE in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State’s taxing rights.<sup>138</sup>

Another important tenet is that “the taxation right of the State where the [PE] is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment.”<sup>139</sup> Several countries have adopted what is known as the principle of general “force of attraction” by which “income such as other business profits, dividends, interest and royalties arising from sources in [the country’s] territory was fully taxable by them if the beneficiary had a permanent establishment therein, even though such income was clearly not attributable to that permanent establishment.”<sup>140</sup>

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3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
  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 customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
  5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
  6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
  7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article. *Id.*

<sup>137</sup> *Id.* art. 7, ¶ 1, at 26.

<sup>138</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.11, at 113.

<sup>139</sup> OECD, CTR. FOR TAX POL’Y & ADMIN., REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS, ¶ 10, at 248 (July 17, 2008) *available at* <http://www.oecd.org/dataoecd/20/36/41031455.pdf> [hereinafter OECD, ATTRIBUTION OF PROFITS].

<sup>140</sup> *Id.*

The amended OECD Commentary makes it clear that the general force of attraction approach has now been rejected in international tax treaty practice.<sup>141</sup> Avoiding the force of attraction approach is important and possibly of immediate application for the international tax practitioner in many countries.<sup>142</sup>

*A. The “Functionally Separate Entity” Approach*

The mere existence of a PE does not, by itself, mean that additional taxes are owed to the country where the PE is located.<sup>143</sup> The 2008 OECD “Report on the Attribution of Income to Permanent Establishments” adopts a “functionally separate entity” approach, where the PE is treated as an entity distinct from its overseas parent for several purposes.<sup>144</sup> According to such approach, “the profits to be attributed to the PE are the profits that the PE would have earned at arm’s length as if it were a ‘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).”<sup>145</sup> Thus, the OECD’s “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” will also be used as guidance to determine the profits attributable, under transfer pricing rules, to a PE.<sup>146</sup> In this sense, the OECD MC Commentary provides that the profits attributable to a PE should be determined by reference to the PE’s functions performed, risks assumed and assets used.<sup>147</sup>

This functionally separate entity approach applies even if the PE is a dependent agent PE.<sup>148</sup> If the dependent agent is a legal entity and a taxpayer itself, issues arise as to whether, after the profits are assigned to the dependent agent under general transfer pricing principals, there would remain any profits attributed to the PE.<sup>149</sup>

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<sup>141</sup> OECD, CTR. FOR TAX POL’Y & ADMIN., REVISED DISCUSSION DRAFT OF A NEW ARTICLE 7 OF THE OECD MODEL TAX CONVENTION 8 (Nov. 24, 2009-Jan. 21, 2010), *available at* <http://www.oecd.org/dataoecd/30/52/44104593.pdf>.

<sup>142</sup> *OECD Model Tax Convention: 50 Years Young*, 35 DELOITTE BELG. TAX Q., 9, 11 (Jan. 2009), *available at* <http://www.deloitte.com/assets/Dcom-Belgium/Local%20Assets/Documents/Quarterly-Jan09.pdf>.

<sup>143</sup> *See generally* I.J.J. BURGERS ET AL., THE TAXATION OF PERMANENT ESTABLISHMENTS (2008).

<sup>144</sup> *See* OECD, ATTRIBUTION OF PROFITS, *supra* note 139, at 25. *See also* L. Peschke-Koedt, *A Practical Approach to Permanent Establishment Issues in a Multinational Enterprise*, 16 TAX NOTES INT’L 1601 (1998).

<sup>145</sup> *Id.* ¶ 69, at 25. *See also* K.R. Sekar, *Attribution of Profits—A “Separate Entity” Approach*, J. INT’L TAX’N (Dec. 2007).

<sup>146</sup> OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010) [hereinafter TRANSFER PRICING GUIDELINES].

<sup>147</sup> *See* OECD, REVISED COMMENTARY ON ARTICLE 7 OF THE OECD MODEL TAX CONVENTION, ¶ 15, at 134 (July 2010), *available at* [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010\\_mtc\\_cond-2010-en](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en) [hereinafter COMMENTARY ON ARTICLE 7].

<sup>148</sup> OECD, ATTRIBUTION OF PROFITS, *supra* note 139, ¶ 268, at 67.

<sup>149</sup> *See id.* ¶ 270, at 67-68.

The OECD has provided guidance suggesting that under some circumstances there might be additional profits to be attributed to the PE in this case.<sup>150</sup>

### B. Income and the Assumption of Risk

The deciding factor on how to assign income to a PE in these circumstances relates to assumption of risks. Outside the PE context, transfer pricing rules dictate that a taxpayer should earn income as return commensurate with the risks it assumes.<sup>151</sup> For instance, a subsidiary can be stripped of all business risk by contract, resulting in the subsidiary being entitled to a lower overall return. Nonetheless, when a taxpayer has a PE, there can be no intercompany contract between the taxpayer and the PE allocating risks.<sup>152</sup>

The OECD states that risk must be assigned to a PE based on functions.<sup>153</sup> For example, the OECD approach would attribute credit risk and inventory risk to a dependent agent PE if, and only if, the dependent agent performed the significant people functions relevant to the management of those risks (e.g., running an accounts receivable department or operating a warehouse).<sup>154</sup>

This seems like a highly technical issue with which it would be nearly impossible for an unsophisticated taxpayer to comply; it gives rise to difficulties when attributing and calculating the income generated through the PE, complicating even more the application of transfer pricing rules when directed at permanent establishments' profits.

## V. THE SERVICE PERMANENT ESTABLISHMENT RULE

In 2008 the taxation of services was added to the Commentary<sup>155</sup> in accordance with a report released as a public discussion draft in 2006.<sup>156</sup> The previous Commentary Article 5 barred the option of a Source State taxing the profits received from the delivery of services in their territory.<sup>157</sup> Thus, to equally tax profits from services and other business activities, some States voiced their wish that Article 5 be

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<sup>150</sup> *Id.*

<sup>151</sup> See generally TRANSFER PRICING GUIDELINES, *supra* note 146.

<sup>152</sup> See generally *International Transfer Pricing*, PRICEWATERHOUSECOOPERS (2011), at 19, available at [http://www.pwc.com/en\\_GX/gx/international-transfer-pricing/assets/itp-2011.pdf](http://www.pwc.com/en_GX/gx/international-transfer-pricing/assets/itp-2011.pdf).

<sup>153</sup> COMMENTARY ON ARTICLE 7, *supra* note 147, ¶ 20, at 135.

<sup>154</sup> See OECD, ATTRIBUTION OF PROFITS, *supra* note 139, ¶ 271, at 68.

<sup>155</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶¶ 42.11-42.48, at 100-10; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.11, at 113. For a review of the changes made to the Article 5 Commentary, see OECD, CTR. FOR TAX POL'Y & ADMIN., THE 2008 UPDATE TO THE OECD MODEL TAX CONVENTION 9-17, ¶¶ 42.11-42.48 (2008), available at <http://www.oecd.org/dataoecd/20/34/41032078.pdf> [hereinafter OECD 2008 UPDATE].

<sup>156</sup> See generally OECD, CTR. FOR TAX POL'Y & ADMIN., THE TAX TREATY TREATMENT OF SERVICES: PROPOSED COMMENTARY CHANGES (Dec. 8, 2006), available at <http://www.oecd.org/dataoecd/2/20/37811491.pdf>.

<sup>157</sup> See Albin, *supra* note 36, at 3.

changed to allow a Source State the right to tax profits from services even if they were not ascribed to a PE in that State.<sup>158</sup>

Under the current PE definition, a resident of one State engaged in an extensive provision of services within the other state, without doing so through a physical or project PE, usually will not be taxed in the other state; providing services usually does not involve acting as an agent.<sup>159</sup> To the extent there is a physical PE, little service income will be attributable to that PE.<sup>160</sup> Therefore, service income will not give rise to substantial tax liability unless an additional type of PE is included in the PE definition.

*A. DIT Mumbai v. Morgan Stanley and Changes in the OECD Commentaries*

This modification in the OECD Commentaries came right after an Indian case involving Morgan Stanley & Co. decided by the Supreme Court of India in 2007.<sup>161</sup> In this case, Morgan Stanley U.S. was involved in the rendering of financial advisory services, corporate lending, and the underwriting of securities.<sup>162</sup> It outsourced a wide range of its support services to its group company, Morgan Stanley Advantage Services Private Limited (Morgan Stanley India).<sup>163</sup>

The Indian Authority held it for Advanced Ruling that Morgan Stanley U.S. did not have a PE in India.<sup>164</sup> This was on the basis that Morgan Stanley India was not considered to be a fixed place of business, and that Morgan Stanley U.S. was not considered to be carrying on business in India.<sup>165</sup> In addition, Morgan Stanley U.S. would not have been considered to have an Indian PE due to the fact that Morgan Stanley India did not have the ability to conclude contracts on behalf of Morgan Stanley U.S.<sup>166</sup> Since some service businesses do not require a fixed place in their territory in order to carry on a substantial level of their activities therein, the fixed place of business requirement existing for PEs under Article 5, evidently, could not be duly applied to services.

For that reason, under the revision of the OECD's 2008 Model Tax Convention, new and specific rules for a characterization of a "Service PE" were created.<sup>167</sup>

<sup>158</sup> *Id.* See also OECD 2008 MODEL CONVENTION, *supra* note 112, ¶¶ 42.13-42.14, at 101; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶¶ 42.13-42.14, at 114.

<sup>159</sup> See OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.18, at 101-02; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.18, at 115.

<sup>160</sup> See OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.18, at 101-02; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.18, at 115.

<sup>161</sup> DIT (Int'l Tax'n), *Mumbai v. Morgan Stanley and Co.*, (2007) Civil Appeal No. 2914 of 2007 (arising out of S.L.P. (C) No. 12907 of 2006) and Civil Appeal No. 2915 of 2007 (arising out of S.L.P. (C) No. 16163 of 2006).

<sup>162</sup> See *id.* ¶ 3.

<sup>163</sup> *Id.*

<sup>164</sup> See generally *id.* ¶¶ 33-35.

<sup>165</sup> See *id.* ¶ 12.

<sup>166</sup> See *id.* ¶ 9.

<sup>167</sup> See generally OECD 2008 MODEL CONVENTION, *supra* note 112, ¶¶ 42.11-42.48, at 100-10; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.11-42.48, at 113-123.



According to such rules, if a non-resident entity provides services within the other Contracting State for a period of 183 days or more within a 12-month period, and more than 50 percent of the gross business revenues of the enterprise consists of income derived from the services performed in that State by the individual, a permanent establishment is deemed established in the Contracting State; this is known as a “Service PE.”<sup>168</sup>

In the alternative, a Service PE may exist where services are provided in that other Contracting State for 183 days or more in any 12-month period, and the activities are performed for a project or set of connected projects for customers who are either residents of that other State or who maintain a permanent establishment providing such services in that other State.<sup>169</sup>

In this regard, the Business and Industry Advisory Committee to the OECD (BIAC)<sup>170</sup> said that those proposed rules and conditions were created to help countries that wanted to “put a special deemed permanent establishment threshold for services taxation in their tax treaties,” but the new rules “did not justify moving away from the OECD’s fundamental principles on PE already in the model convention”<sup>171</sup> (i.e., classical requirements and the negative and positive example list, all mentioned and maintained in Article 5 of the OECD MC).

Therefore, the provision of Services PE should, as a general rule, “be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services.”<sup>172</sup> There is no need to diverge from usual PE concepts and requirements, as long as they fit the service’s nature.

#### *B. Calculating Aggregate Periods for Service PEs*

For purposes of calculating the aggregate period of 183 days for the application of the Service PE rule, the overall period shall be counted based on the total number of days the services are rendered in the other Contracting State upon effectiveness of the service agreement.<sup>173</sup> Thus, the period for residency or for any kind of endeavor

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<sup>168</sup> OECD 2008 MODEL CONVENTION, *supra* note 91129, ¶ 42.23(a), at 102; OECD 2008 UPDATE, *supra* note 155, ¶ 42.23(a), at 11; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.23(a), at 115.

<sup>169</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.23(b), at 102-03; OECD 2008 UPDATE, *supra* note 155, ¶ 42.23(a), at 11; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.23(a), at 115.

<sup>170</sup> The Business and Industry Advisory Committee to the OECD, *available at* <http://www.biac.org/> (last visited Jan. 26, 2012).

<sup>171</sup> *Permanent Establishment is Key to OECD Revisions*, INT’L TAX REV. (June 12, 2008), *available at* <http://www.tpweek.com/Article/1945259/Permanent-establishment-is-key-to-OECD-revisions.html>.

<sup>172</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.11, at 100; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.11, at 113.

<sup>173</sup> *See* OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 5, at 211; OECD, COMMITTEE ON FISCAL AFFAIRS, COMMENTARY ON ARTICLE 15 CONCERNING THE TAXATION OF INCOME FROM EMPLOYMENT, ¶ 5, at 252 (July 2010), *available at* [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010\\_mtc\\_cond-2010-en](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en).

not connected with the services to be rendered shall not form part of the reckoning period. Also, in the event there is an automatic renewal or continuance of the same service agreement, it shall be regarded as being the same or connected project for the purpose of counting the aggregate period of 183 days.<sup>174</sup> Moreover, it is preferred that the personnel and employees are classified as the ones rendering services, considering that an artificial entity cannot act without the people representing it. Precisely for that reason, some scholars say that the Service PEs have been introduced to the OECD MC to compensate for the deletion of Article 14 of the MC in 2000,<sup>175</sup> which is a reasonable justification.

### C. Current Service Permanent Establishment Language and Issues

The current wording of the Service PE clause has thus been summarized by practitioner Tiiu Albin as follows:

1. A PE is deemed to exist irrespective of the short duration of business activities;
2. The number of contracts or clients is irrelevant;
3. It is important where the services are performed, not where the services are consumed or used;
4. The amount of gross revenue is determined on the basis of the domestic laws of the Contracting States, because it has not been specified in the Articles of DTCs;
5. In situations other than one-man enterprises, it may be difficult to determine the percentage of the entity's gross revenue derived from the services performed by a particular individual[.]<sup>176</sup>

The Service PE rules will continually give rise to more discussions regarding the source tax rules and, according to some, "current wording may create uncertainty to taxpayers, [giving] looser rules to tax authorities[,] and can greatly increase the compliance and administrative burden of both the taxpayers and tax authorities."<sup>177</sup>

One of the main problems currently facing the Service PEs is the conflict on qualification of the income derived from employees on a company that may be regarded as having a PE in the Source State, due to the fact that its employees meet the requirements stated in that type of provision or particular treaty. When the source of the income is a third country, and when part of the compensation is paid directly from the client in the Source State, some double taxation may occur; the crucial point is to avoid defining under the Service PE clause if there is a PE in that case.

This issue, however, is not mentioned or even slightly resolved by the Model Convention or the Commentaries, and it definitely should be addressed in the near future.

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<sup>174</sup> See OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.41, at 107; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.14, at 120-21.

<sup>175</sup> Albin, *supra* note 36, at 5.

<sup>176</sup> *Id.* at 4-5.

<sup>177</sup> *Id.* at 5.

## VI. E-COMMERCE AND PERMANENT ESTABLISHMENTS

Although the concept of PEs had been constructed as an answer to the need for quantitative criteria to determine, under a demand for certainty and predictability, the rights of taxation of a Source State over the income derived by a non-resident, technological progress and, unavoidably, the Internet became a real challenge to such international principles as originally written.

It became apparent that the concept of PEs was designed in an almost moldable approach that enables it to fit any kind of business reality. In fact, if we recognize that one fundamental element of existence for a PE is the necessity of a geographical, physical location for the business to operate, it gets extremely difficult to determine where such location is when business is carried out only by electronic means.

Because of electronic commerce (e-commerce), almost no physical contact is made between the consumer in one country and the seller located in another country. There is no physical location to which the Source State may be able to impute the income and, accordingly, no PE could be considered to exist in those cases.<sup>178</sup> The Internet constantly becomes a tool to manage business without the need of a physical interface in the source country and, thus, avoids potential qualification of the enterprise as a PE.

Considering this emerging problem, in January 1999, the OECD Committee on Fiscal Affairs (“the Committee”) set up the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (TAG),<sup>179</sup> an entity that has been providing for the basic standard technical reflection on the topics governing the taxation of e-commerce activities, which have subsequently been regularly discussed and adopted by the Committee to the Commentaries to the OECD MC.<sup>180</sup>

TAG has specifically identified that, despite it being difficult or even impossible to trace the location from which e-commerce transactions are performed, it is, on the other hand, fairly easy to: (a) pinpoint a server in a low-tax jurisdiction; (b) divide business functions related to a commercial transaction between separate servers; and (c) have websites hosted by Internet Service Providers (ISPs).<sup>181</sup> In this sense, although the concept of PE was traditionally directed towards the requirement of physical presence, with the progressive evolution of e-commerce, such traditional views of this concept have been greatly destabilized, and at the same time physical intermediation has disappeared in this specific type of business.

The Committee reached a similar conclusion, clearly expressing its views by stating that “a web site cannot, in itself, constitute a permanent establishment . . . .”<sup>182</sup> Furthermore, paragraphs 42.1 and 42.2 of the Article 5 Commentary have been added to OECD MC in order to further confirm its position.<sup>183</sup>

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<sup>178</sup> See Chetcuti, Jean-Philippe, *The Challenge of E-commerce to the Definition of a Permanent Establishment: The OECD’s Response*, INTER-LAWYER (2002), at 3, available at <http://www.inter-lawyer.com/lex-e-scripta/articles/e-commerce-pe.htm>.

<sup>179</sup> See CURRENT TREATY RULES, *supra* note 37, at 1.

<sup>180</sup> See generally *id.*

<sup>181</sup> *Id.* ¶ 76, at 22.

<sup>182</sup> OECD, COMMITTEE ON FISCAL AFFAIRS, CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE: CHANGES TO THE COMMENTARY ON

After several discussions concerning e-commerce and the characterization of permanent establishments, it was decided that, although a server as such cannot be a PE itself, the place where it is deposited along with the server may constitute a place of business.<sup>184</sup> The presence of computer equipment at a fixed location may itself give rise to a PE in that jurisdiction.<sup>185</sup> However, it is necessary to make distinctions between computer equipment located in a jurisdiction and the data and software used by that equipment.<sup>186</sup> A website would not have a fixed place of business and thus would not be considered a PE under the existing definition.<sup>187</sup> The server, though, would comprise a fixed piece of equipment and be located at a specific location.<sup>188</sup>

Commonly, the company that runs a server will not be the company that carries on business through the website found on the server.<sup>189</sup> Here, the server may not be a fixed place of business of the enterprise carrying on the business. Consequently, the website should not constitute a PE of the organization.<sup>190</sup> In regard to such matter, the Australian Taxation Office has stated that “place of business” should be determined by looking to the functions performed at that place.<sup>191</sup>

Despite the overall consensus reached on the topic of non-qualification of websites as PEs, divergence has occurred when experts analyze the role of web servers as a sufficient physical manifestation of an enterprise “place of business” for purposes of rendering applicable the concept of PE.<sup>192</sup> However, as expressed by the Committee, “the issue whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions [already] performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis.”<sup>193</sup> Examples of functions going

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THE MODEL TAX CONVENTION ON ARTICLE 5, ¶ 6, at 3 (Dec. 22, 2000) [hereinafter OECD, CLARIFICATION].

<sup>183</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶¶ 42.1-42.2, at 97; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶¶ 42.1-42.2, at 110.

<sup>184</sup> *See generally* OECD 2008 MODEL CONVENTION, *supra* note 112, ¶¶ 42.1-42.4, at 97-98; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶¶ 42.1-42.4, at 110-11.

<sup>185</sup> *See* OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.4, at 98; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.4, at 111.

<sup>186</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.2, at 97; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.2, at 110.

<sup>187</sup> *See* OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.2, at 97; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.2, at 110.

<sup>188</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.2, at 97; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.2, at 110.

<sup>189</sup> *See* OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.3, at 97-98; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.3, at 110-11.

<sup>190</sup> OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.3, at 97-98; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.3, at 110-11.

<sup>191</sup> Australian Taxation Office, Electronic Commerce Project Team, *Tax and the Internet: Second Report* (1999), at 97.

<sup>192</sup> *See generally* OECD, CLARIFICATION, *supra* note 182, ¶¶ 14, 42.2-42.10, at 5-7.

<sup>193</sup> *Id.* ¶ 14, at 4.

beyond mere preparatory or auxiliary computer equipment performance have been included in paragraph 42.9 of the Commentary to Article 5.<sup>194</sup>

Although most States have been dealing with the problem by going around the concept of PE as it is—strict requirement of geographical presence—countries like Portugal and Spain do not consider tangibility a necessary requirement for a PE to exist in the context of e-commerce,<sup>195</sup> and, for that reason, an enterprise carrying on business in these States through a website could be treated as having a PE in those States.

Additionally, paragraph 10 of the Commentary to Article 5 expressly recognizes that the business of an enterprise may be carried on through automatic equipment.<sup>196</sup> The same paragraph further announces that a PE can exist where the business of the enterprise is carried on through automated equipment, with the activities of the enterprise's personnel being restricted, to setting up, operating, controlling, and maintaining the equipment.<sup>197</sup>

In spite of the fact that discussions on this subject are far from being finished, the consensus reached by the OECD with respect to determining whether a PE exists for e-commerce entities can be summarized) as follows:

1. Websites do not constitute PEs;
2. Website hosting facilities should not produce PEs for the entity carrying on business through the website;
3. Internet service providers (ISPs) should not represent an agency position and give rise to a PE; and
4. Servers located in a jurisdiction for a suitably long period may be considered “fixed” and comprise a PE.<sup>198</sup>

The agreement seems to be that a server may only constitute a PE when the automatic functions carried out by such equipment had been set up by the principal enterprise and continued to be operated, controlled and maintained by the same principal enterprise. In effect this level of activity by the principal enterprise assured the character of permanence. However, the subject is far from resolution when it comes to PEs under e-commerce specifications.

#### VII. THE OECD'S RECENT PROPOSED CHANGES TO THE PE COMMENTARY: OCTOBER 12, 2011 DISCUSSION DRAFT

On October 12, 2011, the OECD published the “Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention” public discussion draft (OECD 2011 PE Draft),<sup>199</sup> which includes proposals for additions

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<sup>194</sup> See OECD 2008 MODEL CONVENTION, *supra* note 112, ¶ 42.9, at 99; COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 42.9, at 112.

<sup>195</sup> OECD, CLARIFICATION, *supra* note 182, ¶ 6, at 3.

<sup>196</sup> See COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 10, at 97-98.

<sup>197</sup> *Id.* ¶ 10, at 98.

<sup>198</sup> Albin, *supra* note 36, at 6.

<sup>199</sup> OECD CTR. FOR TAX POL'Y AND ADMIN., INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION: PUBLIC

and modifications to the Commentary on the OECD Model Tax Convention following the recommendations of the Committee of Fiscal Affairs' Working Party 1 on Tax Conventions and Related Questions.<sup>200</sup> The proposed alterations appear in numerical order, following the current Article 5 Commentary, with the Annex consolidating all the proposed changes for paragraphs 1 through 35.<sup>201</sup> The deadline for public comments was February 10, 2012, the objective being to include the conclusions of the discussion in the 2014 OECD Commentaries update.<sup>202</sup>

There were 25 issues identified in the OECD 2011 PE Draft, both from prior OECD work (such as business restructuring and attribution of profits) and new inputs.<sup>203</sup> Although the discussion draft recommends several changes to the Commentary on Article 5, it also concludes that some changes are not necessary for others.<sup>204</sup> It is possible to sense some tension from the recommendations, especially regarding the desirability of bright line rules on one hand, and the way to include the diversity of views among OECD member countries on the other.

Based on the 2012 International Fiscal Association U.S. Branch Annual meeting panel, the most important issues dealt with in the public discussion draft were: (1) the "at the disposal of" expression; (2) "converted" local entities (contract manufacturing arrangements); (3) time requirements; (4) the presence of foreign enterprise personnel (i.e., seconded employees); (5) main contractors who subcontract all aspects of a project; and (6) the "in the name of" expression (commissionaire arrangements).<sup>205</sup>

#### A. The "At the Disposal of" Expression

Under the current Article 5 Commentary, the place of business once "at the disposal of" a foreign enterprise may give rise to a PE, provided other requirements are met.<sup>206</sup> The OECD 2011 PE Draft suggests modifications to the current OECD Commentary, explaining that the concept of whether a location is at the disposal of

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DISCUSSION DRAFT (Oct. 12, 2011-Feb. 10, 2012), available at <http://www.oecd.org/dataoecd/23/7/48836726.pdf> [hereinafter OECD 2011 PE DRAFT].

<sup>200</sup> OECD Ctr. for Tax Pol'y and Admin., *OECD Releases A Discussion Draft on the Definition of "Permanent Establishment" in the OECD Model Tax Convention*, OECD.ORG (Oct. 12, 2011), [http://www.oecd.org/document/51/0,3746,en\\_2649\\_33747\\_48836787\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/51/0,3746,en_2649_33747_48836787_1_1_1_1,00.html).

<sup>201</sup> *Id.*

<sup>202</sup> *See id.*

<sup>203</sup> *See generally* OECD 2011 PE DRAFT, *supra* note 199.

<sup>204</sup> *See generally id.*

<sup>205</sup> The 40th Annual Conference of the U.S.A. Branch of the International Fiscal Association (IFA), held in Washington, D.C., on March 1-2, held a panel entitled "Treaty Developments: Permanent Establishments and Beneficial Owners – The Search for Meaning," which included speakers Mary Bennett, Jesse Eggert, Rocco Femia, and James Tobin. The author's opinions described here are based upon many of the findings of this panel. For a compilation of this event's speakers and presentations, see <http://www.ifausa.org/dman/Document.phx/Events/%5Eeman.262/Agenda+Package+-+Technical+Program?folderId=Events%2F%255Eeman.262&cmd=download>.

<sup>206</sup> *See* COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 4.2, at 93.

such foreign enterprise may vary upon two conditions: (1) “the extent of the presence of an enterprise at that location;”<sup>207</sup> and (2) “the activities that it performs there.”<sup>208</sup> The premises are considered “at the disposal” of a foreign enterprise if there is exclusive legal rights to use the location only for carrying on business of the enterprise, or if there is a performance of business activities by the enterprise on a continuous and regular basis during an extended period of time.<sup>209</sup>

The premises are not considered to be “at the disposal of” a foreign enterprise where an enterprise’s presence at a location is so intermittent or incidental that the location cannot be considered its place of business, or where an enterprise does not have a right to be present at the location and does not use that location itself.<sup>210</sup> In order to make the recommendations clearer, the discussion draft includes an example (the “CLIENTCO” example) and debate over whether there is a PE under those hypothetical facts.<sup>211</sup>

### B. “Converted” Local Entities

Another issue concerns the possibility of performance of activities by a “converted” local entity for foreign enterprise, due to business restructurings, leading to the conclusion that the premises of such converted local entity are “at the disposal” of the foreign enterprise or that the business of the foreign enterprise is being carried on on those premises.<sup>212</sup> In such case, the discussion draft generally concludes that the premises of the converted entity are not at the disposal of the foreign enterprise, and suggests the inclusion of a new sentence in the current Commentary in order to clarify this particular issue.<sup>213</sup> The “CARCO” example was used to illustrate this concern.<sup>214</sup>

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<sup>207</sup> OECD 2011 PE DRAFT, *supra* note 199, ¶ 4.2, at 9.

<sup>208</sup> *Id.* ¶ 4.2, at 45.

<sup>209</sup> *See generally id.* at 8-10.

<sup>210</sup> OECD 2011 PE DRAFT, *supra* note 199, ¶ 4.2, at 9.

<sup>211</sup> *Id.* at 10. In the CLIENTCO example, the facts are the following: Peter (the consultant) provides training to CLIENTCO staff over 20 months. Peter provides training in staff offices and is permitted to use 10 rooms for group training or to prepare its courses. Peter is given a security card allowing access to premises during business hours. Peter is required to use CLIENTCO facilities, due to contractual obligation. After analyzing this factual pattern, the members of the OECD group who expressed a view concluded that premises were at the disposal of Peter (the consultant), based on two findings: (1) availability of training rooms for preparation; and (2) training was a “core part” of the business of the consultant. *Id.*

<sup>212</sup> *See id.* at 11.

<sup>213</sup> *Id.* at 11-12.

<sup>214</sup> *Id.* According to the “CARCO” example, CARCO sets up a SUBCAR in State S to assemble cars from parts owned and supplied by CARCO. The parts will be physically sent to SUBCAR, and the cars back to CARCO. However, all property will be owned by CARCO. SUBCAR’s plant will be built by CARCO for manufacturing IP and SUBCAR will retain a cost plus margin for its functions. The conclusion of the OECD Working Group was that CARCO does not have a PE in State S, based on the following findings: (1) the premises of SUBCAR were not used by CARCO and were not at its disposal; (2) no agency PE existed since SUBCAR did not exercise any authority to conclude contracts in the name of CARCO;

### C. Time Requirements

In regard to the time requirements related to PE characterization, the current OECD Commentary provides that a place of business may constitute a PE even if it exists for a short period of time.<sup>215</sup> The same Commentary observes that, empirically, a place of business maintained for less than six months is not commonly a PE, except in case of: (1) recurring activities, where each period of time that the place is used is considered in the aggregate, being added with the other number of times during which the place is used; and (2) short duration of business, where activities constitute an entire business carried on exclusively in the Source State.<sup>216</sup> The OECD 2011 PE Draft recommends some minor changes to the Commentary, mainly characterizing the six month rule as a “general practice” and providing examples for each of the two exceptions previously mentioned to facilitate the identification of these specific cases.<sup>217</sup>

### D. The Presence of Foreign Enterprise Personnel

Another important issue debated in the discussion draft relates to possible changes in the Commentary in order to clarify that employees of a foreign enterprise seconded to an affiliate generally are considered to carry on the business of the affiliate and not of the foreign enterprise.<sup>218</sup> This understanding seems to be applicable even if formal secondment is not in place (i.e., including the cases where the employee is in substance an employee of the affiliate).<sup>219</sup> The matter herein includes reference to the background discussions to Article 15 standards.<sup>220</sup>

An additional topic of concern relates to main contractors who subcontract all aspects of a project, the question being whether this action would lead to the foreign enterprise having a permanent establishment if it subcontracts all aspects of the project to other enterprises.<sup>221</sup> There were two proposed sets of changes made in the discussion draft: (1) adoption of new language in the context of general rules suggesting that a foreign enterprise may be considered to carry on its business through subcontractors even where such subcontractors act alone,<sup>222</sup> and (2) inclusion of additional language in the context of duration of construction sites, stating that the site should be considered at the disposal of the general contractor during the time spent by any subcontractor.<sup>223</sup> The example of a small hotel, in

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and (3) the analysis remains the same notwithstanding if the arrangement was a result of a business restructuring or not. *Id.*

<sup>215</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 6, at 95.

<sup>216</sup> *Id.*

<sup>217</sup> OECD 2011 PE DRAFT, *supra* note 199, ¶¶ 6.1-6.2, at 16-17.

<sup>218</sup> *Id.* ¶ 10, at 18.

<sup>219</sup> *Id.* at 20.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at 20-21.

<sup>222</sup> *Id.* ¶ 10.1, at 21.

<sup>223</sup> *Id.* ¶ 19, at 21.



which the owner of the hotel has a PE even though on-site operation of the hotel is subcontracted to another company, illustrates the main idea.<sup>224</sup>

#### E. The “In the Name of” Expression

Lastly, the clarification of the meaning of “in the name of,” regarding the possibility of a dependent agent constituting a PE of the principal if the dependent agent has (and habitually exercises) authority to conclude contracts “in the name of” the principal, was also addressed in the OECD 2011 PE Draft.<sup>225</sup> Currently, the Commentary provides that the standard applies to an agent who concludes contracts “which are binding on the enterprise.”<sup>226</sup> The discussion draft, however, proposes the inclusion of an additional sentence to the Commentary, noting that in some countries a foreign enterprise would be bound to a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract.<sup>227</sup>

Additionally, the discussion draft mentions the commissionaire example, in which a foreign enterprise agrees to reimburse the commissionaire for any amount due on its contractual liabilities to customers (an “economically bound enterprise”).<sup>228</sup> As for this example, the Working Group stated that it could not reach a common conclusion on situations dealt with in the recent cases *Société Zimmer Ltd.*<sup>229</sup> (France) or *Dell Products (NUF) v. Tax East*<sup>230</sup> (Norway), each of them dealing with a commissionaire, having decided that no dependent agent PE existed in either case because the enterprise was not legally bound.<sup>231</sup> However, it is not clear if the term “bound” means only “legally” bound or “economically” bound (i.e., through a contract between an enterprise and commissionaire).<sup>232</sup>

### VIII. CONCLUSION

The concept of a PE is fundamental in international taxation. It is this concept that determines the right of a contracting state to tax the profits of an enterprise in another jurisdiction. Also, the characterization of permanent establishment is one of the most difficult and complex issues in international business taxation. It is understandable that companies operating in several parts of the world would want to avoid double taxation. For that reason, there is an increasing need to clarify and

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<sup>224</sup> *Id.* at 21-22.

<sup>225</sup> *Id.* ¶ 33, at 38.

<sup>226</sup> COMMENTARY ON ARTICLE 5, *supra* note 7, ¶ 32.1, at 105.

<sup>227</sup> OECD 2011 PE DRAFT, *supra* note 199, ¶ 32.1, at 36.

<sup>228</sup> *Id.* at 35-37.

<sup>229</sup> Conseil d'Etat [CE] [Supreme Tax Court] Paris, Mar. 31, 2010, n° 304715, 308525, 10e et 9e s.-s., *Société Zimmer Ltd.*

<sup>230</sup> *Dell Products (NUF) v. Tax East*: 10-032855ASD-BORG/03, in 13 INT'L TAX LAW REP. 706, 706-746 (London 2011) (posterior decision of the Supreme Court of Norway rendered Dec. 2, 2011).

<sup>231</sup> OECD 2011 PE DRAFT, *supra* note 199, at 36-37.

<sup>232</sup> *Id.* at 35.

harmonize the PE concept and requirements worldwide through tax treaties, either by adding and reviewing the wording of Model Conventions such as the OECD, UN and U.S. versions, or by expanding the Commentaries and Technical Explanations to them on current important matters.

When a state assists in the improvement of an internationally agreed consensus on the interpretation and application of the Article 5 PE rule, they will not only have more legal certainty to impose (or abdicate) taxing powers based on their own rights, but also incentivize cross-border business, since taxpayers will be able to rely on clearer and better legal definitions in order to structure and orient their businesses worldwide.

The guidance produced by the OECD, U.S. and UN Model Conventions is surely useful but is in no way conclusive in addressing all the crucial issues in today's evolving global economy. It may be contended that the concept does not properly reflect the present business environment. With the changes in business practices of companies worldwide (every day more intangible and electronic), there is a need to continually update and revise the OECD Model Tax Convention in order to ensure adherence to its purpose. Efforts to conform to the changing business practice as shown in the revisions to the OECD and UN Model Convention are certainly well appreciated, but do not create certainty for state actors and business interests.

As demonstrated herein, the PE concept is far from being free from problems. Common difficulties include determining if there is a place of business and the possibility of there being more than one, which may result in an increased tax cost due to the inability to offset losses against taxable profits.<sup>233</sup> Indeed, there is much more to be done. The issues surrounding the introduction of the Service PE rule and the development of the e-commerce harmonization with PE concepts is just the start of the development. It is undeniable that, as business methodologies become more complex, Commentaries on the OECD, U.S. and UN Model Conventions must become dynamic and multi-faceted as well, thus changing to reflect current reality.

Therefore, on the one hand, it is vital to help taxpayers worldwide determine if they will have a taxable presence and if there might be a potential increase in their tax burden as investors. Without it, taxpayers would be operating in the dark. On the other hand, if the concept is to continue to be used, it is necessary that it has a "working" definition, periodically revised and improved, with clearer and more updated standards. As the business environment in which we operate evolves so should the concept of PEs to reflect those social, economic and political changes, especially in the international taxation scenario.

The recent OECD discussion draft on interpretation and application of Article 5 is definitely an advance on common problems involving permanent establishments in the current modern economy, and can be considered as a starting point in reformulating some of the rules, as well as adapting new principles and standards for international activities carried on by foreign enterprises. Nevertheless, the OECD 2011 PE Draft still leaves several important points out in the open, due to the

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<sup>233</sup> In the case of construction sites, the issues may appear to be clear-cut. However, the use of a time period as a yardstick can result in difficult negotiations with foreign authorities. The determination of when a project commenced may be up for considerable debate, as well as the non-exclusion of temporary discontinuations due to reasons beyond the non-residents' control from the total time period, which may in some cases appear as punitive rather than practical (e.g., earthquake or financial crisis).

difficulties of reaching a common ground on such volatile and intricate subjects as the commissionaire arrangements, the main contractor who subcontracts all of the project under the converted local entities, and “at the disposal of” circumstances. In addition, due to the non-binding force of the discussion drafts created by OECD which are not yet Commentary but just mere reports on the debate carried out by specialists without formal approval or prescriptive organization coherence, they cannot be used by countries to guide their treaty interpretation and application.

Evolution on this subject has already started, but still much is to be seen as to whether its developments will be suitable for today’s economy. For that to happen, it is necessary for the OECD and States to take their time duly debating these issues to contribute to the harmony of international taxation standards, and more specifically, double tax treaties.