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The permanent establishment concept under tax treaties
and its implications for multinational companies

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**Topic: The permanent establishment concept under tax treaties
and its implications for multinational companies**

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Globalization of business is a crucial issue for multinational companies in order to maximize profits by expanding business markets in foreign countries and to minimize costs by utilizing cheap raw materials and labors in developing countries. International double tax treaties were introduced to encourage efficiency of cross-border trades. Double tax treaties provide clarification of taxing rights of each country, avoidance of double taxation and prevention of fiscal evasion. Many countries have established a broad tax treaty network. In this paper, the tax treaties with Japan, UK, US, Germany, and India will be examined in detail because these countries are influential on negotiating the tax treaties.

The concept of a permanent establishment (PE) under Article 5 in the OECD Model is primarily important because the business profits of an enterprise of a Contracting State are only taxable in the other Contracting State if the enterprise carries on business through a permanent establishment situated therein. The concept marks the dividing line for business between merely trading with a country and trading in that country. If an enterprise has a permanent establishment, its presence in a country is sufficiently substantial that it is trading in the country. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State¹. Under Article 7, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein. Once it has been established that a permanent establishment exists, the profits of the permanent establishment must be calculated based on arm's-length principle².

There are two types of a permanent establishment contemplated by Article 5. The first type of a permanent establishment is referred as an "associated permanent establishment" which is part of the same enterprise and under common ownership and control like an office and branch. This is covered by Article 5(1) ~ (4). The second type of a permanent establishment is referred as an "unassociated permanent establishment". This type of permanent establishment involves an agent who is legally separate from the enterprise, but is nevertheless dependent on the enterprise to the point of forming a permanent establishment. This is covered by Article 5(5) ~ (6)³.

¹ See the Commentary at para. 1

² See the Commentary at para. 16 (Article 7)

³ See Philip Baker, *Double taxation conventions: a manual on the OECD Model Tax Convention on income and on capital* (2001), pp. 5-2/1

(1) The basic concept in Article 5(1)

Article 5(1) contains the key requirements of the first type of a permanent establishment in that there must be a “fixed place of business through which the business of an enterprise is wholly or partly carried on”. In other words, there must be an enterprise of a Contracting State and there must be a business before there can be a permanent establishment. To meet the requirements, three conditions need to be satisfied.

The first condition is that there must be a place of business where personnel exist. In addition, the premises must be the place through which the business is carried out, not the business itself. The business of the enterprise is carried on by the personnel at the premises in most cases, but automated equipment may constitute a permanent establishment in certain circumstances. The OECD Committee on Fiscal Affairs adopted changes to the Commentary to the effect that human intervention is not a requirement for the existence of a permanent establishment⁴. In the *Pipeline Case*⁵, a Dutch oil transport company transported oil to Germany through an underground pipeline. The Dutch company owned the pipeline but had no personnel or place of business in Germany. In this case, the court concluded that the operation of the oil pipeline in Germany did result in a permanent establishment in Germany for the Dutch corporation, whose business is the transport of oil, conducts its business which is the most important part of the Dutch corporation’s business.

The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal⁶. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. The mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required.

The words “through which” must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the

⁴ See the Commentary at para. 10

⁵ See (1996) 1 ITLR 163

⁶ See the Commentary at para. 4.1

disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business “through” the location where this activity takes place⁷.

The second condition is that a place of business needs to be fixed⁸. The nature of the fixed place of business permanent establishment is physical location. One must be able to point to a physical location at the disposal of the enterprise through which the business is carried on. For example, an office, workshop or storeroom for the maintenance of machines, which were leased out by the enterprise, has been held to constitute a permanent establishment. On the other hand, possession of a mailing address in a state without an office, telephone listing or bank account has been held not to constitute a permanent establishment.

There has to be a link between the place of business and a specific geographical point. Where the nature of the business activities carried on by an enterprise is such that the activities are often moved between neighboring locations, there may be difficulties in determining whether there is a single “place of business”. A single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business⁹.

Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature¹⁰. While the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situation where a business had been carried on in a country through a place of business that was maintained for less than six months. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis. The OECD report issued in October 2011¹¹ addressed concerns about the uncertainty concerning the

⁷ See the Commentary at para. 4.6

⁸ See the Commentary at para. 5

⁹ See the Commentary at para. 5.1

¹⁰ See the Commentary at para. 6

¹¹ See OECD, “Interpretation and Application of Article 5 of the OECD Model Tax Convention” (12 October 2011 to 10 February 2012), p.14-17

period of time required for a location to be considered a permanent establishment. The OECD suggested change to the Commentary so that business present in another state for only a short period of time could be viewed as having a permanent establishment if its presence in the other state was recurrent. Clarification of the more subjective standard in the current Commentary is still necessary. In *Joseph Fowler v MNR*¹², a U.S. resident, who every year sold knives and kitchen devices at the Vancouver Pacific National Exhibition for several weeks, was found to be carrying on business in Canada through a permanent establishment for purposes of the Canada-U.S. Convention.

A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated¹³.

The third condition is that the place of business must be at the disposal of the enterprise¹⁴. The OECD report issued in October 2011¹⁵ suggested that “at the disposal of” requires that an enterprise can make use of a place to the extent and for the duration it chooses to pursue its own business plan and activities and to the exclusion of the resident enterprise if necessary. The mere use of unutilized capacity of the resident operation should not be viewed as satisfying the requirement of “at the disposal of”. The premises need not be owned or even rented by the enterprise, provided they are at the disposal of the enterprise. This has given rise to some difficulties where premises are made available to a foreign enterprise for the purposes of carrying out particular work on behalf of the owner of the premises. In that case, the space provided is not at the disposal of the enterprise since it has no right to occupy the premises but is merely given access for the purpose of the project. In *Dudney v. R.*¹⁶ Mr. Dudney was an

¹² See (1990) 90 DTC 1834

¹³ See the Commentary at para. 11

¹⁴ See the Commentary at para. 4.1

¹⁵ See OECD, “Interpretation and Application of Article 5 of the OECD Model Tax Convention” (12 October 2011 to 10 February 2012), p.8-10

¹⁶ See (1999) 99 DTC 147

independent contractor hired by a company (OSG) (that was at that time a Canadian company) to train PanCanadian Petroleum Limited (PanCan) personnel in a high-tech discipline. The issue in that decision was whether Mr. Dudley, an engineer resident in the US, was taxable in Canada on his income earned in Canada. Mr. Dudley could not conduct any other business from there, he could use the telephone only for business related to the PanCan contract and his access to the building was restricted to normal business hours and to weekdays only. Mr. Dudley had no letterhead or business cards identifying him as working at PanCan and he was not identified as working in the PanCan premises, either in the directory in the lobby of the PanCan premises or otherwise. The Court concluded that the PanCan premises were not a permanent establishment (or rather, a fixed base regularly available) to Mr. Dudley. The case confirms that the fixed place of business need not be owned or leased by the foreign enterprise provided that it is at the disposal of the enterprise in the sense of having some right to use the premises for the purposes of its business and not solely for the purposes of the project undertaken on behalf of the owner of the premises.

(2) The illustrative list in Article 5(2)

Article 5(2) contains a list of examples which may be taken to constitute a permanent establishment. The list is illustrative and the place of business will only constitute a permanent establishment if it fulfills the requirements of the general definition in Article 5(1)¹⁷.

(3) The building site and construction or installation project permanent establishment in Article 5(3)

Article 5(3) deals with building sites and construction or installation projects. Historically, Article 5(3) was originally part of the illustrative list in Article 5(2), which is now clearly subject to the requirements of Article 5(1)¹⁸. However, in the case of a construction or installation site, the base need not remain at the same place throughout the whole twelve months but may progress with the project. Moreover, Article 5(3) is concerned only with the permanent establishments of contractors who carry out the work involved in the construction or installation project, not the owners of the premises on which the project is carried out. Thus, if an owner of land employs a contractor to construct a building on the site, the project lasting more than twelve months, it is the contractor who has a permanent establishment and not necessarily the landowner.

¹⁷ See the Commentary at para. 12

¹⁸ See Philip Baker, 'Double taxation conventions: a manual on the OECD Model Tax Convention on Income and on Capital' (2001), pp. 5-2/7

Furthermore, Article 5(3) is concerned with the work of construction or installation, and not supervising others who are undertaking that work.

The OECD Model uses the twelve month test. An amendment to the Commentary in 1992 warns against companies abusing the twelve-month test by splitting a longer contract into several shorter ones with different companies. It should be noted that the UN Model departs from the OECD Model in fixing a six-month period, and many recent double taxation agreements with developing countries have adopted this shorter period. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically¹⁹.

In *J Ray McDermott Easter Hemisphere Ltd. v. Jt CIT*,²⁰ J Ray McDermott was a Mauritian company which carried out installation of offshore oil platforms and related equipment. The taxpayer carried out a number of contracts in Indian offshore oil fields, for one client for eight and a half months and for three and a half further months after a three-month break, and a concurrent contract for another client during part of the first period. Each contract had been separately bid for and a completion certificate was issued in respect of each. The India-Mauritius tax treaty provided that an overseas contractor was deemed to have a permanent establishment in India "where such site, project or supervisory activity continues for a period of nine months or more". The Revenue aggregated the periods and deemed that the taxpayer had been doing business through a permanent establishment and was therefore liable to tax in India. Upon appeal, the Tribunal ruled in the taxpayer's favor because the Jt. CIT had failed to appreciate that these were separate contracts and to show the dependency as a coherent whole in conjunction with each other.

A site exists from the date on which the contractor begins his work in the country where the construction is to be established. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. In the *Dredging Case*,²¹ an initial contract to

¹⁹ See the Commentary at para. 18

²⁰ See 2010) 12 ITLR 915

²¹ See (1986) ET 259

discuss the project occurred in March 1964. The discussions and negotiations took place between March and June. In September the operations manager arrived on site and surveying began on September 9. The dredging work began on September 29 and continued until August 1965. On September 1, 1965 the last pieces of equipment were removed from the site. Finally, negotiations went on between September and December 1965 to settle the amount of the fee due. The Supreme Court of the Netherlands confirmed the decision of the lower court that the duration of the construction project referred only to the actual technical operations and that preliminary commercial preparations and subsequent legal discussions were not to be included in the calculation of the period. Thus the court held that the project commenced on September 9, 1964 and terminated on September 1, 1965 and did not endure for twelve months.

(4) The exclusionary list in Article 5(4)

Article 5(4) contains a list of exclusions to show activities that will not constitute a permanent establishment, even though the activity is carried on through a fixed place of business. The fundamental characteristic of these activities is that they are all of a preparatory or auxiliary nature. The provisions of Article 5(4) are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

Sub-paragraph a) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. In *Airline Rotables Ltd. v. JDIT*²², Airlines Rotables Ltd. “assessee”, a UK Company, was engaged in the business of providing spares and component support for aircraft operators. The assessee entered into an agreement with Jet Airways Limited “airline”, for rendering certain support services. The assessee was to repair and overhaul the components of aircraft outside India providing replacement in the interim. To attain this objective, the assessee had kept a consignment stock in India in premises belonging to the airline. The issues before the Tribunal were whether the assessee had a permanent establishment in India on account of maintenance of consignment stock of goods at the warehouse of the airline. The Tribunal held that though the consignment stock of the assessee was stored at a specific physical location, the storage facility was under the control of the airline and the assessee did not have any place at its disposal enabling it to carry out its business from that location. Since the consignment was given as standby, no business was being carried out. Therefore, the storage of goods on consignment basis at the

²² See (2010) 13 ITLR 226

customer's place did not constitute the permanent establishment under India-UK tax treaty.

It is recognized that a place of business with preparatory or auxiliary character may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in questions. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole²³. In *UAE Exchange Centre Ltd v. Union of India*,²⁴ the parent company, incorporated in UAE, performed remittance services for NRIs in UAE, where it transferred funds to the NRI's family in India, on the payment of a fee. The contract was concluded in UAE and payment was received by the company in UAE, denominated in local currency. However, the company also used liaison offices in India to effect the transfer, and the liaison offices consequently had access to the company's server in the UAE. The liaison office would then download the particulars of the remittance, make the necessary demand draft and dispatch it in accordance with the instructions of the remitter. The Revenue argued that the contract was in effect performed by the liaison office because the essence of the contract was the remittance of money and that this could consequently not be regarded as "auxiliary". However, the fact that the contract could not have been performed without the aid of the liaison office's activities is not determinative of its status as an "auxiliary" activity or otherwise. The Court held that it was auxiliary because it was in "support" of the main activity entered into in the UAE, for payment in the UAE.

Advertising activities are no longer specifically excluded in Article 5(4), but Article 5(4)(e) is intended to exclude "fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or know-how contract"²⁵. For example, a newspaper bureau for the collection of information does not form a permanent establishment; on the other hand, an editorial office may form a permanent establishment. Therefore, the character of the activities is only relevant to the exceptions in the equivalent of Article 5(3). The mere existence of a building or office does not amount to a permanent establishment. Any activity which can be regarded as management, even if only in respect of part of the enterprise, cannot be regarded as preparatory or auxiliary. The activities of the business have to be

²³ See the Commentary at para. 24

²⁴ See (2009) 11 ITLR 714

²⁵ See the Commentary at para. 23

examined.

(5) The dependent agent permanent establishment

A dependent agent within Article 5(5) will constitute a permanent establishment even if the requirements of Article 5(1) are not satisfied by the enterprise. A dependent agent will be legally separate from the enterprise for which it is acting. Thus the agent may be another enterprise, or an employee or director of the principal or a partner of the principal. Such a permanent establishment is referred to as an unassociated permanent establishment.

Article 5(5) stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise²⁶. Moreover the authority has to be habitually exercised in the other State. The requirement that an agent must “habitually” exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contacting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State²⁷.

There is a distinction between the civil law concept of agency and the common law concept²⁸. Under the civil law concept of indirect representation, brokers and general commission agents do not bind their principals, and so they never need to be excluded from Article 5(5). At common law, an agent for an undisclosed principal might bind his principal even if he does not “conclude contracts in the name of his principal”. The agent need not enter into contracts literally in the name of the principal, as long as the agent concludes contracts which are binding on the enterprise²⁹.

In the *Zimmer Case*³⁰, Zimmer SAS, a French commissionaire, sold products in France under a civil law commercial arrangement in its own name, but on the account of, and at the risk of, its UK parent (Zimmer Limited). With regard to the French customers, Zimmer Limited was an undisclosed principal. Before the commissionaire agreement was signed, Zimmer SAS had only been a French distributor of the products sold by

²⁶ See the Commentary at para. 33

²⁷ See the Commentary at para. 33.1

²⁸ See Richard Vann, ‘Tax Treaties: The Secret Agent’s Secrets’ (2005), pp.347

²⁹ See the Commentary at para. 32.1

³⁰ See (2010) 12 ITLR 739

Zimmer Limited. The Supreme Administrative Court held that contracts concluded by a commissionaire, even though they are concluded for the account of its principal, do not bind the latter directly vis-à-vis the counterparties of the commissionaire. It follows that a commissionaire cannot in principle constitute a permanent establishment of the principal, solely because it sells products or services of the principal for the latter's account in execution of its contract of commission while signing contracts in its own name. Zimmer is, therefore, a case in which a PE was not recognized due to the formal civil law peculiarities of the case.

In *Dell Products (NUF) v. Tax East*³¹, Dell Products Ltd (Dell Products) was a company incorporated in the Netherlands but resident in Ireland. It was the sales unit for Dell products in Europe, and purchased products from Dell Products (Europe) BV, which had manufacturing facilities in Ireland. In Norway it sold through Dell AS, which acted as a commissionaire. For the tax years 2003 to 2006, Dell Products submitted returns showing zero liability in Norway. However, the Norwegian Revenue authorities took the view that the company had a permanent establishment in Norway through the commissionaire, and attributed to that permanent establishment 60% of the net profit from sales in Norway. The Supreme Court of Norway held that Dell Products did not have a permanent establishment in Norway. A dependent agent permanent establishment only exists if the agent has, and habitually exercises, authority to conclude contracts binding on its principal. The essence of a commissionaire specifically under Norwegian law is that there is no agreement binding on the principal. Hence there was no permanent establishment within the express words of the convention.

The UK common law concepts of agency does not include the commercial relationship of commissionaire, as such exists under the laws of France, Norway, and other civil law jurisdictions.

(6) The independent agent permanent establishment

An independent agent within Article 5(6), including a broker, general commission agent or any other agent of an independent status, will not result in the enterprise being deemed to have a permanent establishment. Regarding the meaning of "broker, general commission agent or any other agent of an independent status" under Article 5(6), these are forms of indirect representation. A commissionaire contracts in his own name with the customer, but has an agreement with his "principal" under which the goods are

³¹ See (2009) 12 ITLR 829

delivered direct to the customer, title passing directly to the customer and not being taken by the commissionaire who would otherwise be a simple buy-sell agent. Thus the commissionaire never binds his “principal” to a contact with the customer.

An independent agent must be “independent of the enterprise both legally and economically³²” and acting “in the ordinary course of his business when acting on behalf of the enterprise³³”. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has with the enterprise. Where the person’s commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise.

Another factor to be considered in determining independent status is the number of principals represented by the agent³⁴. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent’s activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge.

In the *Downing Case*,³⁵ the taxpayer, who had previously been resident and domiciled in South Africa, went to live in Switzerland on a permanent basis. When he departed from South Africa in 1960, he delegated his authority to a stockbroker with whom he had had dealings since 1948 to manage his portfolio with the objective of yielding the greatest possible income for the taxpayer to enjoy in Switzerland. Downing’s administrator in South Africa held the taxpayer’s power of attorney, retained custody of his shares, collected his dividends and kept his accounts. Pursuant to his mandate, the stockbroker sold and purchased shares on the taxpayer’s behalf. He did not consult with the taxpayer in advance, but merely informed the taxpayer and the administrator of each transaction after it had been concluded. The court held that Article 5(5) of the double tax agreement should be construed to mean that, when a Swiss resident does no more than carry on business through a South African broker and the latter, in

³² See the Commentary at para. 38.7

³³ See the Commentary at para. 38.8

³⁴ See the Commentary at para. 38.6

³⁵ See (1975) SA 518

transacting that business on behalf of his Swiss principal, acts in the ordinary course of his business, the Swiss resident must be deemed not to have a permanent establishment in South Africa.

While insurance companies are not expressly dealt with in Article 5, states may wish to provide expressly that the collection of premiums or the insurance of risks through an agent may represent a permanent establishment since such companies may transact substantial amounts of business through independent agents³⁶. The UN Model, as well as some non-UN double tax treaties contains a paragraph in Article 5 which specifically provides that the collecting of premiums by an insurance agent will give rise to a permanent establishment in the state in which the premiums are collected. Absent a specific provision, the issue turns upon whether insurance agents are dependent or independent.

In *Taisei Fire & Marine Insurance v. CIT*,³⁷ four Japanese insurance companies were the principal customers of Fortress Re, a US reinsurance manager owned by US resident individuals. Fortress Re had authority to conclude contracts binding on its clients, it was accepted that it was not a broker or general commission agent, and it was accepted that it was acting in the ordinary course of business. The only issue was whether it was an agent of independent status. The Tax Court held that Fortress Re was legally independent as it had complete discretion over the detail of its work and was subject to no external control. It was also financially independent, earning substantial profits from its activities, even though most of its profits derived from these four clients. Therefore, the Fortress Re that acted on behalf of four Japanese insurance companies did not cause the companies to have permanent establishments in the United States.

(7) Associated companies

Article 5(7) recognizes the separate legal personality of companies by providing that a controlled subsidiary will not by itself constitute a permanent establishment³⁸. However, if the activities of the subsidiary on behalf of the parent fall within the other provisions of Article 5, then this may constitute a permanent establishment. Though the OECD Model does not specifically mention this situation, a parent company should equally not be regarded by itself as a permanent establishment of its subsidiary.

³⁶ See the Commentary at para. 39

³⁷ See (1995) 104 US TC 533

³⁸ See the Commentary at para. 40

The most obvious example of an associated company as a permanent establishment will be where the company acts as dependent agent for its associate. There is no reason why an associated company should be treated any different from any other person. It will give rise to an agency permanent establishment if it is a dependent agent within Article 5(5) and not an independent agent in Article 5(6).

The other situation where an associated company may give rise to a permanent establishment is where premises owned by one affiliate are placed at the disposal of a foreign affiliate³⁹. Assume that, within a multinational group, the affiliate in State A makes an office regularly available to the CEO of the affiliate in State B. If that office is at the disposal of the State B affiliate, then it will have a permanent establishment just as if it had premises at its disposal in a building owned by any other person. For a multinational group, it is particularly important, therefore, that one affiliate does not place premises at the disposal of another in this way. The determination of the existence of a permanent establishment under the rules of Article 5(1) or (5) must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

In the *Philip Morris Germany GmbH Case*,^{40a} a German company that was a member of the Philip Morris Group (Philip Morris GmbH) received royalties from the Italian Tobacco Administration for the license to produce and supply cigarettes and tobacco products with the Philip Morris Trademark. An Italian company belonging to the same Philip Morris group (Intertaba Spa) supervised the execution of the contract by the Italian Tobacco Administration and performed agency and promotional activities in relation to sales of Philip Morris products in “duty-free” areas. The main business purpose of Intertaba Spa was to manufacture and distribute cigarette filters both in Italy and abroad. The tax authorities assessed the Philip Morris Group, claiming that the royalties derived by Philip Morris GmbH were subject to tax in Italy at the ordinary rates, as they were attributable to a disguised permanent establishment that the group maintained in Italy. The Supreme Court set forth the following principles to be taken into account in deciding the case:

- An Italian company may constitute a multiple permanent establishment of foreign

³⁹ See the Commentary at para. 41.1

⁴⁰ See (2002) 4 ITLR 903

companies belonging to the same group and pursuing a common strategy

- The supervision or control of the performance of a contract between a resident entity and a non-resident entity cannot be considered, in principle, to be an auxiliary activity within the meaning of Article 5(4) in the OECD Model and the corresponding article of the Italy–Germany tax treaty
- The participation of representatives or employees of a resident company in a phase of the conclusion of a contract between a foreign company and another resident entity may fall within the concept of authority to conclude contracts in the name of the foreign company
- The fact that the non-resident company entrusted the resident company with the management of some of its business operation makes the latter a permanent establishment of the former.

Therefore, the Supreme Court held that the German company had a permanent establishment in Italy.

Many multinational groups have sought to limit their exposure to foreign taxes by making changes to their supply chains⁴¹. Typically, the functions performed by a foreign subsidiary in a high tax jurisdiction will be radically reduced in order to reduce the attribution of group profits to that subsidiary. For instance, whereas before, the foreign subsidiary might have carried out manufacturing for the group, buying in materials, using its own intellectual property and employing its own sales force, the subsidiary could be converted to a ‘contract manufacturer’. Typically, the intellectual property used in the manufacturing process and the materials processed would belong not to the manufacturing subsidiary but to a group company in a low tax jurisdiction. The manufacturing subsidiary would then be paid only for its manufacturing activities, usually on a cost plus basis, which would result in a drop in taxable profits. The group has thus switched internal profits from a high tax jurisdiction to a low tax one. Multinational groups often apply similar planning techniques to their distributor subsidiaries, stripping them of their assets, such as marketing intangibles, reducing the business risk borne by them and limiting their functions to that of a commissionaire. Two main tax issues arise from this type of planning:

- Is the foreign subsidiary being rewarded on an arm’s-length basis?
- Has the foreign subsidiary been so stripped of business functions that it is now operating as no more than a permanent establishment of another group company?

A commissionaire is an undisclosed agent of the principal which makes sales in its own

⁴¹ See Angharad Miller and Lynne Oats, ‘Principles of International Taxation’ (2011), pp.196

name. Usually the commissionaire firm would be a subsidiary of, or otherwise controlled by the supplier firm. Essential features of the commissionaire structure are that most of the business risk (inventory, credit risk, and currency risk) is borne by the supplier company rather than the commissionaire. The functions of the commissionaire company are purely sales, and the turnover is normally presented as an amount of commission earned. This minimizes the amount of group profit which needs to be allocated to the commissionaire. Usually the income of the commissionaire will be shown as commission received minus expenses, rather than as profit from the purchase and onward sale of good.

Another issue is whether a partnership interest constitutes a permanent establishment raises the issue of characterizing the foreign entity as a partnership or as a subsidiary. Problems may also arise with a joint venture where the venture has power to bind the participating venturers.

(B) The permanent establishment for services

In the absence of a fixed place of business or a dependent agent, profits from services could remain taxable only in the state where the enterprise is tax resident. There are some reasons for not extending the concept of a permanent establishment to the provision of services. There would be no independent measures of verifying the amounts of revenue earned by the service permanent establishment where the customers were principally retail without preparing accounts which could be cross-checked with those of the permanent establishment, rather than business customers⁴². Enterprises sending personnel to another state might not know in advance exactly how long they would have to stay and thus any time limits for a service permanent establishment might be inadvertently breached, leading to the retrospective recognition of a services permanent establishment, for which no records had been kept. Even if a service permanent establishment was anticipated at the start of the overseas assignment, keeping appropriate books and records and attributing a share of the enterprise's profits to the activities of the personnel assigned to the foreign countries is an inherently difficult task⁴³.

Although the 2008 OECD Model does not include a service permanent establishment, the Commentary to Article 5 recognizes that some states may wish to include the

⁴² See the Commentary at para. 42.12

⁴³ See the Commentary at para. 42.13

service permanent establishment in their treaties, particularly where otherwise large amounts of profits would be made in their territory by foreign enterprises providing services there. The 2008 update of the Commentary on Article 5 of the OECD Model is based primarily on the OECD discussion draft issued on December 8, 2006⁴⁴.

The OECD currently takes the position on a service permanent establishment that no change should be made to the provisions of the OECD Model and that services should continue to be treated the same way as other types of business activities. The profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein⁴⁵.

All Member State agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State⁴⁶.

It is difficult to apply the concept of a permanent establishment in Article 5 to service industries because the core element of a permanent establishment is a physical presence which is not required in performance of services. It could be suggested that incomes from services should be taxed on consumption tax basis. There is the different origin of the concepts between income taxes and consumption taxes. The concept of income taxes is to focus on where income is produced. On the other hand, consumption taxes are based on the place where products are consumed. The taxation of service might be more appropriate to use the base of consumption taxes since a place of business where services are performed is the same with the location of consumption by customers.

⁴⁴ See OECD, "The Tax Treaty Treatment of Services: Proposed Commentary Changes" (December 8, 2006)

⁴⁵ See the Commentary at para. 42.11

⁴⁶ See the Commentary at para. 42.18

Member States agree that it is appropriate not to allow a State to tax the profits from services performed in their territory in certain circumstances, for example, when such services are provided during a very short period of time⁴⁷. Also the provision only applies to services that are performed in a State by a foreign enterprise to third parties⁴⁸.

The OECD interpretation of the application of the ‘fixed place of business’ permanent establishment concept to non-resident service providers appears to be that, provided an enterprise:

- Carries out a core business function in the other state which has commercial coherence, e.g. the same client
- At a single location or multiple locations which possess geographic coherence,
- For a substantial period of time, probably six months

then even in the absence of any special provisions in Article 5 for service, a permanent establishment might well exist.

The OECD provided the alternative provision to determine a service permanent establishment. There are two conditions for a service permanent establishment, which include days of presence test⁴⁹ and gross revenue test⁵⁰. A service permanent establishment rule could cover the profits from the provision of services by an enterprise by an individual who is present in the other state for a period or aggregate periods of more than 183 days in any 12-month period and where more than 50% of the gross revenues earned from the active business of the enterprise are attributable to the services performed in the other state. A 183-day threshold is applied to service carried out for the ‘same or connected projects’. The principle that, to be connected, projects must constitute a coherent whole, commercially and geographically, is articulated⁵¹. In applying the 50% test, the OECD uses the term ‘gross revenues attributable to active business activities’ which it defines as being what the enterprise has charged or should charge for its active business activities, regardless of timing of the billing. It excludes income from passive investment activities.

Both the OECD and UN Model seek to aggregate connected projects in considering whether the time threshold has been breached. In the OECD Model, the connecting

⁴⁷ See the Commentary at para. 42.20

⁴⁸ See the Commentary at para. 42.30

⁴⁹ See the Commentary at para. 42.36

⁵⁰ See the Commentary at para. 42.37

⁵¹ See the Commentary at para. 42.41

factors are both geographic and economic. A number of projects must be considered a single project if they form part of a coherent whole, despite being carried out at different locations.

The UN Model places greater emphasis on the source principle than the OECD Model and Article 5 of the UN Model includes the concept of a service permanent establishment. Like the agency permanent establishment, this is a deemed permanent establishment, because the non-resident does not need to have an actual establishment in the host state so that no premises are necessary. Where a treaty follows the wording of the UN Model, the provision of services for a period or periods aggregating more than six months within any 12-month period is treated as giving rise to a permanent establishment so that the net profits from providing those services are taxable by the host state⁵².

There is a significant problem with characterizing income from services. Many countries, principally developing countries, charge a withholding tax on the gross amount of payments made to a non-resident in respect of services. The distinction between royalties and technical service fees is important because royalty payments may be subject to withholding tax on the gross amount in many treaties. A state can only charge the withholding taxes specified in a double tax treaty if their domestic tax laws also allow them. Although the recent versions of the OECD Model do not permit any withholding tax on royalties, many treaties in existence do so. The UN Model also still permits withholding tax on royalties. In order for a payment to be classified as a royalty, the intellectual property in question must exist prior to the making available of the design or to the imparting of the know-how⁵³. If a payment is in respect of the development or amendment of a model, plan, secret formula or process or for work which will result in the gaining of information concerning industrial, commercial or scientific experience, then there will be difficulties in asserting that such a payment constitutes royalties. The act of development constitutes a service. Article 12 can only apply to the making available of prior knowledge, rather than the development of new knowledge. Furthermore, the distinction between a contract for use of know-how and a contract for the provision of services often rests on who carries out the work. In a contract for know-how, the client himself usually carries out the work, using secret information imparted to him by the know-how provider⁵⁴. In a services contract, it is the

⁵² See the UN Report, Brian Arnold, 'Tax Treatment of Services' (2010), pp.4, para. 7

⁵³ See the Commentary at para. 10.2 (Article 12)

⁵⁴ See The OECD Report, 'Treaty Characterization Issues Arising from E-commerce' (2001), pp.779, para. 15

service provider who carries out the work for the client.

The distinction between payments for intellectual property and payments for services is also essential for transfer pricing purposes. The appropriate method for payments for services would be cost plus a profit margin. In contrast, the method in relation to payments for the use of intellectual property, i.e. a royalty, would be a method based on the extent of the use of the intellectual property, turnover method.

Due to the ambiguity of the classification, payments for service are vulnerable to withholding tax on the gross amount if the treaty contains no provision for a service permanent establishment. Moreover, if the treaty does not define business profits, it is open to the host state to determine whether the service fees are business profits in Article 7, royalties in Article 12 or other incomes in Article 21.

Since the OECD Model has not included a provision for a service permanent establishment, multinational companies need to consider the risk of taxes on income from services performed. To minimize the risk of a service permanent establishment, the multinational companies could perform the services by contracting with independent agents in Article 5(6), especially when the services are conducted in developing countries with tax treaties in the UN Model. In Addition, multinational companies might take into consideration lower withholding tax rates on royalties in tax treaties to avoid the risk of interpretation to define business profits.

(C) Permanent establishment for E-commerce

There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. The critical problem is that the rules of international tax law are premised on some form of physical presence but the whole essence of e-commerce is an absence of physical presence or physical transactions which challenges the whole basis for the present international tax rules. While a server may constitute a permanent establishment, an Internet web site does not in itself constitute a permanent establishment. The internet web site does not have a location that can constitute a “place of business” since it cannot be considered as tangible property. On the other hand, the server is equipment having a physical location which may constitute a “fixed place of business⁵⁵.”

⁵⁵ See the Commentary at para. 42.2

The distinction between a web site and the server is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site⁵⁶. A server at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of Article 5(1).

Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment⁵⁷.

It is common for Internet Service Providers (ISP) to provide the service of hosting the web sites of other enterprise on their own servers. The issue is whether Article 5(5) may apply to deem such ISPs to constitute a permanent establishment of the enterprises that carry on e-commerce through web sites operated through the servers owned and operated by the ISPs. Article 5(5) will generally not be applicable to the ISPs for several reasons. The ISPs will not constitute an agent of the enterprise to which the web sites belong. Second, the ISPs will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts. Third, the ISPs will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. Fourth, Article 5(5) cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise since the web site through which an enterprise carries on its business is not itself a 'person' as defined in Article 3⁵⁸.

In *Berkholz v Finanzamt Hamburg-Mitte-Altstadt*,⁵⁹ the company owner Berkholz with the headquarters in Germany, provided the service of installing and operating gaming machines on board two ferries running between Germany and Denmark. The machines were maintained regularly by employees of the German company but without a permanent staff on the ferryboats. The taxpayer claimed exemption in respect of the

⁵⁶ See the Commentary at para. 42.3

⁵⁷ See the Commentary at para. 42.6

⁵⁸ See the Commentary at para. 42.10

⁵⁹ See (1985) 168/84

supply of services to meet direct needs of sea-going vessels. The German authorities denied exemption and sought to levy tax on the whole of the receipts in Germany. However, the taxpayer contended that even if exemption was not available, the whole receipts were not taxable in Germany, as part of the services was provided in Denmark. On the taxpayer's appeal, it was held that the ship was not a 'fixed establishment', since no permanent staff were employed on the ship and the operation of gaming machines was done on an intermittent/irregular basis. The place of supply was the place of business establishment of the taxpayer which was in Germany. Hence, the services were wholly liable to service tax in Germany. Because the entertainment of passengers was not to meet 'direct needs of sea-going vessels', the exemption in that regard was also not available to the taxpayer.

In *India-Galileo International Inc v Deputy Commissioner of Income Tax*,⁶⁰Galileo International Inc., a resident of the USA, was engaged in the provision of services to hotels and airlines pertaining to reservations and booking through its Computerized Reservation System (CRS). For this purpose, it maintains and operates a huge master computer system (MCS) consisting of 18 mainframe computers with its main server located in USA. This main computer is connected to the airline servers' to/from which data is continuously sent and obtained. All the input processing and output is managed, processed and stored by the taxpayer through the MCS in USA. The taxpayer has entered into agreements with various airlines to provide them with the CRS services. The taxpayer earns booking fees from Airlines. In order to market and distribute the CRS services to the travel agents, the taxpayer appoints distributors and pays distribution fees to them for their services. In India the taxpayer has entered into a distribution agreement (DA) with Interglobe Enterprises Pvt. Ltd., an unrelated party to market and distribute CRS services to the travel agents in India. The issue was whether Galileo had a business connection in India and income was taxable in India. The ITAT ruled that the taxpayer did have a fixed place permanent establishment in India, which came into existence on operation being performed through computers in India. Thus the computers/hardware installed at the travel agents' premises gave rise to the taxpayer's fixed place of business in India. Additionally, Interglobe was completely dependent on the taxpayer in respect of rendering services to the subscribers. Thus that part of the income, which earns its revenue by rendering services to the subscribers, is carried on solely by the taxpayer. Even though the distributor may have other business activities, in respect of the CRS business the distributor acts only for the taxpayer and

⁶⁰ See (2008) 19 SOT 257

not for any other person. Thus the tribunal said that Interglobe was a dependent agent of the taxpayer.

The advent of e-commerce will result in significant changes in the way in which multinational companies operate in the business. Because of the rapid development of communication, multinational companies can make decisions as a real-time access to information and perform marketing, ordering, and delivering services through the Internet. Additionally, the increasing use of intranets facilitates faster and better flows of information within organizations. However, the removal of geographical boundaries due to e-commerce raises the question as to how to allocate the functions of gathering and disseminating information across different organizations and parts of organizations located in different jurisdictions.

The OECD report issued in 2005⁶¹ examined how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and made proposals for alternative rules. It seems necessary to consider a new nexus concept for e-commerce because the concept of a permanent establishment under the current tax treaty rules is based on a physical presence. E-commerce is a new invention of modern technologies which did not exist at the time when the original concept of current international tax law was introduced. Since e-commerce has no geographic presence, there should be an alternative standard to tax revenues from e-commerce. Some Internet technology companies have practiced successful tax planning to reduce the tax burden. First it is difficult to apply the concept of a 'fixed place of business' in e-commerce because one of the advantages in conducting e-business is mobility which makes it possible for an enterprise to conduct the business in timely and cost efficient manner. Second a place of business for e-commerce might be a location where products or services are purchased or consumed by customers.

One of the alternatives to the current treaty rules for taxing business profits proposed by OECD is to add a new nexus of "electronic (virtual) permanent establishment". Since the modern business environment allows many multinational companies to conduct their business operations in other jurisdictions without the need for a fixed physical presence, some commentators have suggested that a more appropriate indicator of sufficient participation in the economy of a jurisdiction may be a "virtual PE". The

⁶¹ See OECD, "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? : Final Report (2005), p.65-71

concept of “virtual PE” seeks an alternative threshold for determining when an enterprise has a significant and ongoing economic presence such that it could be said that it has a sufficient level of participation in the economy of a jurisdiction to justify source taxation, notwithstanding that the enterprise may have little or no physical presence in that jurisdiction. The concept of ‘virtual PE’ is a suggestion of an alternative nexus that would apply to ecommerce operations. This could be done in various ways, which would all require a modification of the permanent establishment definition or the addition of a new nexus rule in treaties, such as:

- Extending the definition to cover a so-called "virtual fixed place of business" through which the enterprise carries on business (i.e. an electronic equivalent of the traditional permanent establishment)
- Extending the definition to cover a so-called "virtual agency" (i.e. an electronic equivalent of the dependent agent permanent establishment)
- Extending the definition to cover a so-called “on-site business presence”, which would be defined to include "virtual" presence

However, the question of the attribution of profits under these three alternatives would give rise to some difficulties under the existing rules. Fundamentally, the arm’s length principle sets out that taxable profit is attributed on the basis of functions performed in a country, having regard to the assets used and risks assumed for that purpose. This raises the issue of whether the arm’s length principle is capable of application where profits must be attributed not by reference to functions performed by people and assets used by the enterprise at a fixed geographical point in the country, but by reference to economic activity generated by the interaction between customers of that country and a web site of that enterprise. Under a conventional functional analysis, it is likely that no substantial profit (if at all) could be attributed to a "virtual PE" or "on-site business presence" under the first and third approaches. This means that alternatives to the arm’s length principle would need to be considered to attribute significant amounts of profit under these two approaches.

As for the second approach (the "virtual agency PE"), the functional analysis would center on the functions of the virtual agent in the country. While it could be argued that this must already be done in the case of the dependent agent permanent establishment under Article 5(5), the difference is that, in the case of the Virtual Agent PE, the “agent” does not perform functions at any geographical point in the country and has no tangible assets in the country. Therefore, the broadening of Article 5 to encompass Virtual Agent PEs would need to be accompanied by consequential changes to Article 7 in order to

consider the notion that profits could be attributable to virtual agents.

Due to the difficulty of applying the arm's length principle in Article 7, an alternative method of allocating profits from e-commerce needs to be considered. Multinational companies might be allowed to apportion their income among cross-border jurisdictions in which they have established nexus by performing specific business operations. Income is apportioned among the jurisdictions based on the percentage of sales, tangible property and payroll located within each jurisdiction as compared to these same factors located everywhere. This method has been used for state income tax purpose in the US. The concept of income apportionment provides more accurate and simple measurement to reflect business activities in each jurisdiction. However, this method may increase much administrative works to collect information and calculate income taxes.

Another alternative is to adopt rules similar to those concerning taxation of passive income to allow source taxation of payments related to e-commerce in order to subject them to source withholding tax⁶². The OECD examined various approaches under which a withholding tax would be applied on all or certain cross-border payments related to e-commerce. The OECD discussed a general option under which a final withholding tax would be applied to e-commerce payments made from a country, whether or not the recipient has personnel or electronic equipment in that country. Many members considered that the arguments in favor of the option described above would be more appropriate to justify a consumption tax approach than an income tax approach to tax the relevant operations. However, it was noted that a consumption tax could not be applied to e-commerce imports only, as this would violate the WTO rules. Also, a general consumption tax on e-commerce only would put e-commerce at a disadvantage compared with traditional commerce. The option to have income taxation of e-commerce through a final withholding tax would be inconsistent with the concept of an income tax since it would be a tax on gross payments. A withholding tax system would only seem practical as regards business-to-business e-commerce, which would mean that e-commerce directed at private consumers would escape the application of the tax. This would introduce non-neutrality. Additionally, the imposition of a withholding tax on e-commerce operations would require a definition of e-commerce. Furthermore, there is a risk that a withholding tax on e-commerce payments to foreign enterprises might be

⁶² See OECD, "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? : Final Report (2005), p.51-54

considered to be discriminatory against offshore vendors and subject to challenge under WTO rules (e.g. Article III of the GATT). It would clearly impose a more burdensome taxation on e-commerce goods and services from abroad. The potential violation of the international trade rules would seriously undermine the chance that the option could quickly gain universal acceptance. The implementation of the option would require modification of existing treaties. While treaties with and without the proposed provision could easily co-exist, such co-existence would mean that multinational e-commerce activities would preferably be carried on from countries that generally oppose the adoption of the option in their treaties. Indeed, at this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries. The OECD will monitor the evolution of the impact of e-commerce on tax revenues⁶³.

The OECD concluded that it would not be appropriate to embark on such changes at this time based on the analysis of the various advantages and disadvantages of the current treaty rules for taxing business profits and of a number of possible alternatives.

(D) The difference between the OECD Model and UN Model

It is important for multinational companies to note that there are some different interpretation and applications of Article 5 in tax treaties between the OECD and the UN Model because 75% of tax treaties entered into by developing countries reflect the UN Model position⁶⁴. Under the UN Model, a building site, construction or installation project needs to exist only for six months instead of twelve months. The six months will normally cover supervisory activities as well as the project itself. Another difference is that the list of activities which will not give rise to a permanent establishment is restricted in that delivery activities are omitted. Thus, for instance, the maintenance of a fixed place of business solely for the purpose of storage or display would not be a permanent establishment. On the other hand, a fixed place of business, such as a warehouse, might constitute a permanent establishment because it is used for the delivery of goods.

There is a provision for a services permanent establishment in the text of the UN Model,

⁶³ See OECD, "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? : Final Report (2005), p.51-54

⁶⁴ See OECD, "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? : Final Report (2005), p.42, para. 199

rather than merely in the Commentary of the 2008 OECD Model. Under the OECD Model, a dependent agent will constitute a permanent establishment if he has an authority to conclude contracts in the name of the enterprise and habitually exercises it. The UN Model extends the definition to persons who do not have this authority, but habitually maintain a stock of goods or merchandise from which they regularly make deliveries on behalf of the enterprises. Some treaties go further, with many Indian treaties deeming a permanent establishment to exist if the agent habitually secures orders for the enterprise.

There is a further provision in the UN Model which deems an agent who would otherwise be regarded as an independent agent to constitute a permanent establishment if the agent's activities are devoted wholly, or almost wholly, on behalf of the foreign enterprise and dealings between the agent and the enterprise are not on wholly arm's-length terms. Moreover, the UN Model includes a limited 'force of attraction' provision. The effect of this provision is that any profits a multinational companies makes in the developing country through sales or other business activities are taxable there if there is a permanent establishment and the activities are the same or similar to those concluded by the permanent establishment. Although this rule is permitted by the UN Model, not all treaties based on this Model include the rule. Some Indian tax treaties include a force of attraction rule.

The different interpretation and application between the OECD Model and the UN Model may cause problems to multinational companies. First there is the lack of consistency with conceptual base for sharing the tax base. Developing countries tend to set a high value on source taxation with the broader definition of a permanent establishment. In addition to this inconsistency, many countries concern about effectiveness and fairness of taxing rights because more profits could be attributed to source countries. Also there might be uncertainty due to the different interpretation of a permanent establishment. Therefore, it is suggested that both the OECD and the UN should make efforts to minimize the discrepancy of the concept of Article 5 and establish universally agreed rules at a reasonable level.

(E) The definition of a permanent establishment in Japan, UK, India, Germany, and US It is essential for multinational companies to understand the definition of a permanent establishment under a state's domestic law because, unless a state has the right to tax a non-resident under its domestic law, it cannot tax the non-resident by virtue of any

double tax treaty. Hence, before there can be any taxation of a non-resident's business profits, the non-resident must have a taxable business presence in the host state under the host state's domestic law. Many states have designed their domestic definition of a permanent establishment in order to reflect the definition in the OECD Model, so that the states can make use of the extensive Commentary in the OECD Model as a tool to interpret the concept of a permanent establishment for domestic law purposes as well as for treaty purposes. The definition of a permanent establishment in Japan, UK, India, Germany, and US are examined below:⁶⁵⁶⁶

Japan

The definition of a permanent establishment in Japanese domestic law is wider than that found in the OECD Model. A fixed place of business would include a hotel room or a display area in which sales are also made. Supervisory work in connection with construction operations in Japan can give rise to a permanent establishment under domestic law, as can the presence of a Japanese agent who fulfills orders for a non-resident, even though he does not bind the non-resident in contract in Japan. Japan's tax treaties define a permanent establishment on the basis of Article 5 of the OECD Model. The treaty definition is similar to the domestic law definition with two exceptions. First, the use of facilities or the maintenance of a stock of goods or merchandise solely for the purpose of delivery of the goods or merchandise is specifically excluded from the definition of a permanent establishment. Second, a person who habitually secures orders for a principal does not constitute a permanent establishment, although in treaties with some developing countries, such as China, an order-securing agent is deemed to constitute a permanent establishment.

UK

The UK uses a definition of a permanent establishment for corporation tax purposes which is broadly consistent with the OECD Model, although it is a little wider. Thus foreign partnerships and sole traders are dealt with differently. Non-corporate non-residents may be liable to UK tax if they are trading in the UK. In this case, it is not necessary for there to be any place of business in the UK. However, there is no requirement to self-assess and unless there is a UK agent of some sort, HMRC does not have the practical means of collecting any tax which is theoretically due. The UK takes the view that a server used by an e-tailer, either alone or together with web sites, could not as such constitute a permanent establishment.

⁶⁵ See International Fiscal Association, 'Is There a Permanent Establishment', (2009)

⁶⁶ See Jinyan Li, 'International Taxation in The Age of Electronic Commerce' (2003)

India

Foreign enterprises are taxable in India on profits if they have a 'business connection' with India. This does not require a fixed place of business but refers to a real and continuing business relationship in India. This partly explains why India has been ready to argue that the mere presence of machinery or equipment in India can constitute a permanent establishment, for instance, an automated airline reservation system. India has also considered that a ship or other offshore vessel anchored in Indian waters is capable of being a permanent establishment.

It is fair to say that although Indian courts do place reliance on the OECD Commentary, the concept of a permanent establishment under domestic law is considerably wider than that under the OECD Model. India is well known for its use of the source principle. In addition to the use of the UN Model for its double tax treaties, many of which include the concept of a service permanent establishment, there have been many cases where India has used its domestic law to interpret the provisions of its treaties in order to assess the existence of a permanent establishment. The concept of a 'business connection' is crucial in establishing whether any of the profits of an enterprise are subject to tax in India. The key concepts to be examined are the functions performed and risks assumed.

Germany

The domestic law definition requires a fixed place of business but this is interpreted to mean any significant assets used for carrying on a business and in particular, a pipeline running through Germany. The domestic definition is wider than the OECD Model: the fixed place of business merely has to serve the activity of the non-resident rather than be a place from which the business is wholly or partly carried on. An agency permanent establishment can arise under domestic law if the agent consistently carries out the business of the non-resident and is bound by instructions from the non-resident, but there is no requirement that the agent be a 'dependent agent'. Germany takes the view that in order to permit the assumption of a fixed place of business, the necessary degree of permanency requires a certain minimum period of presence during the year concerned, irrespective of the recurrent or other nature of an activity. Germany does in particular not agree with the criterion of economic nexus to justify an exception from the requirements of qualifying presence and duration.

US

The underlying concept of a permanent establishment is that foreign corporations engaging in trade or business within the US are taxable in the US on income effectively

connected with the conduct of trade or business in the US. The OECD Commentary is relied upon for interpretation. The existence of mobile drilling rigs has given rise to US a permanent establishment, as has logging (forestry) equipment kept within the US for the purpose of demonstration. Under a typical US treaty, the definition of a permanent establishment is similar to that of the OECD model and is narrower than that of "engaged in trade or business in the US." Therefore, activities carried on by a foreign person in the US that would cause the person to have a permanent establishment generally would also cause that person to be engaged in a trade or business within the US. Tax treaties protect foreign taxpayers from the US force of attraction rule. According to Article 7 of the US model, only business income attributable to a permanent establishment is subject to US taxation; income from unrelated business income is not.

(F) Tax planning for multinational companies

Tax planning is important for multinational companies to minimize their tax burden and maximize business profits. Between 2006 and 2009, the average effective tax rate of US corporations on a consolidated financial basis was 27.7%⁶⁷ although the statutory tax rate in US was approximately 39%. Compared to the effective tax rate of US corporations, the average effective rate of Japanese corporations was 38.8% during the same period. From this statistic, Japanese multinational companies tend to be less aggressive in tax planning than companies in the US and European countries.

There are two types of tax planning strategies to reduce tax burden for multinational companies.

The first method is to shift business activities and incomes to lower tax jurisdictions. It is advantageous for multinational companies to recognize their business incomes in foreign countries which have lower tax rates since the corporations in developed countries, especially US and Japan, have a high tax rate.

The fragmentation of business function in the multinational companies is necessary to consider in order to move the incomes to the lower tax jurisdictions. One of the major practices in recent tax planning is holding intangible assets in the lower tax jurisdictions because the companies can avoid excessive profits from royalties on

⁶⁷ See the PWC publication 'US accounting and Taxation' Vol.13, p.12 (August, 2011), <http://www.publications.pwc.com>

intangible assets moving into higher tax jurisdictions. It is much easier for business with intellectual properties to move the profits to the lower tax jurisdiction than it is selling automobiles or machineries. Also patents on software or downloaded applications can be sold from anywhere. To maximize tax saving possibilities and to keep ownership of the intangible properties in a separate entity, it is recommended that an intellectual property rights (IPR) company be established as the company to own all rights to the intangible assets, as well as to own and develop the brand with appropriate protection through trade mark registries.

First, the location of the company should be in a country with low tax rate since it may be beneficial to sell the patent rights at some future date through corporate restructuring or to third parties without tax burden. For example, the tax advantages and incentives offered by tax haven Cyprus include zero withholding tax⁶⁸ on dividends, interest, royalties and inheritance, zero capital gains, and corporate tax rate ranked lowest in the EU. Also the software the company develops could be rolled into other business and adapted to meet their specific requirements like music industry and literary world by licensing to competitors. The licensing agreements could be entered into by an intermediary licensing company that may be established in a high tax jurisdiction with a broad double tax treaties network, which would minimize the imposition of foreign withholding taxes. The United Kingdom has the largest network of treaties, covering over 100 countries⁶⁹. However, if development costs are very high, then higher-tax jurisdictions may be appropriate if they permit the company to amortize costs incurred in the development of the rights which are then licensed. Thus, royalty income may be offset by such amortization.

Second, the royalty income receivable ultimately by the IPR company would be considered to be passive income and could potentially be subject to tax in the company owning such a passive company under Controlled Foreign Company (CFC) legislation. CFC legislation is common in most high tax jurisdictions, normally applicable to passive companies rather than active subsidiaries. CFC legislation is generally designed to repatriate the income of a company deemed to fit the criteria of a CFC and include it in the income of resident shareholders, regardless of whether it is actually distributed to them or not. For many countries the basis of the legislation is to prevent income accumulation in tax havens if the nature of the underlying transactions has no genuine

⁶⁸ See the PWC report, 'Tax Treaties Withholding Tax Table' (2009), http://www.pwc.com.cy/en/tax-legal-services/assets/pwc-cy_taxtreaties_09.pdf

⁶⁹ See the HM Revenue & Customs report, 'Double Taxation Treaties', <http://www.hmrc.gov.uk/taxtreaties/dta.htm>

business purpose. However, licensing companies could be considered to be part of the trading group and therefore non-passive royalties, but this needs to be considered by reference to the tax laws of the holding company jurisdiction. This strategy is generally common in high-tech and pharmaceutical industries.

It is also suggested that the multinational companies should establish an appropriate finance company within the Group. This company will be responsible for raising the necessary finance and for utilizing existing retained earnings in the most tax efficient way. The company may also be able to reduce the Group taxation through interest deductions from those companies in high tax jurisdictions which require further finance to develop their business. Additionally, it is important to understand international money markets which would enable surplus funds to be invested in the most tax efficient way. Inter-company transactions will inevitably expose the Group to exchange gains or losses, particularly when currency markets are volatile. The finance company needs to consider the tax consequences of exchange gains, and the ability to carry forward exchange losses, or to offset these losses against other income which can be generated through the Group. The finance company could neutralize the exchange gains and losses on inter-company loans through the acquisition of interest rate swaps. For the overall financing arrangements within a group, the deductibility of interest charges against taxable income is the most important consideration. The intra-group interest must be at arm's length under transfer pricing rules.

The location of the finance company should take into account double tax treaties so that foreign withholding taxes are minimized or non-existent in respect of portfolio interest payments. For example, tax haven Luxembourg offers an attractive fiscal regime. The tax incentives and advantages in Luxembourg include:

- Zero income and corporate tax on Luxembourg companies which are managed and controlled outside of Luxembourg and whose income is earned solely outside of tax haven Luxembourg
- No withholding tax on interest and royalties for local companies. Moreover, Luxembourg has entered into 64 comprehensive double tax treaties based on the OECD model tax convention on income and capital in order to mitigate the risks of double taxation for businesses

Establishing an E-Commerce sales organization is another fragmentation of business function for tax planning purposes. First, the companies need to determine where to

establish the servers with huge bandwidth availability to house the amount of data that needs to be available for the public to consider whether to purchase the products. When E-commerce is developed, tax authorities worldwide seek to find a nexus to their own jurisdiction so that relevant profits could be taxed. According to the OECD guideline, a website cannot, of itself, constitute a permanent establishment but a server could amount to a permanent establishment, particularly in circumstances where it remains situated in the same place for a period of time and the functions performed at that place are significant as well as an essential or core part of the business activity of the enterprise.

Either Jersey or Guernsey could be advantageous jurisdictions because the company will not be registered for VAT which may lead to product cost benefits, although tax administrations have now identified a VAT nexus where products above a certain value are received by purchasers. Nevertheless, servers located in the Channel Islands can generate e-commerce sales for the companies without a nexus in high tax jurisdictions, so that the profits can be achieved without the imposition of profits tax. Moreover, it is essential to make sure that there is adequate bandwidth through the fiber optic cables connecting Jersey or Guernsey to the mainland, and that there is adequate backup through recovery arrangements should these be required.

Second, it is required that the profits which remain with the company should be justifiable under transfer pricing arrangements as for any other inter-company transactions. In general, transfer pricing relates to the method as to how prices should be charged between related parties, particularly between companies within the same group. Often, however, it is difficult to determine what arm-length prices between related parties should be, since information on comparable transactions in the open market is unavailable. When the business of a company is unique, the profit split method could be used to determine the arm-length price. The profit split method examines the profit that has been assigned to each transaction in relation to the value of a given company's real economic contribution to the overall profit on a product. This allocation process is called a 'functional analysis' in which the functions performed and risks assumed by each group member is taken into account.

The multinational companies may want to establish an administration center where employees can be contacted by prospective customers before they finally purchase the products online or deal with problems experienced by the customers. The companies

also may need warehouses to maintain the products or facilities solely for the purpose of storage or display or delivery of goods belonging to the companies. It is recommended that the office opened by the companies should be a representative office and the activities limited to those that a representative office can perform without creating a permanent establishment until commercial requirements dictate a greater presence abroad. According to Article 5(4) in the OECD Model, a permanent establishment would not exist in circumstances where the activities are of a preparatory or auxiliary character which includes:

- Providing a communication link between supplier and customers
- Advertising goods or services
- Relaying information through a mirror server for security and efficiency
- Gathering market data for the enterprise
- Supplying information

Furthermore, it is vital to determine the types of entity structures to avoid a taxable presence. There are two major types of entity structures to operate a company which are branch and subsidiary. When the company operates as a branch, it generally subjects the parent company to taxation on its entire company income since the branch office is not a separate legal entity from the parent company. When the company incurs the losses at the beginning of its operation, it can take advantage by offsetting the losses of the branch with the profits of the parent company. When the company is formed as a subsidiary, it shields the parent company from liabilities incurred at the subsidiary level because a subsidiary is a separate legal entity from the parent, although owned by the parent company. Thus, it is beneficial to structure a subsidiary when the subsidiary has profits. It is recommended that a new company should be a subsidiary for controlling tax and liability issues once its operations make profits.

While the business activities and functions which involve intangible assets and high risk of recognizing excessive profits in the future are established in lower tax jurisdictions or tax havens, the multinational companies can also conduct the sales and manufacturing activities in higher tax jurisdictions only by contracting independent agents. Under Article 5(6) in the OECD Model, an enterprise does not have a permanent establishment by carrying on business through independent agents, provided the agents are acting in the ordinary course of business.

The second method to reduce the tax burden in tax planning is to utilize tax incentives offered by each country. Not only developing countries but also many developed

countries offer inducements in the form of reductions or exemption from import duties and income taxes for a certain period of time. Common tax incentives include tax holidays, loss carryforward or carryback, investment credit, and accelerated depreciation.

The US could be a suitable location to engage in research and development activities because the US offers tax credits for expenditures incurred on the activities. China introduced corporate income tax incentives for software and integrated circuit industries from 1 January, 2011. According to Circular 27, qualified software and integrated circuit enterprises are entitled to corporate income tax incentives in respect of tax holidays, reduced tax rates, deductions of training expenses, assets amortization and depreciation, and treatment of Value Added Tax (VAT) refunds. In 2009, Japan enacted foreign dividend exclusion rules under which 95% of foreign dividends received by Japanese corporations can be excluded. Under a common organization structure of Japanese multinational companies, the companies established their subsidiaries in the US which could be used to expand the business in foreign countries like Canada and Mexico. However, Japanese multinational companies have started to change their business structure by investing directly in foreign countries without the US subsidiaries due to this foreign dividend exclusion system.

It is crucial for multinational companies to organize their business in consideration of tax incentives in each foreign country. In fact, one of the most aggressive tax strategies has been practiced by Google Inc. The company cut its taxes by \$3.1 billion in the last three years using a technique that moves most of its foreign profits through Ireland and the Netherlands to Bermuda. Google's income shifting which involves strategies known as the "Double Irish" and the "Dutch Sandwich", helped reduce its overseas tax rate to 2.4 percent, the lowest of the top five U.S. technology companies by market capitalization⁷⁰.

In conclusion, while multinational companies are enthusiastic about expanding their business in global markets, the companies make every effort to avoid permanent establishments in foreign business operations or shift the business activities to lower tax jurisdictions for tax planning purposes. In addition to this contradiction between the concept of a permanent establishment in international tax law and tax planning

⁷⁰ See The Bloomberg report 'Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes' (October 21, 2010), <http://www.bloomberg.com/news/2010-10-21>

strategies for multinational companies, the development of new business industries through e-commerce and services which do not require physical presence give the multinational companies huge potential to avoid taxes. Furthermore, the lack of clarification and undevelopment of the concept of a permanent establishment in some tax cases has stimulated the multinational companies to put more aggressive tax planning into practice. US corporations like Google Inc., GE, and Apple Inc. have already found tax loopholes to reduce their effective tax rates.

From tax authorities' point of view, high tax jurisdictions may lose the tax revenues because there is no taxing right without a permanent establishment. Many developed countries have recently reduced their tax rates to take advantage of tax competition. For example the Japanese government has passed the proposal for a reduction of the effective corporate income tax rate in two phases: first by approximately 2.7% points for three years and another 2.3% points thereafter, from the current approximately 41% to approximately 36%⁷¹. The tax authorities may also supplement the reduction of revenues from corporate income tax with consumption and other taxes.

There must be difficult issues to change or modify the existing rules of a permanent establishment because it is more likely that developed countries do not agree with a position of source taxation which is favorable to developing countries. Also due to different nature of business industries including manufacturing, services and e-commerce, new tax rules agreed universally among all states can be hardly established. However, a tax treaty should be a guideline that includes a principle of a taxing right in international business transactions and solution for double taxation and conflict of profit attribution. Therefore, the concept of a permanent establishment in the current tax treaties will need to be adjusted in consideration of the way the multinational companies conduct the business.

⁷¹ See The Deloitte report "Two-phase 5% point corporate Tax Rate Reduction Proposed", Japan Tax Alert (November 16, 2011), http://www.deloitte.com/view/en_GX/global/services/tax

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