Papers on Selected Topics in Protecting the Tax Base of Developing Countries

September 2014

Preventing the Artificial Avoidance of PE Status

Adolfo Martín Jiménez

Professor of Tax Law, University of Cádiz, Spain

Contents

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United Nations
Department of Economic and Social Affairs
United Nations Secretariat, DC2-2178
New York, N.Y. 10017, USA
Tel: (1-212) 963-8762 • Fax: (1-212) 963-0443
e-mail: TaxffdCapDev@un.org
http://www.un.org/esa/ffd/tax/2014TBP2/

Preventing the Artificial Avoidance of PE Status

Adolfo Martín Jiménez

1. Introduction

At first sight, Action 7 of the OECD BEPS Action plan may seem of limited relevance. A closer analysis, however, reveals that this Action refers to very complex issues, both from a theoretical and practical perspective. From an academic viewpoint, it affects, first, one of the most relevant and complicated institutions of international taxation, the permanent establishment ("PEs") and art. 5 OECD / UN MC, and, second, attribution of profits to PEs and art. 7 OECD / UN MC, another intricate and controversial issue. Third, there is a direct connection of this topic with transfer pricing issues and international taxation of group of companies. From a practical perspective, having or not having a PE in a jurisdiction is crucial for tax administrations and taxpayers since the threshold effect of the PE concept marks whether a taxpayer obtaining business profits is subject to tax or not in such a jurisdiction and pays taxes there. The conceptual difficulties connected with PEs and attribution of profits to PEs and their evolution have an important impact upon practical situations: lack of clarity and different interpretations of the same concepts mean that there is a wide margin for conflict between tax administrations and taxpayers, on the one hand, and tax administrations themselves, on the other. Still, tax administrations, in general and developing countries in particular, should be able to identify when a taxpayer is conducting a relevant business activity within its territory and avoids having a PE there: taxes are lost in that case for the country concerned. For taxpayers, it is also critical to know when they may have a PE in a given jurisdiction to avoid undesired surprises and disputes, manage tax risk and, in the end, pay the correct taxes that are due to every jurisdiction where economic activity is conducted.

Therefore, it is crucial for tax administrations in developing countries to understand that Action 7 will have impact upon a domain that is extremely complex, subject to scrutiny and discussion in the international tax arena, where there are controversial issues that have not been fully closed, and, as a consequence, disputes may often arise. In this context, it is difficult to speak about "artificial avoidance of PE status": if the concept of PE, a central institution of international taxation, is not completely clear, it is hard to fix the contours of avoidance of PE status.

That basic idea has conditioned the structure of this paper. Before trying to define what is abusive in terms of avoiding a PE, it is essential to discern, first, the scope and context of Action 7 and the importance of PEs for tax administrations and taxpayers (section 2 tries to answer the question why action in this field is needed and what may be the reach of such an action). Second, it is difficult to grasp when there may be artificial avoidance of PE status if the main features and configuration of PEs over time are not known, which requires to carefully study the historical evolution of this institution in the OECD context (section 3). Only after that study is done a sort of anti-avoidance standard of art. 5 OECD MC can be described (section 3.6). This complex, although necessary exercise, seeks to explain that some consequences of applying art. 5 OECD MC do not result in artificial avoidance when they are inherent to the configuration of the PE institution that, in the end, presents an important bias, for the reasons that will be explained, in favour of residence countries. Sections 2 and 3 focus on Article 5 OECD MC (1963-2014) because the evolution of PEs took place, for many years, in the context of the OECD MC. The paper then moves on in section 4 to study the contribution of art. 5 UN MC 2011 in this field and the relevant differences between the anti-avoidance standard of PEs in the UN and the OECD MCs. Last but not least, potential solutions and tools for developing countries to fight against artificial avoidance of PE status are explored in Section 5.

It should remarked that the effects of Action 7 go beyond the strict boundaries defined for such an Action and there is an important overlap and direct connection with other parts of the OECD BEPS Action Plan (e.g. Action 1 on addressing the challenges of the digital economy, Action 6 on preventing treaty abuse, the transfer pricing Actions, n. 8-10 and 13) and chapters of this book (e.g. taxation of services). This paper will, however, try to focus on the main problems of avoidance of PEs from the perspective of Action 7 BEPS and touch on other Actions only indirectly.

2. BEPS Action 7 on artificial avoidance of PE status: context and scope

2.1 Introduction

This section describes the scope of Action 7 of the OECD BEPS Action Plan on artificial avoidance of PE status and explains the policy and practical problems behind it. First, reference is made to the OECD documents were Action 7 is dealt with. Second, some reflections are added on the policy difficulties behind this Action. Last, Action 7 is connected with the current problems faced by taxpayers and tax administrations (including those in developing countries) regarding PEs, which are very intensively connected with the policy issues and problems behind Action 7. The aim of this section is to explain that the scope of Action 7 is more complex than it may be though at first sight since it touches core issues of international taxation.

2.2 The scope of Action 7 OECD BEPS Action Plan

Action 7 should be read in the context of the main policy goal of the BEPS Action Plan:

> "No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it"[1].

Therefore, Action 7 should be expected to deal with disaggregation between business activity in a country and taxation in that country produced by the concept of PE or, rather, by artificial avoidance of PE status: substantial activity in a jurisdiction avoids having a PE there with the consequence that such a jurisdiction may not have any right to tax business profits generated within its borders.

However, in the first OECD document on BEPS, *Addressing Base Erosion and Profit Shifting* (12 February 2013), the issue of artificial avoidance of PE status was not directly mentioned, only some general references to the problems of PEs were

[1] OECD BEPS Action Plan, p. 10.

made.[2] Artificial avoidance of PEs came, therefore, as a sort of new issue –not surprisingly though—in the *OECD Action Plan on Base Erosion and Profit Shifting* (19 July 2013). Action 7 of the OECD Action Plan on BEPS explained and proposed the following:

> "The definition of permanent establishment (PE) must be updated to prevent abuses. In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by "commissionnaire arrangements" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.
>
> *ACTION 7. Prevent the artificial avoidance of PE status.*
>
> Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues"[3].

Basically, as described in the BEPS Action Plan, Action 7 seems to be concerned with two specific cases: commissionaire agreements, which refers to art. 5.5. OECD MC, and artificial fragmentation of activities to take advantage of the exemptions in art. 5.4. OECD MC. As such, the scope of Action 7 may be limited, which may explain the limited deadline for deliverables on this action (September 2015). It has been interpreted, however, that this Action may have wider effects[4] in the form of revision of the PE concept and attribution of profit rules to PEs –the emphasis on significant people functions in the current system of attribution of profits to PEs as opposed to all functions in a corporation opens up avenues for significant tax planning-- or to subsidiaries – the current overestimation of risk as a profit driver and the possibility of shifting risk by contract within a multinational group is one of the main reasons for tax planning nowadays[5].

As concerns **'commissionaire agreements'**, these structures are well-known and, for some time (or, rather, too long) they have been a matter of concern for tax authorities and the OECD.[6] Commissionaire agreements exploit the differences between civil and common law of agency to defend that, mainly but not exclusively, in civil law countries, there is no dependent agent PE where the subsidiary located

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[2] See, for instance, p. 35 (on the need to adequate international tax rules in a world of changing business models and increasing advance in technology and communications) or p. 84 (to connect base erosion with the previous works of the OECD on PEs). A very indirect reference to a potential commissionaire / stripped risk structure appears in p. 78 in one of the examples of (aggressive) tax planning.

[3] OECD BEPS Action Plan, p. 19

[4] Collier (2013), p. 641.

[5] See Sasseville and Vann (2014), they anticipate that "a combination of revamping the separate entity arm's-length principles and the PE definition will occur" (p. 12). See also Vann (2010).

[6] For a recent discussion on 'commissionaires' and the problems of art. 5 para. 5 through 7, see, for instance, Arnold (2014), pp. 47 ff., Carmona Fernández (2013), Sheppard (2013) or Obuoforibo (2013).

in that country sales products / services of the group acting in its own name but on behalf of a foreign company, usually located in low tax jurisdiction or being regarded as an hybrid to obtain a low tax treatment. These structures are based on a literal and legal interpretation of art. 5.5. OECD / UN MC. In addition, remuneration attributed to the subsidiary acting as commissionaire in high tax countries is low - usually determined by applying a cost-plus method with a low margin-- because, in the end, most of the relevant risks (e.g. inventory, obsolescence, bad-debts etc.) connected with the sales are located in companies of the same group located abroad in more favourable tax environments than that offered by the source country.

Despite what Action 7 seem to suggest, focus on strictly speaking 'commissionaire arrangements' is unlikely, and a broader study of commissionaire-like or other profit stripping structures having the same effect[7] will probably be carried on if only because if changes were to affect just 'commissionaire structures' the resulting norm would be easy to avoid[8]. The importance of different forms of outsourcing and organization of value chains and business models puts also pressure on providing general solutions rather than ad hoc agreements on just a specific type of structure[9].

Fragmentation of activities is closely related to 'commissionaire-like agreements'. In the end, fragmentation pursues the same outcome –avoiding taxation in the source country by splitting functions among different persons in the same jurisdiction—and this tax planning technique is usually combined with 'commissionaire-like' structures[10]. From 1992 onwards, fragmentation was contemplated with some concern in the Commentaries to art. 5, but a comprehensive study of the effects of art. 5.4. was left aside, specially where the exceptions in art. 5.4. are combined with other fixed places, dependent agents that do not meet the dependent PE test or even independent agents the same company or other companies of the group may have in the same jurisdiction. As shown below, this type of fragmentation was already explored in the OECD context in the works towards the 1977 OECD MC. In the end, fragmentation permits a company or group to have a substantial economic presence in a country without incurring there in tax liabilities commensurate with it. Like in the case of commissionaires, it seems that the OECD may be forced to consider a horizontal or holistic view with regard to fragmentation and study this problem from the perspective of art. 5.1., 5.4., 5.5. and 5.7. OECD MC.

The issue of attribution of profits, as announced in Action 7, is also most likely to arise in this context since in the past it was regarded that arm's-length remuneration of all the entities involved in the transaction, usually cost-plus with a low margin, might achieve the desirable result[11], but this attitude is changing. In

[7] For instance, contractual arrangements with the same effect to commissionaire agreements in common law countries, or risk stripped structures in subsidiaries which minimize profits in the source State, either as a distributor or as a manufacturer (e.g. conversion of contract manufacturers on toll manufactures). All of them have similar features and operate by transferring risks from the source country to the residence country of the entity to which most of the profits are attributed. For simplicity, sometimes to refer to this group of tax planning techniques based on stripping risk from subsidiaries in source countries the term 'commissionaire-like structures' or 'agreements' will be used.
[8] Collier (2013), p. 641-642.
[9] On outsourcing, see Desai and Goradia (2014).
[10] For several examples of structures of this type, see section 5.3. and the facts of the Spanish cases reported there.
[11] Collier (2013), p. 644-645; on how the issue of attribution of profits is connected with artificial avoidance of PE status, see sections 3.2., 3.3. and 3.5.2.e) below.

fact, it can be argued that the problem of artificial avoidance of PE status has a lot to do not only with the concept of PE in art. 5 but also with the system of attribution of profits to PEs as designed by art. 7 OECD MC in the different versions of it (pre and post 2010) and with art. 9 OECD MC. Therefore, most likely Action 7 will also cover new works on attribution of profits[12].

As a matter of fact, the OECD invitation to interested parties to identify strategies that allegedly result in artificial avoidance of PE status (22 October 2013) seems to adopt a wide perspective and is not focused only on commissionaires or artificial fragmentation. The only response received has also adopted a wide perspective[13]. The limited response to the OECD's invitation should not be taken as an indication that the issue is not relevant or important. As explained in section 2.3., this problem is very relevant for developed and developing countries.

2.3 Policy issues behind Action 7: how can artificial avoidance of PEs be defined?

As anticipated in the section above, Action 7 has several inherent weaknesses:

- If the action concentrates on very limited issues, it would not solve the problems with tax planning structures and artificial avoidance of PE status. However, the limited time allowed for completing this action (September 2015), makes it very difficult to expect a revolutionary approach that could solve all the problems on the concept and attribution of profits to PEs that have not been figured out in almost a century of experience with PEs.
- The importance of the problems with the PE definition in art. 5, on the other hand, make it very difficult not to think about lowering the PE threshold, which will open the source / residence country rights debate (this issue seems to be embedded also in Action 1).
- The ambiguity of the Commentaries to art. 5 OECD MC, their evolution, without a very clearly explained guiding policy principle have produced as an outcome different interpretations in diverse countries on the concept of PE and make it a real need for taxpayers and administrations alike to have more certainty in this area. But, at the same time, where different tax administrations and courts have developed divergent standards and positions on interpretation of art. 5 OECD MC, solutions to the problems are also more difficult which may affect the outcome of Action 7.

This means that there is in Action 7 a cocktail that is difficult to handle or mix appropriately: it touches the definition of PE, as well as attribution of profits to them but without having a well-defined approach to international tax avoidance, it moves in a context where it is easy to connect its scope with the debate on source / residence country taxation and, at the same time, it will have effects on a domain that is subject to different interpretations and approaches in different jurisdictions. All these aspects make it important to take some sort of coordinated action at the international level, but countries will no doubt assess which models fit better with their specific situation and the difficulty of mixing adequately the ingredients may cloud the outcome of this Action.

[12] Sasseville and Vann (2014), section 1.1.2.7.4.

[13] See the response by Mr Tejas Chandulal Shah of 9 November 2013, who did not focus exclusively on abuse and basically claimed for more source country tax jurisdiction.

Additionally, it may be perceived that fight against artificial avoidance of PEs may be easier with increased source country taxation. It is important to keep in mind that two issues are mixed in the discussions on Action 7 (fixing art. 5 and giving source countries more taxing rights), but it should be clear from the beginning they should not be confused: whereas fighting artificial avoidance may amount to restoring source country rights that are already (or should be) recognized in the present system of distributing tax jurisdiction, the discussion about source country rights seeks to lower the threshold of source taxation. This conceptually clear-cut difference may not be so evident in the practise of PEs: the contours of this institution are not clearly defined in the current international tax framework and, therefore, the two conceptually different issues of restoring tax jurisdiction and attributing more source country jurisdiction may mix up together, especially because for countries with less sophisticated tax administrations the easiest way to tax activities taking place within their border will be having more taxing rights, rather than approaching PE and PE attribution of profits issues from the sophisticated position of a more developed tax administrations. Inevitably, therefore, the debate on Action 7 in the context of developing countries raises the issue of source country taxation, either at the policy level or when interpreting the concept of PE under art. 5 OECD / UN MC.

Besides, the main problem with Action 7 is that defining 'artificial' may call, first, for a definition of 'avoidance' or even of 'PE'. As a consequence of the evolution of this institution, that may not be an easy task. In the end, the PE --that is to say, taxation in the country or source-- is a threshold designed as an exception to a general rule, taxation in the country of residence (art. 21 OECD MC), so it is not easy to say that when the outcome of a structure or transaction is in line with the general rule (taxation in the state of residence), it is 'artificially avoiding' the exception (taxation in the State of the PE), especially if the policy goals beyond the exception are more intensively inclined towards the interest of residence countries and the institution seems to be designed –regardless of whether one may like this result or not- to avoid as much source taxation as possible. It is difficult, therefore, to meet the main policy goal of the BEPS Action plan with an institution, the PE, that inherently may produce the effect of segregating taxable income from activities that generate it. That is the challenge of Action 7.

The latter reflections simply try to underline that, as it is today, the PE concept is a minefield[14] and that Action 7 BEPS Action Plan will develop in a shaky, dangerous and very, technically and from a policy perspective, difficult area, if possible, to bring more clarity and certainty to taxpayers and administrations. From a theoretical perspective, as explained, Action 7 BEPS Action Plan poses very challenging problems since, in the end, it touches a fundamental institution of international taxation, the concept and the attribution of benefits to PEs, but also how corporate groups should be taxed internationally. From a practical perspective, PEs and artificial avoidance of PE Status is no less relevant in the current international context.

[14] Collier (2013).

2.4 *The importance of managing PEs risks for companies and tax administrations, specially in developing countries*

The limited response to the invitation by the OECD for comments on Action 7 BEPS Action Plan does not mean that artificial avoidance of PE status is not of relevance for taxpayers and tax administrations. A number of factors have contributed to raise the practical importance of PEs in the last years[15]. Probably, for taxpayers (multinational companies) evolution of business models, virtualisation, internationalisation, 'presence' of companies in more and more jurisdictions, increased mobility of factors with employees and assets scattered around the world and travelling in and out of jurisdictions have increased the risk of having PEs in different jurisdictions. For taxpayers, therefore, the need to prevent contingencies and manage PEs risks --of dismantling the minefield-- is nowadays most important, as it is the legitimate concern of reducing there overall tax exposure in different jurisdictions, among other things, by avoiding having a PE (as long as this cannot be labelled as artificial). For multinational groups, the current state of uncertainty with regard to PEs is not satisfactory: taxpayers often prefer to pay something rather than being subject to the uncertainty of arbitrary tax claims, double or multiple taxation, and lengthy disputes.

For tax administrations, in the last years, the PE concept has provided a powerful weapon to attract tax basis within their jurisdiction, above all when transfer-pricing policies of multinationals cannot be challenged under national law or the OECD standard, as represented by the OECD Transfer Pricing Guidelines. A PE challenge, if successful, may bring more revenue to the source country that transfer-pricing audits of domestic subsidiaries of a group. The PE concept has even been used in the context of transfer pricing audits as a thread to increase attribution of profits to domestic subsidiaries. In this respect, some high profile cases (e.g. Spain[16]) have probably fuelled the appetite of tax administrations to enter into PE audits, especially in a context were it is widely known that multinational companies have diverted profits from source countries with well-known structures like commissionaires and other risk stripping strategies, as well as fragmentation of activities in source jurisdictions. An example of this reality is also provided by International Tax Manual of the HM Revenue & Customs in the UK, and its considerations on commissionaires which proposes that, where significant people functions and risks are connected with UK activities, it is feasible to argue that there is a PE in the UK and attribute profits to the foreign head office by using a cost plus method so that the rest of profits would be taxable in the UK.[17] Uncertainty and

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[15] See, PwC (2013) for a very interesting survey on the relevance and risks of PEs for multinational companies.

[16] See section 5.3. below.

[17] See HM Revue and Customs (UK), *International Tax Manual,* Section "INTM441050 - Transfer Pricing: Transactions and Structures: business structures: marketing and distribution - commissionaires: practicalities" (available at http://www.hmrc.gov.uk/manuals/intmanual/intm441050.htm, last visited 28 July 2014). The following excerpt is illustrative of the approach of the UK tax administration:

> "Attribution of profit between a principal and a PE in another country involving the transfer of function and risk cannot be dictated by a legal agreement alone - there must be a detailed consideration of whether in fact the risks and functions lie with a PE or the principal overseas.
>
> Once the functions and risks have been allocated between the PE and the home territory of

ambiguity on the interpretation of key concepts of art. 5 OECD MC have created the breeding ground for more aggressive interpretations of the PE concept by tax administrations[18].

In the end, creative interpretation of the PE concept by tax administrations of some developed countries reveals not only that there is scope for different interpretation and application of the same concept, but also that there is tax planning going on in this domain and that something should be done. There is also some evidence that avoidance of PE status is not only a problem for developed countries but it is also affecting developing countries. A recent IMF paper explains in this regard:

> "For example, a large proportion of non-natural resource based multinational businesses located in developing countries are organized as low risk, routine, light manufacturing or commercial ventures, rewarded with accordingly low profit rates. It is common, under the application of transfer pricing methods, to assign these operations a fixed rate of return for tax purposes, under which productivity gains rarely translate themselves into higher local profit margins. A risk in introducing such simplified schemes, despite their attractions for administration, is that they thus may not respond to changing commercial circumstance, and can perpetuate inappropriately low fixed rates in developing countries".
>
> . . . Countering this aggressiveness would be greatly facilitated by developing concrete guidance where it is lacking and repudiating perverse interpretations of the ALP (commonplace and often tacitly accepted), such as condoning risk stripping and other arrangements that provide no documented productivity gain for the MNE. Carefully designed harbours that apply a fixed mark up to certain costs can play a greater role than generally recognized [Brazil rules for transfer pricing could be an example: minimum gross profit margins, very specific rules upon indices of commodities transactions, limitations on intracompany export transactions as a total of net export transactions]." [19]

While the latter quote contemplates the problems of tax base shifting from developing countries and the solutions to them from a 'transfer pricing perspective', in the end, it refers to 'commissionaire' and 'fragmented' structures that keep a substantial presence in a developing economy but manage to substantially reduce source country taxation by avoiding PE status. In this regard, tax administrations of developing countries should be aware of the fact that transfer pricing may help

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the principal, appropriate profits can be allocated to those functions and risks. It will be simpler to establish a reward for the activities, which relate to ownership of the assets, such as managing and insuring stock. A cost-plus method could be used, leaving the balance of the profits from the overall selling activity to be allocated to the PE.

The questions of whether there is a PE of the principal trading in the UK, and if so the profits that should be attributed to the PE are very complex issues.

The OECD guidelines on the attribution of profits to a PE say that there should be no automatic force of attraction of profits to the PE. In the same way, there should be no automatic force of attraction to the head office of the enterprise. Only a careful examination of the facts will show whether functions are carried out by the PE in the UK or by the rest of the entity overseas".

[18] See PwC (2013) with warns in this regard to companies to manage the risk of PEs by establishing adequate procedures and safeguards as a consequence of the reaction of some tax administrations, especially in Europe.
[19] IMF Staff Report, "Spillovers in International Corporate Taxation", IMF: Washington, 2014, p. 33.

bring a part of the tax base to the source country, but identifying the existence of PEs may be an alternative to that route (sometimes an even more productive or easier one)[20].

From the perspective of developing countries, the answers to the questionnaire by the UN Subcommittee on BEPS to developing countries and stakeholders also reveal that Action 7 is regarded as very important, which shows the needs to take some action[21].

3. What is the PE function and when is it artificially avoided? The concept of PEs in the context of the OECD MC and its evolution

3.1. The basic function of PEs

Artificial avoidance of PE status –and, therefore, the scope of Action 7 OECD BEPS Action Plan-- can only be fully understood if the function and role of PEs is clear.

As known, the concept of PE is defined in art. 5 OECD / UN MCs and has been used in the international tax arena from the very beginning, with the works of the League of Nations[22] and before, in the first tax treaties. The PE concept is one of the thresholds –perhaps the most important one—in the OECD / UN Models as well as in tax treaties: it marks the line below which the source country can tax business profits since art. 7 OECD / UN MC permits the source country to tax only those business profits that can be attributed to a PE located within the source State.

Therefore, if a non resident taxpayer has a fixed place of business (art. 5.1. OECD), construction works that lasts more than the fixed time (art. 5.3. OECD, 12 months), or a dependent agent with the power to habitually enter into contracts in the name of the taxpayer (art. 5.5. OECD), there would be a PE in the source State. The profits of that PE can be taxed in the State of source[23]. However, art. 5.4. OECD MC excludes the right of the source country to tax business profits that can be attributed to 'special' or auxiliary and preparatory activities even if these activities are carried out through a fixed place or through a dependent agent.

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[20] See, on this issue, section 5 below. In this sense, the UK *International Tax Manual,* Section "INTM441050 - Transfer Pricing: Transactions and Structures: business structures: marketing and distribution - commissionaires: practicalities", suggests that if the majority of the activities and risk are in the UK, either through the commissionaire or the PE of the principal, "[r]ather than trying to separate out all three separate profit centres [head office, PE in the UK and local subsidiary acting as commissionaire], it will be much easier to separate the costs of activities such as debt management and stock management (to the extent that there are staff outside the UK who carry out these activities) and agree an arm's length reward for those activities. This will avoid the subjective exercise of trying to establish an arm's length price for the activities of the commissionaire".

[21] Of the five answers published so far (the deadline ended on 8 August 2014), three of them identify Action 7 as a priority (Mexico, Brazil, and Economic Justice Network and Oxfam South Africa).

[22] For a through study of the concept see, for instance, Arnold (2014), Skaar (1991).

[23] There are very relevant differences between art. 5 OECD MC and art. 5 UN MC. Attribution of profits does not follow the same principles either in art. 7 of the OECD MC and art. 7 UN MC. These differences will be referred to below in section 4 below.

At first sight, the function of the PE concept is clear, its interpretation and application is not. The Commentaries to art. 5 OECD MC can be read in different --sometimes even contradictory-- forms with the consequences that uniform interpretations by tax authorities or courts in distinct countries are natural. The underlying economic / policy principles behind the PE clauses in art. 5 OECD / UN MC are not always obvious either: the PE was designed to tax significant activity carried on in the State of source, but it permits some relevant presence and activity taking place there to go untaxed. And, the system of up-dating the Commentaries to the OECD MC from time to time (an incorporating them by some countries) without having a fully established policy direction may add confusion and fuel divergent interpretations: from time to time the perception of what is admissible may vary, the boundaries of the PE threshold may move over the years and what is admissible in a country today may not be accepted tomorrow (which is a problem for discussions between countries with fiscal systems in different stages of development).

In this context, it is complex to speak about 'artificial avoidance', because what may be avoidance for one country may not be the same for another that interprets the PE principle in a different form. This is obvious, for instance, with the Dell cases in Norway and Spain: whereas a typical commissionaire structure withstood the exam of the Norwegian Supreme Court, which ruled that there was no PE in such a situation, the same agreement was regarded as a PE in Spain.[24] Perceptions of what is admissible also change over the years[25].

In this situation, understanding the current problems of the PE --and, therefore, defining what artificial avoidance of PEs is-- calls for a reference to the historical evolution of the concept since, without this historical perspective, it is not easy to fully comprehend the present problems of that institution. Moreover, history may help understand the policy, economics or legal reasoning behind the PE concept and will also be of aid to discover whether there has been any behaviour over the years that could be regarded as artificial in connection with PEs, a sort of 'common', internationally accepted standard of when avoidance of PE is artificial. Therefore, understanding history will help understand PEs and the scope of Action 7.

There are several historical periods of relevance, which are referred to within the next sections. A conclusion will be added at the end of each of them on the relevant ideas to fix the standard of artificial avoidance of PEs. A final conclusion, or, rather, an attempt to define when there may be artificial avoidance of PE status, will also be added at the end of this section that may help identify the solutions to the problem of artificial avoidance of PE status.

3.2. The League of Nations and PEs: priority of residence taxation, legal form and the separate enterprise arm's-length principle as basic principles

The 1923 Report on Double Taxation of the League of Nations (of the four economist)[26] marked a significant change in international taxation: from a more or

[24] See 5.3. below section.

[25] As said, PE attacks to multinationals have resurfaced within the last years after some time of more importance being attributed, for instance, to transfer pricing.

[26] Report on Double Taxation, Document E.F.S.73.F.19, April 5, 1923 (Report of professors Bruins, Einaudi, Seligman, and Sir J. Stamp) Legislative History of United States Tax

less active defence of the situs or origin principle, this Report initiated a change in the status quo when it proposed a move to resident-state taxation. The PE principle was one of the exceptions to residence-state taxation, and, as such, it has remained from the 1920s until today (with the only exception of the Mexico Model that regarded the PE as an example of source taxation and not as an exception to the main principle that was followed by the model).

The reasons behind the acceptance of the residence taxation principle as a general rule and the PE principle as an exception were not so clearly explained neither in the League of Nations materials nor later on in the OEEC / OECD documents. The main arguments to defend the change of status quo were that tax treaties embraced the residence only principle and that it is difficult to tax foreign enterprises efficiently and equitably if they do not have a PE in the source country. The fear of industrialized countries to give up revenue in favour of source countries probably was an additional driving force behind the position adopted, first, by the League of Nations and later on by the London and OECD Models[27].

As a matter of fact, the elimination of double taxation was a concern of countries with enterprises doing business abroad and, because these countries, in order to promote cross-border commerce, gave relief for taxes paid abroad, it was natural that they tried to limit the source country power to tax income obtained by their residents in order to avoid tax costs for their –by them very affected because of the War and the Great Depression-- budgets. There was the feeling that relief should be split between source and residence countries, or, in some cases of balanced trade, that source countries could give up their rights if a reciprocal treatment was granted to their businesses[28].

Therefore, a mixture of economic theory, administrative convenience and political interest explain the bias in the current international system towards residence taxation. These premises, as it will be explained, had an important impact upon the configuration of PEs.

It was in this context, in the 1920s and 1930s, that the PE concept began to have its current form. At that time, source and residence countries had different views on how to tax business profits[29]. For some of them, profits from sales could be taxed in the market state, whereas the countries where the goods were produced claimed that most, if not all, the profits from the production had to be attributed to the country of production[30]. Some source countries were not even happy with taxing benefits attributable to 'factors located' within their borders and also requested the

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Conventions, Vol. 4, 1962, (electronic version available at http://setis.library.usyd.edu.au). See also Skaar (1991), p. 80 ff.

27 Skaar (1991), p. 82 ff.

28 See Carroll (1939).

29 Carroll (1939), p. 6-7.

30 Carroll (1939), p. 7: "Some administrations were not content with determining the profits of a local branch on the basis of factors within their jurisdiction, but demanded of the head office its accounts showing net income arising from operations throughout the world, in order that they might determine the proportion of the entire net income attributable to activities within their territory. If several countries of different languages, different tax laws and different accounting practices all asked the enterprise to supply head office accounts, translated and adapted to their different laws and practices, in order that each might cut its slice of the entire net income, the resulting burden on the enterprise is evident, especially in view of the propensity of each administration to attribute the largest portion of the net income to the activities within its border".

accounts of the head office, therefore creating a burden on foreign enterprises. In order to avoid that burden, subsidiaries were incorporated, but some countries even tried to pierce the veil of the local subsidiary to reach the profits of the foreign parent[31]. The desire to promote commerce, avoid double taxation, and the economic context of the time in the most industrialized countries (after World War I and the Great Depression international commerce was reduced dramatically) probably had an impact in the situation of international taxation and the definition of PEs.

As an exception to the residence principle, it was assumed source countries should be able to tax business profits attributable to production factors located within their territory. Since these production factors were immobile in the 1920s and extractive, industrial and commercial establishments were the predominant industries (transportation industries were given a special treatment from the beginning, like, to some extent, banks due to the differences between 'creditor' and 'debtor' States), the source country should only tax profits attributable to the 'fixed elements' (*rectius* production factors) present within her territory. That explains why the 1928 Draft Model and the 1933 work of the League of Nations relied on a concept of PE that focused on fixed places of business[32].

Even if local subsidiaries first were regarded as a PE of their parent / sister subsidiaries in the 1927 Draft Convention of the League of Nations[33], the reference to them was eliminated in 1928 Drafts[34] probably to limit the above mentioned expansive theories of some tax administrations of the time that tried to attract the benefits of the foreign parent / affiliates into the tax base in the source State. In 1933, "subsidiaries" appeared together with the list of examples of fixed presence constituting a PE but to make clear that they were not PEs[35].

At this time, agencies were also conceived of as fixed establishments, included within the list of examples of PE in the 1927, 1928 and 1933 Draft Conventions, only independent agents were excluded from the definition of PEs. There seems to be no trace of the modern debate on whether they were agents in a legal sense or regarding the substance of their acting. However, as Vann points out, it seems that the context points in the direction that economic substance was not accepted, context suggests a rather legal interpretation of 'agents'[36]. This idea is clear in the

[31] Carroll (1939), p. 7: "In order to avoid this burden, corporations quite generally organised a local company, so that the business assets within the country might be readily segregated. If the subsidiary showed losses, its separate legal existence did not daunt the ingenious collectors of taxes. They evolved theories which justified extending the fiscal arm to cover the foreign corporation and bring it within the jurisdiction of their courts: the subsidiary company was held to be a mere "organ" of the foreign corporation, or to constitute with the parent corporation an "economic unity", or the parent corporation, through controlling a subsidiary corporation with similar objects, was itself viewed as extending its exploitation into the taxing jurisdiction. Such theories not only served to reach foreign parent corporations but even to corral foreign grandparent or great-grandparent corporations."
[32] Skaar (1991), p. 67-68.
[33] Double Taxation and Tax Evasion: Report; C. 216. M. 85, Draft of a Bilateral Convention for the Prevention of Double Taxation, art. 5.
[34] Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, Publications of the League of Nations. II Economic and Financial 1928.II.49, art. 5 Model 1a, art. 2 Model 1b, art. 3 Model 1c.
[35] Para.2 Protocol to the Draft Convention on the Allocation of Business Income Between States for the Purposes of Taxation, League of Nations Fiscal Committee: Report to the Council on the Fourth Session of the Committee. C.399.M.204. 1933.II.A., p. 4246.
[36] Vann (2006), p. 361-364.

reflections of Carroll on whether subsidiaries could be regarded as agents of their parents: in principle they should be regarded as separated companies, just because they were subsidiaries. If subsidiaries (and legal form) are in principle respected, it would not make any sense to interpret the concept of 'independent agent' in a form other than legally[37]. As a result, in this context, it seems that enterprises could use legal form (subsidiaries) to avoid agency PEs (by then, fixed places), and the lack of independence of the subsidiary from an economic perspective from the parent was not regarded as important: there will be no PE of the parent / other group company as long as the subsidiary is not legally an agent of the parent / other group company[38].

However, corrections of those situations of recognition of legal structures (starting with subsidiaries) were not excluded, although for Carroll such a correction depended directly on the independent enterprise principle[39]. In a context where the residence principle was given priority, where subsidiaries were being 'attacked' by source countries it is normal that legal reality, as opposed to economic substance, was given priority, since this limited the exposure to double taxation as a consequence of aggressive behaviours in source countries and that deviations from what was desirable could only be corrected not by piercing the veil of the subsidiary, but rather by treating it as an independent company.

These structural changes --priority of residence taxation and allowance of source taxation as an exception for profits attributed to the PE, pre-eminence of legal form and legal independence as opposed to economic substance-- are crucial to understanding the main problems behind the PE concept today. Probably neither these conclusions were fully evident in the 1930s from a theoretical perspective nor they were unanimously accepted by all States, but it is very relevant to understand them in order to fully comprehend the current problems on artificial avoidance of PEs. In fact, these are the assumptions that were used to define the concept of PEs in the 1946 Mexico and London Models, even if such a concept had a different function in both of them (in the former it was only one of the forms in which profits could be taxed in the State of source, in the latter the PE concept had a threshold function closer to the one it has nowadays).

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[37] Vann (2006), p. 363 explained that "[t]he legal form approach to associated enterprises made it natural to conclude that agency was also being used in a strict legal sense".

[38] Vann (2006), p. 363.

[39] Carroll, Taxation of Foreign and National Enterprises: Methods of Allocating Income, League of Nations, Geneva, 1933, vol. IV, para 627-628: If its income is diverted to other units of the enterprise in any manner, the tax authorities, as a general rule, have only to examine the inter-company transactions, appraise their terms and results in the light of sound legal and business principles, or by comparison with independent companies engaged in similar activities under similar circumstances, and recapture any profit that may be shown to have been diverted. Obviously, if the diverted profit is retrieved after it has already been taxed as income of another unit, double taxation will result, unless the administration of the other country is willing to reduce its assessment and refund a proportionate amount of the tax.

As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.

Although attribution of profits to PEs is outside the scope of this paper, a historical note is relevant at this point. Carroll's work on attribution of profits to associated enterprises and PEs made certain assumptions that are critical from the point of view of defining the contours of PEs[40]. As Vann rightfully pointed out, Carroll adopted an approach to attribution of profits that was especially apt for limiting the tax authority of source countries[41]. By establishing the principle that subsidiaries or PEs have to deal with their parents or head offices at arm's-length, the residual value of transactions –the reason why corporate groups exist-- was diverted from the source country. In this model, remuneration of PEs or subsidiaries for the 'service provided' is natural, since, in the end, the PE / subsidiary is assumed to be remunerated as an independent party, but the benefits of the sale are allocated mainly to where managing activities are carried out, the head office. In cases of contract-manufacturing, the manipulation of the outcome of the transaction is relatively easy: a manufacturing subsidiary is set up in the country of source as a contract manufacturer that sells to the parent company, which, in turn, sells back to the country of manufacture involving another subsidiary in that country but in such a way that the subsidiary is only providing services to the parent and not acting as its legal agent by assisting in the sales to the third parties. As Vann shows, with Carroll's theory, the one accepted by the League of Nations, a manufacturer subsidiary makes only a small part of profit as does the sales-assisting subsidiary, with the residual profits of the transactions accruing to the parent company[42]. It is curious, however, that Carroll's model on attribution of profits was not easily accepted at the time, even if it found its way into the model on attribution of profits of the League of Nations[43]. There advantages were immediately noticed by multinational corporations and the first cases of commissionaire-like arrangements and fragmentation started to be heard by courts in this period[44].

Another feature of Carroll's theory was that profits were attributable to *each* PE. This is probably the germ of most of the historical and modern problems of PEs since the tax base of a single taxpayer could be fragmented between different presences in a country with the result that if some of them did not meet the PE threshold, the taxable income was attributed to the residence country and, if the PE threshold was met, the independent enterprise theory accepted by Carroll will also favour attribution of residual value to the same residence country[45].

Conclusion:

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[40] For the evolution of the attribution of profit system to PEs, see Sasseville and Vann (2014), section 1.2.

[41] Vann (2006), pp. 364 ff.

[42] Vann (2006), p. 367. As he suggests, "the critical structural feature of these variations is that the subsidiaries supply services to the parent and do not deal with third parties, at least in a legal sense, though they do in a practical sense, leaving this legal role to the parent". Taxpayers, he continues, immediately realized the outcome of Carroll's assumptions to put in place structures that had the effect (and probably the aim) of stripping profits from source countries.

[43] Vann (2006), p. 369.

[44] See Vann (2006) on these cases in the UK and Australia.

[45] Vann (2010), p. 319, criticized the separation of activities in determining PE status as the 'more important problem'. For him, "[i]t encourages tax planning by artful segregation of activities and reliance on the implied or express limitations in the fixed place / agency / minor activities rules . . . More significantly, separation of activities pervades the whole transfer pricing mindset by shifting the focus from the overall to individual activities of the firm in a country".

The concept of PE was born as recognition of the source country rights in a scenario where taxation in State of residence was proposed and fostered as a rule to eliminate double taxation and favour international commerce. Two developments affected the future configuration of PEs dramatically while at the same time also reinforced taxation in the State of residence as the general rule:

- The concept of PEs and companies within the same group was conceived of in terms of legal definition, which facilitated the independent consideration of foreign subsidiaries and PEs, rather than a substance / economically oriented conception.

- In terms of attribution of profits, the arm's-length principle and the separate consideration of PEs also produced the effect of reinforcing the residence principle with the effect of reducing the taxable base in the country of source.

Both elements facilitate avoidance of source taxation and maximization of residence country taxation.

3.3 The OEEC works and the preparation of the (Draft) OCDE MC 1963-1977: fixing the contours of the modern PE concept

3.3.1. The works towards the 1963 Draft OECD MC

The OEEC Fiscal Committee worked on what finally were art. 5 and 7 1963 Draft OECD MC. In particular, Working Party 1 (Germany-United Kingdom) elaborated on the concept of PE and presented a draft of art. 5 in 1957[46]. From a policy perspective, there are several developments worth mentioning:

- A general definition of PE was given, which very much resembled the current concept of PE. The link of PEs and fixed places was definitively established by refusing to tax itinerant business in the State of source (which at that time were not considered as very important)[47].

- The exception for preparatory and auxiliary activities was included in art. 5.3. and it encompassed --contrary to what had previously occurred-- the maintenance of stock, which was not judged as sufficient to create a taxable nexus in the State of source.

- The dependent agent PE was finally detached from a fixed place of business and the authority to conclude contracts 'on behalf' of the principal was added as a requirement to qualify as a PE.

All those changes seemed to seek a common goal: administrative simplicity and elimination of obstacles to international trade. Even if it is recognized that all parts

[46] Final Report on the Concept of PE, WP n. 1, FC/WP1 (57) 3, 8th November 1957.
[47] Final Report on the Concept of PE, p. 8: "A special provision to deal with these people [itinerant merchants, pedlars, watermen, circuses and travelling entertainers] is not, in the view of the Group, necessary because the incomes will, in general, be small and it is likely to be most difficult to tax them in any country except the one in which they reside . . . loss of tax which a country may suffer through giving up its right to tax itinerants, etc., from other countries is likely to be more or less compensated by the fact that it will have the sole right to tax itinerants residing within its own borders" (p. 8). On this issue, see Vann (2011).

of an enterprise may contribute to the final profit of it, administrative considerations / facilitation of international relations explain the three main changes to PEs in comparison with the period of the League of Nations: itinerant business were difficult to tax and relatively not important, the (non-exhaustive) list of preliminary and auxiliary activities should not be taxed to foster international commerce and for convenience of administration and was conceived of as an exception to the general definition to limit its scope,[48] only dependent agents having a certain degree of intervention in the source country on behalf of the non-resident should be able to qualify as PEs[49].

This represented a fundamental shift from the League of Nations' works, still one that reinforces in an important fashion the rights of resident countries and opens up new possibilities of having presence in a country without being taxed there: art. 5.3 (at the time there was no construction paragraph in art. 5), with the exception for preliminary and auxiliary activities, recognized that a fixed presence in the source country should not give rise to taxation, art. 5.5. that not every dependent agent acting in the source country should be attributed a portion of the profits of the enterprise; the exclusion of itinerant merchants also stressed that more or less permanent presence if not fixed could not give rise to source country rights.

At the same time, the changes built on the concept of (legal) independence of the works of the League of Nations. Therefore, subsidiaries were regarded in art. 5.6, in principle, as independent from their parents or other companies of the group simply because they were separate legal entities[50]. If this was the case with subsidiaries, it is difficult to say that dependent agents were considered to be PEs in cases other than legally binding the foreign principal since an economic interpretation of 'binding' did not fit well in the evolution of the concept of (dependent agent) PEs: by then not every dependent agent was a PE, only those having and habitually exercising the power to enter into contracts binding the principal[51]. A parallel interpretation of the situation of agents and subsidiaries clearly supported a legal interpretation of the (proposed) art. 5.4. and the nature of the authority of the agent to bind the principal.[52]

This point of departure clearly marked the evolution of the PE concept since the commentaries of the 1957 Report were basically kept in the Commentaries to art. 5

[48] Final Report on the Concept of PE, para. 5: "The general definition in paragraph 1 has, therefore, been drafted in its present form because it is the one which gives the greatest in clarity and which promises to be the easiest to administer. . . . In paragraph 3 there is provided a list of specific exceptions which, although they involve 'a fixed place of business', should be excepted from the general rule in order to foster international trade or for convenience of administration".

[49] Final Report on the Concept of PE, para. 14: "Having thus excluded the independent agents from the term 'permanent establishments', it would likewise not be in the interest of international economic relations to treat all dependant agents [note that the previous paragraphs referred to persons deemed as PEs 'must be strictly limited to those who are dependent, both from the legal and the economics point of view'] as being permanent establishments. Treatment as a permanent establishment should be limited to dependent agents of those enterprises which, in view of the scope of their agent's authority or of the nature of their agent's business dealings, take part to a particular extent in the business activities of the other state . . . only persons having the authority to conclude contracts shall be treated as permanent establishments".

[50] Final Report on the Concept of PE, para. 19-20.

[51] Final Report on the Concept of PE, para. 14.

[52] For a similar argument, see Vann (2006), pp. 370-373.

1963 OECD Draft MC. The right of residence countries and the limits of source countries, therefore, were consolidated and enhanced with regard to the previous period.

A full picture of this period would not be complete without a reference to the works on attribution of profits since they contributed to further define and explain the PE concept. The Report on Attribution of Profits to PEs and Subsidiaries of Working Party 7, 4 September 1958, FC/WP7 (58) 1, OEEC, proposed a per PE taxation, and formally rejected the force of attraction principle, with the consequence that the various presences of a foreign taxpayer in a jurisdiction could give rise to more than one PE to which profits should be attributed. The reasons for that approach were explained in Appendix II (commentaries to the draft article on business profits and associated enterprises), para. 5:

> "The working group, in common with most countries of the OEEC, prefer the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way . . . in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate items of profit that the enterprise derives from their country and should apply to each item of profit the permanent establishment test".

This principle (separate consideration and attribution of profits to PEs, hereinafter, referred to as the 'per PE principle') was kept in the Commentaries to the OECD MC from 1963 until 2014 and is critical to understanding how the PE concept operates in the OECD MC: it applies per item of income and not per taxpayer, joint-consideration of activities should be the exception and not the rule.

This understanding is, as can be imaged, at the core of fragmentation of activities in the source State, because, certainly, it facilitates tax planning since several business presences in a country, regardless of whether they give rise or not to a PE, cannot be 'horizontally' accumulated. The drafters of the 1958 Report were well aware of the fact that rejection of the force of attraction principle and attribution of profits per PE facilitated avoidance of the PE status through fragmentation of activities in the source State in order not to meet any of the thresholds of the article (fixed place or dependent agent). They thought, however, that simplicity and effective administration were, by far, more important considerations and that trade should be facilitated without imposing undue restrictions, because fragmentation might respond to 'genuine reasons' (historical pattern of business or commercial convenience). If profits were accumulated for different activities within the same State, the tax authorities, the Report went on, might be unduly interfering with ordinarily commercial processes. The Report even recognized that acceptance of force of attraction for different activities, inasmuch as it interferes with ordinarily commercial processes, will be 'out of keeping with the long terms aims that the committee has set itself'. The Committee, however, conceded that they did not want to provide any shelter to 'illegal evasion of tax' and, when undisclosed channelling of profits away from a PE was identified, the tax authorities were entitled to apply 'the consequences that would follow' from a domestic perspective. Therefore, the conclusion of the Committee was that undue weight should not be given to tax avoidance and much more importance was attached to 'the desirability of interfering as little as possible with existing business organization and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous'[53].

In modern language it could be said that the 1958 Report assumed that anti-avoidance doctrines and norms should be applied as an exception to the PE principles and that, as a matter of fact, the separated consideration of PEs should be the rule and disregard of splitting of activities an exception that should be applied with great caution. It should be stressed that the system of attribution of profits was designed in a context where the State of residence rights were further reinforced by stating in art. 5.3. that preliminary and auxiliary activities were not to be taxed at source (and this included the maintenance of stock) and that agents or subsidiaries were not, per se, PEs unless they had the authority to conclude contracts and habitually exercised it.

It should be recalled that the same 1958 Report proposed what later would become art. 9 OECD MC to accept the arm's-length principle for dealings between companies of the same group. This was the explicit acceptance of Carroll's system of attribution of profits, which, as explained, also reinforced the rights of residence countries when it was permitted that the residual value of transactions could go to the country of the parent. When combined, the per PE and the arm's-length principle clearly limit the source country rights to tax activities taking place within its borders in two different directions: the former reduces the source country rights to tax a taxpayer by making it apply the PE test to every single presence and, if a PE exists, by limiting the profits attributable to that presence, the latter remunerates presence through subsidiaries in a very limited form. In that context, it seems that fragmentation of activities was permitted except in very extreme cases.

Conclusion

In short, between 1957 and 1958 the pillars of the modern PE concept were defined in two mutually reinforcing movements: the definition of PEs and the attribution of profits to them. In the name of administrative simplicity and promotion of international commerce the concept of PE and the attribution of benefits to it were designed in a form would that further limit the rights of source countries and facilitated fragmentation of activities to avoid having a taxable presence there through adoption of the per PE principle. This fact, contrary to what may be assumed, was perfectly known by those who designed the system, who envisaged that any attempt to (artificially) divert profits from the PE in the source State should be counteracted with anti-avoidance provisions. The respect of business dealings and structures, the goal of simplification and administrative convenience, was a fundamental feature of the system in order to promote free trade. In fact, this left little margin for tax avoidance doctrines since clearly conditions the results of the application of those theories: any business reason for not meeting the PE threshold and for fragmentation of activities excluded the effects of anti-avoidance theories. The arm's-length and the independent and separate entity principles, the legal consideration of subsidiaries as 'independent entities' in principle, also facilitated the reduction of tax basis in source countries and the proliferation of structures designed to avoid source country taxation.

[53] Report on the Allocation of Profits to Permanent Establishments and Subsidiary Companies, Working Party N. 7 of the Fiscal Committee (UK-the Netherlands), FC/WP (58) 1, 25 August 1958, para. 7-10, the same ideas were repeated in the "Revised Report on the Allocation of Profits to PEs and Associated Enterprises", FC/WP7 (60) 1, p. 7-8, 18 January 1960, para. 6-9.

3.3.2. The 1977 OECD MC

After 1963, further refinement of the PE concept was needed. The most relevant document in this regard is the Preliminary Report on Questions in Connection with the definition in art. 5 of the term permanent establishment, WP 1 (drafted by the German representative), FC/WP1 (70) 1, of 17 August 1970 ("1970 Report on art. 5"). This Report is important because:

- It explained the basic elements of the PE concept of art. 5.1.: fixed place of business (*permanently* established at a *distinct place* understood as a geographical point) *and* the carrying on of business of the enterprise by the PE (use by the enterprise of the place of business, through persons dependent of the enterprise or 'automated facilities'[54]).

- The question of how to deal with two or more different construction, building or assembly projects was raised with the conclusion that the 12 months period should apply per project 'if the building sites are at different locations and in no factual connection' even if the works are performed for the same principal[55]. It should be recalled that, in this period, there was no separate provision similar to art. 5.3. OECD MC 1977-2014 and 'construction, building and assembly projects' were one of the examples included in art. 5.2. (even if the temporal requirement was different and 12 months were needed for these projects to turn into PEs). The conclusion of the German delegate is fully coherent with the works on attribution of profits to PEs of the 1950s and 1960s, which rejected the force of attraction of a PE and assumed that attribution of income should be done per PE, not per taxpayer[56]. As can be imagined, this requirement is the precedent of the 'commercial and geographical coherence test' which, according to its evolution, is applied nowadays in the context of art. 5.1. (after 2003) and art. 5.3. OECD MC (after 1977). In fact, the Report also applied this test when considering the combination of activities in art. 5 that could give rise or not to a PE.

- Peripatetic construction projects were studied to conclude that works moving from one place to another could also be regarded as PEs since they are at a 'distinct place' and movement is linked to the nature of the work. This entailed a relaxation of the fixed element of the definition. In this context the 'single project' requirement appeared to make clear that a geographical connection exists between the different phases of construction requiring movement from one place to the other[57].

- The document suggested a non-literal interpretation of the preparatory and auxiliary exception, then in art. 5.3. 1963 Draft OECD MC, which required to study the factual situation and the specific line of production of the enterprise involved before it could be concluded that activities had such a nature and could be excluded from the PE concept. In general, if the activity

[54] 1970 Report, p. 4.
[55] 1970 Report, p. 13.
[56] The 1970 Report, p. 13, remarked that "[t]his provision is in keeping with the principle that a place of business is deemed to be a PE only if it is located permanently at a specific place".
[57] 1970 Report, p. 14-15.

was an essential part of the business operations of the enterprise, it could not be covered by art. 5.3. OECD MC[58].

- As to the meaning of independence with regard to agents, the document expressed some doubts on how this term should be interpreted (legal and economically independence?) and suggested to clarify the issue in the Commentaries[59].

- Combination of activities: The point of departure was the separate consideration of the different tests and activities in art. 5 since the attribution of profits had to be done per PE, but accumulation was possible under some circumstances. There is one limit to the interpretation proposed: combination of activities refers to those taking place within the same place of business[60]. Some principles are relevant:

    - Exceptions in art. 5.3 OECD MC (1963) are there for activities of an auxiliary nature (incomplete portion of operations of the enterprise), if, however, combination makes that portion economically significant, an 'economically self-contained function' is carried out and no privileges should be granted.

    - The same considerations apply with regard to combination of activities that, by themselves, would not constitute a PE (e.g. dependent agent without power to enter into contracts and auxiliary and preliminary activities).

    - The guiding principle should be that combinations 'will have to be considered individually, i.e. taking into account the economic situation as it arises from such link-up'. As a consequence, 'only such facilities will be deemed to constitute PEs as play a substantial part in the economic life of the State of source and whose business results can be readily ascertained by the tax authorities of that State'. The WP was inclined to deem a PE existed in several examples that may sound very familiar in today's debate:

        - Combination of processing by another company in the source State (a subsidiary), storage and delivery in an economically –although not legally-- self-contained process,
        - Combination of place of business purchases, stores, display and delivery of goods, which amounts to carrying a trade in the State of source in a self-contained economic manner,
        - Combination of a place of business used for advertising but also comprising a stock of goods if the stock of goods is substantial enough to be used for delivery purposes,
        - Combination of auxiliary activities with substantial ones in the same place of business, the latter would attract the former because they are connected organizationally.
        - Combination of a place of business with an agent employed or not by the company but without power to sign contracts since from the economic point of view this is equivalent to a

[58] 1970 Report, pp. 15-21.
[59] 1970 Report, p. 23.
[60] 1970 Report, p. 27.

branch staffed with employees (if the agent is independent the conclusion would be different).

The 1970 Report defended a non-literal interpretation of art. 5.3. and argued for an economic approach, but, it should not be forgotten, its effects were limited: its considerations refer to the same place of business. If there are several places of business, then they should be considered separately and the principles of the 1958 Report (the per PE principle) would apply.

The conclusions of the 1970 Report on combination of activities were basically assumed –with some modifications that are not relevant for our purposes-- and found their way, in a revised form, to the Commentary on art. 5 OECD MC 1977. The most important modifications in the 1977 OECD MC were probably:

(1) Replacement of the situs theory by the more ambiguous 'link between a place of business and a specific geographical point' (also reinforced by the substitution of the word 'through' for 'in which' with reference to the connection between the place of business and the activity and make clear that the activity did not have to be done in the place of business);

(2) Reference to the fact that a place of business may exists "where no premises are available or required for carrying on the business of the enterprise and simply has a certain amount of space at its disposal",[61] and,

(3) Inclusion of building, construction and assembly projects in a separate paragraph to detach this example from the list of art. 5.1. and make clear that it was not subject to the conditions required under such a paragraph[62]. The requirements of geographical and commercial coherence were added to single out to which projects art. 5.3. could be applied separately[63].

But probably, the most relevant variation in this period was the slight change of philosophy that the 1970 Report represented with respect to previous works. The German Representative in WP 1 seemed to assume that, at least in some circumstances, economic reality should prevail over legal form, this is why, for instance, he analysed the combination of activities of art. 5.3 from an economic perspective, rather than a strictly legal one. For him, it could be said, substance prevailed over form and determination of substance required to attend to the relevance of the economic activity of the non-resident company in the source State. The German delegate went as far as to regard the activities of another company in combination with other of the non-resident taxpayer carried on in the source State,

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[61] A reference that was originally included in the first report of the German delegate to differentiate places that are occupied on a temporary basis from those that are more stable in connection with itinerant circuses, ice shows and similar enterprises, see 1970 Report, p. 9.

[62] See the *Third Report of WP 1 on Art. 5*, CFA/WP 1 (75) 6, 13 October 1975, the *Note on the Revision of Art.5 1963 Draft Convention* (note of the Swiss Delegation 6 February 1975, DAF/CFA/WP1/75.3) and the *Summary of Discussions Concerning the 14th Meeting of Working Party n. 1 on Double Taxation,* held on 17th-20th December 1974, Paris, 29 January 1975, DAF/CFA/WP1/75.2.

[63] Para. 17: "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 geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses)".

but only if they were carried out through the same place of business.[64] In the same vein, activities of a dependent agent (not authorized to conclude contracts) in a place of business at the disposal of the foreign taxpayer may also give rise to a PE[65]. The 1977 Commentaries did not include any reference to 'economic substance', 'self-contained economic activities' but certainly assumed a substantial part of the 1970 Report. By so doing, the 1977 Commentaries to art. 5 left a fundamental doubt: whether they should be interpreted literally or in a more substantial form as the German delegate proposed. His proposals, however, referred to a single place of business and were of limited scope. Therefore, it could be assumed that with regard to different places of business the same principles of the 1958 Report still applied (anti-avoidance norms as the way to attack fragmentation of activities, business reasons / economic models as a shield that protected the taxpayer).

However, a less formalistic interpretation of art. 5.1. and the, by then, brand new art. 5.3 (added by the 1977 OECD MC) was included in the Commentaries to art. 5 OECD 1977 in line with the 1970 Report: the 'link to a site' was made more flexible in the case of fixed placed PEs and the time spent at a site by subcontractors was to be taken into account in art. 5.3. OECD MC 1977.

As a consequence, the Commentaries to art. 5 OECD MC (1977) seem to reflect a tension or ambiguity that it is difficult to solve. On the one hand, the more legalist construct of the separate attribution of profits to PEs and independence of legal entities governed the relations between different PEs, especially if they classify under different paragraphs of art. 5 OECD MC, and between PEs and subsidiaries within the same jurisdiction (as long as they are not located within the same place of business). In these cases, the 1958 Report acknowledged that different places of business could only be regarded together if avoidance was identified, but there was a presumption of respect for different business models.

On the other hand, a more substantialist view was breaking ground in the interpretation of art. 5.1., art. 5.3 and art. 5.4. in the Commentaries to art. 5 OECD MC (1977): the fixed place of business of art. 5.1. was more flexible and covered geographical points, with the consequences that several fixed places could be accumulated within the same PE, the construction works to be taken into account for the 12 months period were those not totally unconnected (if they were a single project, they form a coherent whole commercially and geographically), some mobile activities could qualify for the test of art. 5.1. if they moved from one place to another as a consequence of the project undertaken, and art. 5.3., as well as, art. 5.4 admitted a more substantial interpretation when several preliminary or auxiliary activities are combined within the same place. As it will be explained below, this tension has not disappeared today.

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[64] The example in the 1970 Report, p. 34 illustrates this conclusion: "Mineral oil supplied by enterprise A is processed by enterprise B (e.g., a subsidiary) into fuel oil or petrol; subsequently, these products are stored in bunkers of enterprise A for delivery to buyers. The above operations –processing, storage and delivery—constitute a process which is economically –though not legally—self contained and which could lead to the existence of a PE. In this connection, it appears to be irrelevant whether or not the delivery of operations are carried out by an agent of the enterprise within the meaning of paragraph 4. This case may possibly have to be considered differently if the processing by enterprise B merely constitutes and insignificant portion of the overall production of that enterprise".

[65] 1970 Report, p. 38-39.

3.4 *Interim conclusions on the function of PEs and the standard for avoidance of PEs*

Several forces – economic theory and certainly an economic context based on physical presence, promotion of free trade, administrative simplicity and reliance on legal form-- joined in the years studied to push all in the same direction: the attribution of taxation rights to the State or residence at the expense of source States. At the same time, drafters of the models were well aware of the fact that the PE threshold could be avoided, commissionaire structures and artificial fragmentation already existed from the beginning of the century and after, and the delegates of the Fiscal Committee of the OEEC / OECD were knowledgeable of these situations when they drafted the Commentaries leading to Draft OECD MC (1963). At some point (1958), they even expressed their view that the most severe cases could be corrected by applying antiavoidance rules of the State of source; later on (1970), a more flexible or even economic interpretation of the concept of PE started to emerge, but their effects were limited to certain aspects of art. 5.1. (geographical consideration of fixed place and coherence of projects), 5.3 (computation of 12 month period), art. 5.4. (accumulation of activities within the same place of business that completed a business cycle).

It is curious that, at this time, there is no trace of antiavoidance / economic doctrines into the Commentary to art. 5 OECD, although the problem of avoidance had emerged in some of the Reports (1958, 1970) used for the Commentaries to art. 5 OECD MC. It is not known whether avoidance is not referred to in the Commentaries because it was an ancillary worry for the delegates or because they (and, as a consequence, the OECD) adopted a rather formalistic position in which antiavoidance doctrines could not be accommodated easily in the context of tax treaties. Certainly, promotion of free trade and administrative simplification ranked high in the preferences of the drafters of the Commentaries to art. 5 OECD (1963 and 1977), whether that was their ultimate goal, obsession or alibi is not for this author to judge. In their defence, let us remind the foundations of the modern concept of PE were established in years of (sometimes desperate) promotion or free trade as a goal (first, after World War I, the Great Depression, and, second, after World War II and in the context of GATT and the, by then, nascent EEC). It is understandable that in such a situation promotion of free trade and elimination of obstacles to commerce could have been the main priority of the delegates.

Be that as it may, what is certain is that the PE and the system of attribution of profits per PE, together with the independent enterprise / arm's-length principle of art. 9 and the respect of legal form of subsidiaries produced the effect of allocating a very important (primary or residual) tax jurisdiction to the residence country at the expense of the source countries, although it was recognized that in cases of abuse such an outcome might be questioned.

3.5. *(R)evolution of the PE concept?: 1990s to present*

3.5.1. *PEs reveal their limits*

After some time of study of associated enterprises (1979, 1983 and 1995 OECD Reports), PEs were back in vogue in the 1990s for several reasons: removal of barriers to banks and financial institutions, integration of financial markets, technological advances, developments and substantial increase in the trade in services, new business models, the incremental importance of services and, why not, increased tax planning opportunities that were exacerbated by all those factors and the specific configuration of the PE in art. 5 and the system of attribution of profits of art. 7[66]. All these developments marked another phase in the evolution of PEs, in particular, the concept and attribution of profits to PEs were the object of new studies, especially after the arm's-length principle was developed and explained in the 1995 Transfer Priding Guidelines.

These changes revealed the limits of the PE concept, but also those of 'artificial avoidance of PEs". First, the fixed place of business of art. 5.1. and the threshold for construction works in art. 5.3. were relatively easy to avoid, in some cases not necessarily in an artificial manner[67]:

- Some business models do not need physical presence in a country without this involving any type of avoidance or aggressive position. This is especially the case with mobile business, services, technological enterprises or the digital economy[68]. Simply, in a service and digital economy, the fixed place of business may not be relevant to capture profits in the source state[69].

- The separate consideration of fixed places of business / projects of the same taxpayer meant that the PE threshold could easily be avoided. It may even be said that this principle, that affects equally art. 5.1. and art. 5.3. OECD MC, encourages tax avoidance. The separate consideration of the activities of different companies even if they are within the same group or refer to the same project or line of business also increases the possibilities of avoiding the PE threshold[70].

- The connection between the fixed place of business and the carrying on of business was cut early by conducting business at places that in theory could not be 'available' or at the disposal of foreign enterprises: e.g. hotels, homes of employees, premises of clients, subcontracting all or substantial parts of a project etc.). Some elements of artificiality –attempts to avoid PEs-- might be present in some models. This also affects the permanence test of the PE concept since it is very easy for some businesses to have short time or intermittent presences in a country without being continuously in the same location (e.g. renting of meeting rooms, presence at the premises of the client, hotels, ships entering and exiting the jurisdiction etc.).

- The exceptions in art. 5.4. OECD MC, especially if interpreted literally, offer a wide margin to carry on activities within a jurisdiction without exposure to tax[71]. If combined with the more and more frequent possibility of avoiding

[66] Vann (2006), p. 373.

[67] See, on this issue, for instance, Skaar (1991), p. 109 ff; Arnold (2003), especially pp. 81-84, or Schaffner (2013).

[68] The digital economy is left out of this paper and is dealt with by Li in this same book. For an enlightening example of a very familiar case for tax lawyers of a business model that does not give rise to PE in source jurisdictions despite its intensive presence in several countries where there is no trace of artificiality at all, see Falcao and Michel (2014).

[69] As argued by Hellerstein (2014), the virtual PE may not be a solution either.

[70] Arnold (2003), p. 81, Vann (2010), p. 319.

[71] As Vann (2010), p. 319, footnote 73, points out, while "the exception does not cover firms whose very business is activity in question, it is not clear if there is an overall preparatory or auxiliary limit on the exceptions, and nowadays the listed activities include significant value-

having a business presence or agent in a territory, the per PE approach and the legal independence of companies within a group, there is considerable margin to minimize taxation in the source country.

Second, the problem of dependent and independent agents of art. 5.5 and 5.6. OECD MC was there from the very beginning of the works of the League of Nations and the OEEC / OECD but it aggravated with the economic and technological changes of the last three decades:

- In a more mobile world, with better telecommunications, connecting the PE dependent agent to the conclusion of contracts 'in the name / behalf' of the enterprise does not make much sense. At the time of the League of Nations or the OEEC, probably, it was assumed that the agent was, more or less, immobile (a fixed place), but in the new world after the 1990s it is easy to avoid this requirement either by concluding the contract outside the country of source or by making the principal to finally sign the contract while at the same time avoiding the fixed place of business requirement[72]. Moreover, a person only having dependent agents not empowered to conclude contracts or independent agents, or a combination of both, in a country can avoid having a PE as long as this person does not meet the fixed place of business test[73].

- Reliance on legal dependence (as opposed to economic one) made subsidiaries to (almost always) be considered as 'independent' creatures of the other companies of the same group. As long as their activity was remunerated at arm's-length and they are not dependent agents PEs of art. 5.5. OECD MC, substantial business profits could be stripped from the country of source as long as they were attributable to a non-resident company, which could be located in a low tax country[74], take advantage of hybrid structures[75] or ring-fenced regimes[76] to reduce taxation.

- Article 5.4. also had incidence in this context: a subsidiary or another person could carry on auxiliary and preliminary activities without them being accumulated, in principle, to those of other persons within the same jurisdiction, especially if they took place in different locations.

In this context, already in the 1990s and before, fragmentation of activities or commissionaire-like agreements that permitted foreign companies to have a substantive economic business presence in a country but avoided having a PE at all or only left to the source country the benefits attributed to a subsidiary that carried on a limited business activity could easily be implemented. To such extent the problem was perceived as acute that, already in 1991, Skaar wrote the following:

> *"the effects of the PE concept in international fiscal law have changed, in particular during the last few decades. Rather than protecting the tax base in the source State, the PE principle today has become instrumental in ensuring*

adding elements – purchasing, warehousing, delivery, advertising, collection of information, and market research".

[72] Arnold (2003), p. 91.

[73] Arnold (2003), p. 91-93

[74] E.g. Ireland.

[75] E.g. Hybrid structures in the Netherlands.

[76] E.g. Special regime in Switzerland for principals.

avoidance of source-state taxation for some economically important business operations".[77]

More importantly, he envisaged a certain evolution of the PE concept towards new standards in which, amongst others,

(1) the relevance of the fixed place of business was reduced to treat equally mobile and immobile business,
(2) more importance was attached to permanent or intense presence in a country (with a reduction in the time thresholds for these purposes),
(3) the relevance of the 'right of use test' of the fixed place of business was watered down;
(4) a less formal (an more economic) conception of the dependent agency test or the relationship between associated companies for the purposes of art. 5.7;
(5) a more substantial approach or even quantitative approach to art. 5.4. and the concept of auxiliary and preliminary activities and their relationship with other activities carried out by the same company in the same country by itself or through independent agents[78].

And, specially, he elaborated on how the concept of PE could evolve:

- By creative interpretation of the concept by tax administrations and courts.
- Tax treaties.
- Changes to the OECD / UN MC.

As envisaged by Skaar, the PE concept evolved in those three different settings. At this point, however, it is important to know how the PE concept evolved in the OECD context. The other contexts will be dealt with in other sections of this paper (especially in section 5).

3.5.2. The OECD Reaction

3.5.2.a) 1992: explicit recognition that art. 5.3. OECD MC could be abused

In 1992, a new sentence –still present today in the same paragraph-- was added to the Commentary of art. 5.3 OECD MC, para. 18, on the 12 month test that marked a significant change of perspective:

> *"The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations".*

This was an explicit recognition that there may be abuse in the case of construction PEs where contracts were (artificially) split to avoid meeting the 12 months

[77] Skaar (1991), p. 559.
[78] Skaar (1991), p. 560-570.

threshold. In fact, this change picks up the spirit of the 1970 Report which, already with regard to art. 5.4. OECD MC, considered the possibility of accumulating several activities taking place at the same place of business, or of the 1958 Report that admitted that, in cases of artificial fragmentation, anti-avoidance theories had a role to play. However, there are other considerations that push in another direction and limit the effects of this 'abuse test': the per PE approach and separate consideration of business sites --which has interpretative problems of its own in this context (what is a coherent and commercial business whole?) [79]-- and the idea of respect of business structures derived from the 1958 Report can limit the effects of the new phrase. Difficulties in applying the abuse threshold and the per PE approach / connected project test probably make the Commentary to art. 5.3., para. 18, recognize that another threshold for these purposes could be negotiated by two contracting States[80]. This is an explicit recognition that the problem of abuse can be tacked by modifying the rules on attribution of tax jurisdiction of the OECD MC, which, in itself, is also an indication of the problems that the PE concept intrinsically presents for source countries.

3.5.2.b) 1994: Abuse of dependent agents?

In 1994, para. 32 of the Commentaries to art. 5 OECD was modified and the following sentence was added:

> *"Also, the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise"[81].*

This new sentence led the UK to withdraw the reservation made in 1992 whereby this country pointed out that there might be a dependent agent within the meaning of art. 5.5. OECD MC not only where the agent (1) was not independent and (2) has the authority to conclude contracts on behalf of the foreign principal "whether in his own name or that of the enterprise"[82].

Did this represent a new direction towards a more economic view of dependent agents? Certainly, the Commentaries were going in the direction of a less literal legal interpretation of art. 5.5. but they stopped far from a more substantive view of dependent and independent agents. This new sentence, together with the withdrawal of the reservation by the UK, could be interpreted as an attack to 'commissionaire type structures' but this was not really the case. There was no modification to the concept of 'legal independence' in art. 5.7. Therefore, the change in position did not amount to a reversal of the 'legal' tradition that accompanied the interpretation of 'in the name of'. True, if the agent was acting 'on behalf' of the principal and did not sign contracts in its own name, there might be a dependent agent, but, at the same time, the legal bond should exist between the client and the principal as a consequence of the acts of the agent, if it did not exist, or even if it existed but the agent was independent (in the legal sense), there was still no PE. A step in the direction of abandoning a strict literal interpretation of dependent agent PEs was given, but it was not a big leap from legal form to a more substantial

[79] The criteria for aggregation of activities are neither clear nor easy to apply: see Reimer (2013), para. 198-219. The UN is currently working on the meaning of connected projects.
[80] See section 5.2.4.c) below on these clauses.
[81] OECD, "1994 Update to the Model Tax Convention", Paris: OECD, 1994.
[82] Para. 45 Commentaries to art. 5 OECD MC (1992).

interpretation of dependent agent PEs. Ambiguity, however, permitted the Commentary to accommodate different interpretations, and the commissionaire saga in different countries (*Zimmer, Dell Norway, Roche, Dell Spain etc.*) reveals that the issue was not put to rest with this changes[83].

3.5.2.c) The 2002-2003 'reform' to art. 5 (and 1) OECD MC

Changes to art. 5.1., 5.3. and 5.4. OECD MC

As a consequence of the 2002 Report,[84] the Commentaries to art. 5 OECD MC were substantially amended. It is important to give an overview of the new commentaries in order to check whether there was any change of position on artificial avoidance of PEs.

Allegedly, the most relevant and controversial changes in 2002 were those relating to the relationship between the enterprise and the fixed place of business, since the 2002 document and the 2003 Commentaries got rid of 'disposal' in a legal sense of the place of business in favour of a more factual test of use of an amount of space in the source State (para. 4.1. Commentaries to art. 5.1). With this change, apart from the controversy it has generated (especially with reference to the painter example in the Commentaries), it appeared that a more substantial, less formalistic, approach was finding its way into the interpretation of art. 5.1., with the consequence that 'disposal' should be interpreted more flexibly. This permitted to capture within art. 5.1. some of the most obvious ways of avoiding a fixed place in a jurisdiction (e.g. hotel rooms, working at a client premises etc.) [85]. Changes in para. 17 (on-site supervision included in art. 5.3) went also in this direction[86].

That first impression is wrong if other changes to the Commentary on art. 5 OECD MC are considered. First, the concept of fixed place was further relaxed to admit that some peripatetic business may still be fixed even if they moved from one place to another (para. 5.1.-5.4), but this fact had to struggle with the reality of different PEs and the per PE principle: if two or more places of business met the test of art. 5.1., there will be separate PEs as para. 5.1. recognizes; if some met the test and others did not, the PEs will not attract profits that cannot be attributed to them. In order to 'clarify' when the taxpayer had a single or multiple PEs, the idea of 'geographical and commercial coherence' was imported from the Commentaries to art. 5.3., where it appeared in 1977, to the Commentaries to art. 5.1.

[83] See on this problem Pijl (2013).

[84] "Issues arising under art. 5 (Permanent Establishment) of the Model Tax Convention" in OECD (2002).

[85] At this point it was clear that a home could be a PE, the following example was used by the 2002 OECD Document in connection with art. 5.2.a): "38. The Committee also discussed the case of a craftsman who owns a house in one state, of which he is a resident, and who works at various sites in a neighbouring state, where he also has a house. The Committee agreed that in that case, the craftsman's house in the other state could be considered to be a place of management, and thus a permanent establishment, to the extent that the craftsman uses that house to manage his business, i.e. if it is where he receives calls, stores his tools, prepares his accounting records, etc.".

[86] Since the disposal test was already included in the Commentaries in 1977, it can be argued that not much has changed in 2003.

These changes in para. 5.1. ff. of the Commentaries to art. 5 OECD MC represented a move in two different directions. The first and most obvious one is that the term 'fixed' is given a looser interpretation. In this regard, this move is aligned with the more flexible interpretation of the 'disposal test' mentioned above. How far this interpretation can go to capture some, per se, not fixed activities (e.g. activities on board of a ship) is not fully clear in the Commentaries. Probably a natural evolution would be that fixed be given a geographical meaning, so that what matters is the constant business presence in a certain area[87].

The second move, however, is not fully coherent with the first. By importing (from art. 5.3.) the 'geographical *and* commercial coherence' test into the Commentaries to art. 5.1., it was recognized that the activities of a single taxpayer within a jurisdiction could only be accumulated where there was a coherence whole commercially *and* geographically. In order to explain how to apply this principle in the context of art. 5.1. the OECD took refuge in examples which, contrary to the less formalistic interpretation of the concept of PE suggested by other changes to the Commentaries to art. 5.1., contributed to revitalize the per PE approach: there is no commercial coherence for the (in)famous painter that works in the same office building for different clients but coherence exists if work in the same building is performed under a single contract (para. 5.3.); there is no geographical coherence if a consultant works in the context of a single contract in different branches of the same bank, but if the consultant moves from an office to another within the same branch, there is geographical and commercial coherence, and, therefore, a PE. One may question the policy rational of the examples, but certainly they are in line with the tradition of the per PE approach: accumulation of activities of the same taxpayer in a jurisdiction by way of exception was admitted but it could not be done too lightly. Like in the precedent period, reaction against artificial fragmentations should come from the anti-abuse angle, like in art. 5.3 and the 1958 Report, although in this context there is no explicit reference to anti-avoidance rules. A difficult layer of complication was added, however: it was necessary to determine when there is commercial and geographical coherence of a project, which is not an easy task[88]. It could even be said that the commercial *and* geographical tests, as explained in the examples of the painter and the consultant, even reduced the possibilities of using anti-abuse norms to aggregate activities of a taxpayer within a jurisdiction.

Para. 20 of the Commentaries to art. 5.3. also added some more nuances in this regard:

> "where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months".

It is difficult to say that this example meets the test proposed in the Commentaries: there is commercial coherence in the example but it lacks geographical one[89]. This last paragraph is also difficult to harmonize with the 2003 additions to para. 16,

[87] See Schaffer (2013).
[88] Even it may be more complex in this case than in those falling under art. 5.3. See Reimer, (2013), para. 128 ff. on the specific problems of aggregation.
[89] Arnold (2014), p. 35.

where quite incomprehensively it is said that an office that coordinates several constructions projects each of which lasts for less than 12 months can be regarded as a PE (art. 5.1. and 2) but only profits attributable to the functions and risks assumed by the office can be taxed in the source State. Beside the fact that this statement on profit attribution does not belong to the Commentary on art. 5 OECD, it reveals that the force of attraction of one fixed place upon others is conceived as very limited and that there is a wide margin for attributing benefits to the state of residence and for avoiding taxation at source. Again, this example seem to condition the application of anti-avoidance doctrines of the source State.

Taken together, the three changes affecting geographical and commercial coherence are confusing. The change in para. 20 reveals that it would make sense to consider as a whole in the source country the activities of the same taxpayer where there is a (horizontal) connection and commercial coherence between them, the geographical coherence test, however, pushes in the direction of disaggregation. However, the changes in para. 5.1.-5.4. Commentaries to art. 5 OECD MC and para. 16 seem to go in another direction and propose a strict interpretation of the per PE principle whereby only the activity strictly linked to the geographical place where the fixed place of business exists will be considered, without connection to other activities within the same country even if they are performed also through fixed places of business where an activity is carried on that is strictly linked (from a commercial viewpoint) to that of the coordination office. As such, by aligning with a very formalistic interpretation of the PE principle, the changes in para. 5.1.-5.4. and para. 16, especially if interpreted too strictly, facilitate fragmentation of activities.

Changes to the Commentary to art. 5.4 OECD MC complemented those on art. 5.1. and art. 5.3. in another disconcerting twist. From 2003, para. 27.1 makes clear that:

> "Places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity."

Was this change really needed? The answer is not obvious. As explained above, the spirit of the considerations of the combination of activities in the 1970 Report was that economically substantive presence through preliminary and auxiliary activities in the source country could not be covered by art. 5.4. OECD MC. But the 1970 Report, on combination of activities, had in mind significant activities taking place 'in one and the same place of business'[90]. This was clear also from para. 20 and 26 Commentaries to art. 5 OECD MC 1977 (current para. 21 and 27). What did this new sentence add? If read in isolation, it could be thought it was inconsistent with the geographical coherence test applicable to art. 5.1. and 5.3. OECD MC. If read in the context of the previous sentence[91] and the changes to the Commentaries to art. 5.1.,

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[90] 1970 Report, p. 27: "The fact that, under Article 5, certain places of business are no PEs and that agents are regarded as a PE only if they are authorized to conclude contracts gives rise to the question concerning the treatment of cases in which an activity which alone does not constitute the place of business a PE is combined, *in one and the same place of business*, with another activity of this kind or with an activity which, by virtue of the definition, is to be regarded as constituting a PE" (emphasis added).

[91] "Sub-paragraph f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of the sub-paragraphs a) to e) provided that they are separated from each other locally and organisationally, as in such a case each place of

5.3. and 5.4. OECD MC it only seeks to clarify what 'organizationally' means, but this does not modify the geographical coherence test to which para. 27.1 Commentaries to art. 5 OECD MC 2010 (former para. 27) refer. Or, in other words, even if activities of subparagraph f) where combined and had commercial coherence, they could not be accumulated if they were performed in different places because they lack geographical coherence. Is not this an explicit support to fragmentation as long as the taxpayer takes care of conducting the activities in different places in the source country? If activities of the same taxpayer could not be regarded as coherent from a geographical perspective when distributed in different places, was not that more the case where the activities were conducted by different taxpayers (scattered in the source country through subsidiaries of the taxpayer or independent agents) even if they form a coherent whole from a commercial perspective? From a policy viewpoint, the outcome does not make any sense. Why is it that the activity is taxable and there is accumulation if conducted in one place but it is not if the places are separated or if the same activity is conducted by different taxpayers on behalf of the same foreign taxpayer? Once again, the change, as it was pointed out with regard to the modifications in the Commentaries to art. 5.1. OECD MC, seems to further reduce the scope of anti-avoidance theories to support fragmentation: if fragmentation is natural in art. 5 where it lacks geographical coherence and admitted, when is it going to be artificial?

Against this background, it is easy to understand the 2002 Report position on business restructuring involving fragmentation of activities, although their considerations on this issue were not added to the new Commentaries to art. 5 OECD MC. The following example was given by the Committee[92]:

> A non-resident parent company owns a resident subsidiary that hitherto has been engaged in selling both automobiles and spare parts. The spare parts storage facility is now to be hived off and treated as a separate branch of the parent company. The activities of the storage facility will be limited to the storage, relocation, and distribution of the spare parts, which will be ordered "directly" from the parent by the customers. Specifically, this means that (a) the settlement of the transactions, with regard to both contracting and accounting, is to be effected exclusively by the parent in its name and for its account; (b) ancillary activities such as settling warranty claims, installing, performing customer service, and advertising are not performed by the storage facility; and (c) the necessary staff is provided under a lease contract, and the facility's own staff is engaged merely in instructing and supervising.

The conclusion of the Committee was that the source country had lost taxing rights because the new activities conducted by the branch fall squarely in art. 5.4. The Committee made the point that the activities in art. 5.4. letters a) through d) "are always exempt and are not subject to examination for whether or not they are truly preparatory or auxiliary" since those letters were initially adopted to 'provide certainty to taxpayers that their income from those activities would be taxable, if at all, only in the country of residence' (p. 100, para. 95). Even if this could give rise to tax planning, they argued that, as long as the transaction was not *'exclusively'* tax motivated, the taxing rights should be allocated to the residence country (p. 100, para. 96). For them, the company could have commenced with that structure and it would have obtained the same result without it being judged offensive. As can be inferred easily, the example is a warm support for business restructuring and fragmentation of activities even if tax savings in the source country play a very

business has to be viewed separately and in isolation for deciding whether a permanent establishment exists".

[92] 2002 Report, p. 100-101.

relevant role in the restructuring.

In the end, it appears that the separate consideration of PEs (the so called per PE principle), reinforced by the changes in the Commentaries to art. 5.1., 5.3 and 5.4 OECD MC, as well as the legalistic interpretation of 5.4, gave an important support to fragmentation structures. For the Committee, only 'exclusively' tax motivated structures could be challenged, which means that the spirit of the 1958 Report was revived and potentiated. It could even be said that the scope of anti-avoidance doctrines and norms was reduced by the new changes. The changes reinforced the idea that significant economic presence in a country, through fragmentation, is admitted without giving rise to a PE as long as business presences, considered individually, do not meet the thresholds of art. 5.1., 5.3. or can take refuge in art. 5.4. OECD MC. A more horizontal view of the significant economic presence of a taxpayer (or a group) in the source country is missing in the new Commentaries.

The dependent / independent agent problem

Some of the developments in 2003 regarding agent PEs were rather natural and reinforced the legal form approach that permeates art. 5.5 and 5.7. OECD MC[93], but at the same time, they reveal the tensions to maintain the PE principle as it is conceived. For the first time, the 2002 Report provided a very relevant discussion on the policy behind art. 5.5. OECD since in the 1958 Report a rather sweeping assumption was made that involvement in the economy of a State was connected with signing contracts in that State[94].

First, the Commentaries clarified that an agent PE does not need to be a resident in the PE State. After the 1950s, this clarification was not really a surprise: the place or residence of the agent was irrelevant once it was assumed the habitual exercise of authority to conclude contract as the relevant threshold of presence in the economy of the source State in art. 5.5 OECD MC. The issue, however, was not clear and this is why it was explicitly referred to in the new 2002 Commentaries to art. 5 OECD MC, para. 32. Apart from technical deficiencies[95], the reasoning of the Committee in the 2002 Report is not very convincing: the dependent agent PE is presented as a sort of anti-avoidance clause for the fixed place of business, so that habitually entering of contracts in a jurisdiction was a measure of economic presence there that acted as a substitute for the fixed place of business. As such, signature of contracts is not a relevant measure of significant economic activity in a country, it is the quality of such a presence what really matters[96]. In the 1950s and before, the fixed place of business sought to tax that relevant presence of a foreign enterprise in an economy, and art. 5.4. tried to exclude from art. 5 fixed places of business that were not indicative of relevant business presence or activities that amounted to a business presence but should be encouraged to foster international commerce and reduce administrative burdens. As such, signature of contracts is not act equivalent to a fixed place of business as a measure of introduction and activity in a country. Rather, it seems to limit even more the source country rights in cases where significant

[93] Vann (2006), p. 374.
[94] Vann (2010a).
[95] As known, itinerant merchants / principals were excluded from the concept of PE when they signed contracts, but it seems that their employees, if they have the power to conclude contracts, could be regarded as PEs because they fall into the category of dependent agents. See Vann (2010a).
[96] See Vann (2010a) on this issue.

presence in the source country does not entail the signature of any contract *and* there is no fixed place of business. In these cases, it is enough to sign contracts abroad in order to avoid taxation in the source country, even if significant activities are conducted there.

Second, the meaning of the authority to 'conclude contracts' was clarified as a follow-up to the 1992 changes: the agent was presumed to have authority to conclude contracts where she did all the phases of the transaction with the client, except signing the contract if the enterprise routinely approves the transactions. The discussion of the Committee on this point was most interesting: they were aware of abusive behaviours and that was why some changes in the Commentary were needed. At the same time, they recognized that they had difficulties in identifying abuse because if the agent was paid a 'market-rate' fee there was nothing else to tax in the hands of the principal even if it had a PE. It was argued, however, that such an argument was not correct and the PE could be attributed a profit that will well exceed the arm's-length price of the reward given to the agent[97]. In the end, this is recognizing the core of the problem (the tax planning activity that can take place in the source country by using distributors or affiliated companies with limited functions), but the Committee decided simply to focus on 'rubber stamp' and if and when the acts of the agent were binding for the principal from a legal perspective. The discussion is contradictory: it seems to focus on substance and anti-avoidance but it avoided the real problem, the fact that significant activities of a taxpayer in a jurisdiction may escape taxation there if the principal acted through an agent but was regarded not to have a PE in the State of source. If a real anti-avoidance perspective had been adopted, the problem was not to know what conducts are equivalent to signing a contract, but whether the activity of the agent was binding, from a substantial or material perspective, for the principal and whether the principal had a substantial activity in the country through the agent. The issue was, however, buried to simply admit that a less literal interpretation of concluded contracts, as per new para. 32.1. OECD MC, was enough for the moment.

Third, the Committee recognized that the requirement that the authority to conclude contracts be habitually exercised could be easily avoided: it was enough to split the coverage of a source country market among a large number of agents or by systematically sending in different people to the source country to carry out the agent activities. While all the agents would have the authority to conclude contracts none of them would exercise it habitually. For the Committee these cases were best dealt with antiavoidance norms, but still they proposed to add new paragraph 33.1 to provide some guidance that 'habitually' may mean 'permanent' within the meaning of para. 6 Commentaries to art. 5 and its interpretation will also depend on the quality, frequency or intensity of the presence in the market. Again, the position of the Committee is surprising for two reasons. First, because they considered the splitting of the same activity between agents could be abusive but do not seem to accept the same conclusion with regard to splitting across different concepts in art. 5 (fixed places, auxiliary and preliminary activities, subsidiaries). Second, and more importantly, this discussion is the explicit recognition that 'habitually signing contracts' is not a measure of economic presence in a jurisdiction and, in the end, the Committee, by sending to the criteria of para. 6 Commentaries to art. 5, seems to acknowledge that significance of the activity and the fact that a person is regularly conducting such an activity within a jurisdiction is more important than habitually signing contracts.

[97] 2002 Report, p. 104, para. 109.

Fourth, changes in the Commentary to art. 5.6. OECD MC were very relevant in order to make clear when an agent is independent[98]. For this aspect, it is enough to say that the changes continued to reaffirm legal independence of companies of a group even if they were economically dependent and to separate the problem of dependency from the issue of whether a company was a PE of another.[99] These changes were very much in line with the new para. 27.1 which, as explained above, only permitted combination of business with regard to the same taxpayer as long as there was commercial and geographical coherence so even if a subsidiary was regarded as a dependent agent of the foreign principal, this would not involve that other activities of the principal in the jurisdiction (i.e. through other dependent or independent agents or fixed places of business) could be attracted and accumulated with that of the subsidiary (even if they were carried on in the same place). Relaxation of the 'disposal criterion' of art. 5.1 OECD MC, however, inevitably raised the issue –for which a solution was not provided until 2005-- of whether the premises of the dependent agent subsidiary were at the disposal of the foreign principal.

Interim conclusions on the 2002 Commentaries to art. 5 OECD MC and connection with the new Commentaries to art 1 OECD MC

A reference should be made to the new Commentaries to art. 1 OECD that in 2003 admitted the possibility of application of domestic anti-avoidance provisions in the context of DTCs. Regardless of the opinion on these controversial changes, they represented a shift in direction by the OECD from a more formal understanding or tax treaties to a more substantial one.

It may be thought that this anti-avoidance analysis entered also the Commentaries to art. 5 OECD MC, but, as explained above, this is far from true. By maintaining a too rigid interpretation of the geographical coherence test in art. 5.1., 5.3, and 5.4. OECD MC and a strict defence of the per PE approach (a principle that accompanied art. 5 OECD MC since its inception), as well as a rather literal and legal interpretation of art. 5.4. and 5.5., the Commentaries to art. 5 were fostering fragmentation of activities and commissionaire like agreements that could be used to avoid having a PE in the source State. In fact, the Commentaries to art. 5 OECD MC seem to contradict the Commentaries to art. 1 OECD MC. They set the principles on where abuse of PEs may exist and leave little margin of manoeuvre for source States: only exclusively tax motivated transactions avoiding a PE in the source country could be attacked, no horizontal consideration of significant activities of a taxpayer or group in the source country was admitted as a matter of principle, and a formal reading of art. 5 OECD MC was preferred over a more substantial or economic one. This line is not incoherent, though, with the historical evolution of the PE as an institution designed to protect 'business structures' and foster administrative simplification and international commerce, all in favour of residence countries. It may be an extreme version of the historical configuration of PEs, but certainly not incoherent with its original matrix.

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[98] 2002 Report, p. 107, para. 121 ff.

[99] The case of subsidiaries is very enlightening. Para. 38.1, added in 2003, clarified that ownership of the subsidiary by the parent did not mean legal control or dependence but, at the same time, the Committee, para. 134 recognized that "[f]or example, where the agent and principal are affiliated, the relevant comparison may rather be the business activities carried out within that corporate group" in order to determine whether the subsidiary acts in the ordinary course of its business. Both statements read together mean that (1) if the subsidiary carries on activities closely related to the parent and (2) the parent exerts a certain degree of control (legal and economic), there may still not be a PE.

In this context, other changes with regard to art. 5.1., 5.3. OECD MC that appear to favour a more flexible, less legal or formal, interpretation of art. 5 OECD MC (e.g. the controversial factual test of disposal of a place) do not seem to be aligned with the trend identified above on fragmentation of activities / commissionaire like agreements. In view of this conflicting positions of the Commentaries to art. 5 OECD MC (a more formal versus a more substantialist view of PEs), the risk of different and not always compatible interpretations of the Commentaries increased.[100]. The *Philip Morris* case in Italy is an example of it, although it is not probably a reaction to the changes in 2002.

3.5.2.d) The 2005 reaction by the OECD to the Italian *Philip Morris* Case

After the Italian *Philip Morris* case[101], where the Corte di Cassazione adopted a joint approach to groups by linking the dependence / independence test to circumstances of the group as a whole, and not the subsidiaries considered in isolation, the OECD felt the need to dismantle this attack to the legal independence of companies of a group, since this represented a fundamental change with regard to the concept of PE as it had evolved[102]. The changes of 2005 to the Commentaries on art. 5 OECD MC (which, as known, affected para. 33, 41, new 41.1. and 42) basically made clear that:

- The fact that a person participates in negotiations between an enterprise and a client does not mean that this person has authority to conclude contracts in the name of the enterprise (even if this is relevant to establish the exact functions of this person) (para. 33).

- A parent company or any company forming part of a group will only meet the PE threshold if it has a fixed place of business at its disposal in the premises of the subsidiary or the latter has the authority to conclude contracts within the meaning of art. 5.5. (para. 41 and 41.1).

- The PE test must be applied separately for each company of the group (para. 41.1).

Additionally, the OECD stressed that a company of the group, when it provides services to another company of the same group in its premises and with its personnel, is not a PE of the latter, which does not carry out a business in the premises of the former, regardless of the fact that the other company of the group may receive and economic benefit.

Like Vann points, out "the changes reinforce the separate legal entity status of associated enterprises and indicate that it is not generally possible to pierce the corporate veil and attribute the acts of one associated enterprise to another on the

[100] Vann (2006), p. 374-375.
[101] Judgement of the Italian Corte di Cassazione of 7 March 2002, n. 3667 and 3368. This case was the first of a number of decisions that are substantially identical, see, for a summary of the decision, the IBFD's Tax Treaty Case-Law Database.
[102] This fact was recognized by the OECD in a document available on internet ("OECD Work on the PE definition", on www.uscib.org/docs/OECD_Note_PE_Definition.pdf.). The document expressly recognized that the 2005 changes were motivated by 'clarifications that business and some member countries have asked the OECD to make following a well-known court decision". For a summary of this case and others on groups, see Schoueri & Günter (2011).

basis of a deemed agency or place of business"[103]. In this regard, the 2005 additions are aligned with the 2002 changes to the Commentaries to art. 5 OECD MC that reinforced the per PE principle and the formal interpretation of para. 1, 3, 4, and 5 of art. 5 OECD MC.

If the Italian court was simply trying to apply a substance over form principle, this was not inconsistent with the OECD MC, especially after the Commentaries to 1 accepted the compatibility of anti-abuse rules and doctrines with DTCs,[104] and the factual 'at the disposal test' admitted after 2003. However, it is true that the *Philip Morris* decision was not very much in line with the formal (fragmentation friendly) interpretation of para. 1, 3, 4, and 5 of art. 5, which was reinforced after 2002, and it is natural that the OECD wanted to clear the doubts the Philip Morris decision created. More tensions would soon appear, and cases like *Roche* or *Dell Spain* are sons of the contradictory evolution of the Commentaries in this regard and the dissatisfaction of some countries with the situation. To make the matters worse, the same OECD document that explained the changes to para. 33, 41, 41.1., 42 as a reaction, on request of business, to *Philip Morris* announced further changes as a consequence of the work in the OECD on business restructuring, this would include examining 'commissionaire arrangements' after the OECD seemed to give such arrangements its blessings in the 2002 Report[105].

3.5.2.d) The OECD works on attribution of profits to PEs and the OECD Transfer Pricing Guidelines

Although attribution of profits to PEs, as well as transfer pricing, is not an issue to be dealt with in this paper, a reference to these issues may help understand much of the tax planning to avoid PEs[106]. As explained, transfer-pricing rules have often been criticized as giving rise to artificial results, since they facilitate that the residual value obtained by a group of companies will be included within the taxable base of the place where headquarters of a company are located. The freedom of contract between associate companies also helps obtain this result. In fact, conversion of full fledged manufactures in toll manufactures and distributors into commissionaires very much relies on the possibility of associated companies to move risks by legal contracts: by shifting risks from one company to another, the contract manufacturer or commissionaire is remunerated usually on a cost plus basis, therefore, reducing the corporate tax base in the country where the subsidiary is located. Preference in the 1995 OECD Transfer Pricing Guidelines for traditional methods of valuation (e.g. cost-plus) has promoted this result: the local subsidiary is remunerated on a cost-plus basis that permits to allocate the most part of the profit to a foreign parent or associated usually located in a favourable tax environment. This result was very much in line with the assumptions of Carroll in the League of Nations period, as explained above. After 2010, with the revision of Chapters 1-3, and specially Chapter 2, of the Transfer Pricing Guidelines, hierarchy of methods was eliminated –now there is a most appropriate method rule-- although a certain preference for traditional methods over transactional profit ones (e.g. profit-split) is still kept in the 2010 TP Guidelines[107].

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[103] Vann (2006), p. 374.
[104] Arnold (2014), p. 63.
[105] OECD Work on the PE definition, p. 2.
[106] The analysis by Vann (2010), pp. 321, has been particularly useful for this section, even if there are differences in the analysis and conclusions.
[107] See, for instance, Silberztein (2011), p. 153; Maisto (2011), p. 177.

To the extent that the PE threshold, as explained, does not provide a measure of economic presence in the source country or permits to avoid taxable presence there, it produces a similar result to transfer pricing: the residual taxable base goes to the residence country at the expense of source countries. As a matter of fact, fragmentation and commissionaire structures use both transfer pricing and PE thresholds as mutually reinforcing tax planning tools.

The OECD works on attribution of profits to PEs (mainly the 2008 and 2010 Reports), which have been developed from 2001 onwards, have also had an impact in current developments and attitudes of taxpayers and tax administrations[108]. Two main features of the Reports on attribution of profits stand out. First, since a PE is part of an entity, unlike between associated companies, there is no possibility of contractual allocation of risks within the same corporation. Under the 2008 and 2010 Reports, for attribution of profits, risks follow functions and functions are located where significant people in a corporation carry on their job; capital and assets are to be allocated to where significant people functions are[109]. Second, the Reports gave support to the dual taxpayer approach with regard to attribution of profits, especially for dependent agents. Under this approach, if the dependent agent PE assumes functions, assets or risks above those attributed to the dependent agent company (associated company of the same group), those additional profits are also taxable in the source State in hands of the enterprise having the PE. The dual taxpayer approach is not inherent to the AOA, and could also be applied in the context of the traditional attribution of profits[110]. As a matter of fact, the 2008 Report –which also recognizes the dual taxpayer approach-- is attributed an important function with regard to art. 7 OECD MC 2008 (and previous versions of that article), which follows the traditional approach to attribution of profits to PEs.

The OECD Reports on attribution of profits have worked in two directions that may contribute to explain why conflicts around PE structures have proliferated:

- *For tax advisors, the new approach provided an important tax planning tool:* if significant people functions are located in favourable tax jurisdictions this would mean that most important profits of a company would go with them (risks follows functions, and functions are identified with significant people within the company)[111]. Constant travelling of this people in and out of the source country, as long as it does not create a PE, only has the effect of

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108 It should be reminded in this regard that the 2008 Report has an important impact in the interpretation of art. 7 OECD MC (1963-2008), and the 2010 Report mainly projects its effects upon art. 7 OECD MC (2010-2014). This means that the Reports projects their effect upon existing tax treaties and new ones that follow art. 7 OECD MC 2010.

109 Report on Attribution of Profits (2010), para. 15: "Accordingly, the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE".

110 For examples of use of the dual taxpayer approach, in cases involving subsidiaries and PEs of the same group or commissionaire agreements, see Australian Taxation Office, *Attribution of Profits to a Dependent Agent PE* (last modification 26 October 2012), last visited 11 July 2014); or the UK HM Revenue & Custom's International Manual, at Intm441040-441070, "Transfer Pricing: Transactions and Structures: business structures: marketing and distribution –commissionaires" (last visited 11 July 2014).

111 See Vann (2010), especially pp. 326.

removing more profit from that jurisdiction if 'services' are provided there. Probably, this approach is flawed because it tends to ignore that a company is much more than 'significant people' and that all parts of the firm, and especially employees but also other associated companies and subcontractors, contribute to profits[112]. Combined with the PE thresholds and the freedom of contract to allocate risks between associated companies, the final result is that it is relatively easy to remove profits from the country of sale or manufacture of a product (through contract-manufacture agreements combined with fragmentation and / or commissionaire agreements if the country is also a relevant market), provided significant people are in the right place[113].

- For tax administrations, the OECD Reports and the importance they attribute to risks and significant people functions has given them an important tool to attack traditional fragmentation and commissionaire-like agreements[114]. In a peculiar interpretation of the principle that risk follows functions, some tax administrations have identified that where functions and risks are in fact, not in law, in a source country a PE may exist[115]. Relaxation of some of the criteria to interpret PE thresholds after 2003 has contributed to reach this outcome. Intuitively one may thing that the solution to the problem of undertaxation of groups in the country of source should be provided at the level of the subsidiary by increasing its profits. If this is not possible, and emphasis on contractual freedom of associated companies render it more difficult, the only way of correcting the undesirable result is by attributing to a PE of the parent in the source country all or part of the residual value obtained by the parent company from activities in the source country[116]. In fact, it seems that both strategies have been used by tax administrations as mutually reinforcing: sometimes the PE argument is used as a "sword" to reach a more balanced result in the transfer pricing area.[117] Even if, in

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[112] Vann (2010), p. 330-332. For him, contrary to the usual assumption, profits from services provided by significant people should be located where they are used (in modern corporations it is increasingly difficult to know the place of provision of services). The OECD MC, however, does not permit the source country to tax those services, especially if the PE threshold is avoided.

[113] Vann (2010), p. 337.

[114] Collier (2013), p. 640.

[115] The following excerpt from the UK H&M Revenue & Customs International Tax Manual, section INTM441050 illustrates this statement: "The principal, through the UK commissionaire, is participating in the selling activity in the UK; the selling activity is the source of the profits of the PE. In the example, the profits included in the accounts for the principal are derived from the inventory and debtor functions and risks and the residual profit. Attribution of profit between a principal and a PE in another country involving the transfer of function and risk cannot be dictated by a legal agreement alone - there must be a detailed consideration of whether in fact the risks and functions lie with a PE or the principal overseas. Once the functions and risks have been allocated between the PE and the home territory of the principal, appropriate profits can be allocated to those functions and risks. It will be simpler to establish a reward for the activities, which relate to ownership of the assets, such as managing and insuring stock. A cost-plus method could be used, leaving the balance of the profits from the overall selling activity to be allocated to the PE".

[116] See Vann (2006) and (2010).

[117] In this respect, Muller (2011), p. 53, of the Maerks-Group emphatically pointed out: "You always know when you have a subsidiary. PEs, especially dependent agent PEs, can appear out of nowhere. In various countries inside and outside of the OECD, the opening move of an aggressive tax authority will be to claim the existence of a PE. E.g. some tax authorities argue

theory, other solutions would be more theoretically desirable, the current interpretation of the PE concept in a formal way by the OECD is a limit to a more active use of this institution[118].

This section would not be complete without a reference to Chapter IX of the OECD TP Guidelines (2010). The new chapter –which is more focused on parent and subsidiaries— deals extensively with conversions of full-fledged into limited-risk distributors or full-fledged manufactures into contract or toll manufacturers, but does not focus on other activities of the group in the jurisdiction of the converted entity or how they are linked with the entity that was converted. Indeed, Chapter IX considers that if the stripped entity still has assets, risks and functions affected by the restructuring, not all the residual value can be allocated to the foreign associate[119], the same effect can be attained if the disregard principle is applied[120]. But if the stripped entity does not keep any of those assets, functions and risks, the transaction will be upheld for transfer pricing purposes, and no other relevant asset, function or risk in the State of source can be attributed to such an entity, the residual value should go to the State of residence of the foreign company. Chapter IX clearly opts for respect of legal independence of associated parties so legal control over the risk, functions and assets by the parent acts, in principle, as a barrier for profit attribution to the subsidiary. The disregard principle is not an effective tool in this context either for two reasons: (1) the as-structured principle the OECD Guidelines recognize and protect gives priority to form over substance in the first place, with the effect that the group is not considered as an entity in itself and the reality of

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that entities carrying no risk must be dependent agents for those entities carrying the risk instead. To date many of these disputes end up in transfer pricing settlements, where it is acknowledged by the taxpayer that the local entity does in fact carry some risk, and therefore should receive an increased compensation".

[118] See Vann (2006), p. 376-380 for a criticism of the authorized approach as applied by the OECD to dependent agent PEs. He ends his criticism by proposing a solution: "If a PE is avoided on legal form grounds even though not independent, it is necessary to have recourse to the associated enterprises article to capture the profits in the country of the alleged PE. The second problem relates to . . . use of legal form based on separate legal entities and the respect for transactions to shift the residual more or less at will (taking care to relocate a bit of brainpower at the same time) . . . If PEs could be created on an economic substance approach (based on independence for the boundary of the firm) with real profits attributed to them for significant activities in a country regardless of playing with risks between associated enterprises, the residual might end up where it seems to belong. Alternatively if transactions between associated enterprises were less sacrosanct than they are now an a realistic value approach were taken to allocation of residual profits, again it would be more likely that profits align with reality" (p. 380). Vann proposes to solve the current problems in the following manner: "(1) the independence criterion should be used to conceptualize the firm and its boundaries, the recognition of separate legal entities in international taxation and the concept of the firm based on common ownership has been the source of much confusion since independence has been relegated to a secondary role to legal form (treaty provisions could be re-interpreted to reverse the current situation); (2) the use of legal form to oust economic substance needs to be recognized and addressed . . . independence can be made concrete by treating associated enterprises in the sense of common ownership as PEs of each other unless it is established that they are legally and economically independent. In this way legal form would not stand in the way of substance, but rather assist it. It would again be possible, though more daring, to reach this result by treaty reinterpretation. The PE definition could be regarded as incorporating a concept of independence. Both the fixed place of business and the agency PE provisions could be interpreted in this light. The provision on associated enterprises not constituting a PE would only apply if the enterprises are in fact independent".

[119] See Chapter IX TP Guidelines, para. 9.146.

[120] See Part IV Chapter IX TP Guidelines.

individual subsidiaries is taken as the useful parameter[121],(2) the configuration of the arm's-length principle in itself since, as long as, comparable transactions can be used as a benchmark, it cannot be argued that the transaction should be disregarded even if, as a whole, it contains elements of artificiality.

Chapter IX is in line with art. 5 OECD MC, especially with para. 6 and 7, and the legal independence principle to which it serves. As a matter of fact, it can be said that it can act as a shield for much of the tax planning business restructuring based on contract-manufacturing and commissionaires[122]. But above all, Chapter IX explains why some tax administrations have identified PEs strategies as a useful tool to attack tax planning based on business restructuring conducting to fragmentation and commissionaire agreements: if well prepared and executed, those transactions are difficult to attack from a transfer pricing perspective.

3.5.2.f) *The more recent works by the OECD on art. 5 and PEs*

As known, right before the BEPS Action Plan, the OECD published two drafts (2011 and 2012)[123] on the concept of PE. The OECD considered and provided clarification for a vast array of issues, some of them closely related to BEPS Action 7. As Collier summarized, the business reaction to the proposed changes was not good, there were concerns about lowering the PE threshold and, moreover, a sense of uncertainty was transmitted with the meaning that the bright line test for PEs was being diluted and, therefore, not clear to business[124].

And it is true that the proposed changes were somehow confusing since, with regard to some issues, they go in the direction of reinforcing (legal) independence and the current interpretation of the Commentaries to art. 5 as explained in previous sections (e.g. cases of contract manufacturing or cost tollers, whose premises are not deemed to be at the disposal of the foreign parent[125], some paragraphs on application of anti-fragmentation rules in art. 5.4. OECD MC OECD which are only relevant with regard to the same company and not for fragmentation of the same activity within a group of companies or with independent agents[126], interpretation

121 Chapter IX TP Guidelines, para. 9.178 emphasizes: "However, it is worth re-emphasising that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business (see paragraph 1.6). As a consequence, it is not sufficient from a transfer pricing perspective that a restructuring arrangement makes commercial sense for the group as a whole: the arrangement must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the arrangement (i.e. consideration of the post-restructuring arrangement plus any compensation payments for the restructuring itself), and realistically available options".

122 Para. 9.182 manifestly recognizes this: "Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring (see paragraph 9.178)" [see the previous footnote with para. 9.178]. See also, for instance, example A in para. 9.188 Chapter IX TP Guidelines.

123 OECD (2011) and (2012).

124 Collier (2013), p. 640-641. See OECD *Public Comments on the revised definition of the PE (art. 5) of the OECD MC*, and, for instance, the comments by BIAC of 31 January 2013.

125 Revised Draft on art. 5, pp. 8-9.

126 Revised Draft on art. 5, p. 24-28.

of art. 5.4. OECD MC[127], refusal to clarify the meaning of independence because it may require changes to art. 5.6 and further study[128]) whereas others seem to assume a more economically or substance oriented approach (e.g. deeming home offices[129], ships[130], temporarily recurrent or intensive short duration activities[131], subcontracting by a general contractor of all of its activity[132] as PEs in certain cases, suggestions that an economic interpretation of the term dependent agent might be compatible with art. 5.5. to consider some commissionaires as PEs[133]).

Reflections in the OECD Draft 2012 on para. 27.1 Commentaries to art. 5 OECD MC deserve a closer attention. As an answer to the question whether such a paragraph could be used against fragmentation of activities resulting from business restructuring, the Committee, para. 104, remarked:

> " . . . no changes should be made to the Commentary with respect to this issue because paragraph 27.1 of the Commentary deals with the combination of activities carried on by a single enterprise at different locations in a given State and is therefore not relevant in the situation where a foreign enterprise maintains places of business covered by the exceptions of Article 5(4) and a converted ('stripped') local enterprise is also carrying on in that State activities that were previously carried on as a full-fledged operation. The Working Party also noted, however, that such situations could, depending on the circumstances, be addressed through the application of legislative or judicial anti-abuse rules (as was the case for the fragmentation of contracts referred to in paragraph 18 of the Commentary)".

Para. 105, however, noted that:

> 'in practice, a better approach will often be to examine whether the various local companies have received an arm's-length consideration for their activities'.

The two paragraphs are indeed surprising. First, as explained above, para. 27.1 only applied to combinations of activities within the same place of business, but the Working Party seems to assume that it applies to combination of activities that lack geographical coherence, which is certainly 'quite an innovation' (this interpretation would make it easier to fight against fragmentation of activities of a single taxpayer, but would call for a reformulation of the geographical coherence test in the context of art. 5.1. and art. 5.3. OECD MC). Second, if para. 27.1 can apply to combinations that lack geographical coherence, as the Working Party (wrongly) assumes, what is the reason that prevents applying that paragraph to the situation it describes in para. 104? Is it legal independence of the parties? The 1970 Report, that formed the basis of the Commentaries to art. 5 explicitly recognized that combination of activities of a taxpayer and a local subsidiary should be considered from the perspective of the economic cycle performed in the source country, so once the Working Party assumes that geographical coherence is not a problem, it could be interpreted that para. 27.1 applies to the situation they had in mind unless a very formal / legal interpretation of the concept of independence is assumed (as it is the case with the Commentaries to art. 5, as the changes following the *Philip Morris* decision clearly show). Third, the recommendation of the Working Party to deal

[127] Revised Draft on art. 5, p. 30 ff. (on letters a) and b) of art. 5.4. OECD MC).
[128] Revised Draft on art. 5, p. 37-38.
[129] Revised Draft on art. 5, p. 9-11.
[130] Revised Draft on art. 5, p. 11-12.
[131] Revised Draft on art. 5, p. 13-15.
[132] Revised Draft on art. 5, p. 17-19.
[133] Revised Draft on art. 5, p. 33-35.

with these situations in the context of anti-avoidance measures is understandable and connects with the traditional view in the 1958 Report that fragmentation of activities could be deal with anti-avoidance provisions when an exclusive tax motive was identified.

The recommendation also sheds light upon the fact that the 2012 Draft has also affected (or tries to put to rest) the strategy of some tax administrations of finding PEs of foreign companies in situations of typical tax planned business restructuring. Many of the changes –described above as reinforcing legal independence-- regarding the relationship between parent and subsidiaries in the document have this goal. What is really striking is that (1) para. 104 compares the situation with that of fragmentation of contract in para. 18 Commentaries to art. 5 OECD MC, which refers to the very different problem of computation of the 12 months threshold, although this reference should probably be interpreted with the meaning that it recognizes an entry gate for domestic anti-avoidance doctrines, but then, what is the effect of the geographical coherence test?; (2) para. 105 refers back, as the preferred alternative, to transfer pricing rules when Chapter IX OECD Transfer Pricing Guidelines clearly revealed the limits of transfer pricing rules in cases of business restructuring and they can be used as a shield against attacks by the more aggressive tax administrations.

In a nutshell, the OECD Drafts on art. 5 seem to continue the tradition of history and, above all, the 2002-2003 changes. If any, the reaction to fragmentation of activities must come from the angle of anti-avoidance doctrines, but, as explained above, after the 2002-2003 changes, the scope for those doctrines in the context of art. 5 OECD is very limited unless it is interpreted that they are downplaying the role of geographical coherence, which would be a very relevant innovation. On the other hand, explicit recognition of a more economically oriented approach to dependent agents PE goes in the opposite policy direction, and can only contribute to create ambiguity, uncertainty and different interpretations of art. 5 OECD MC.

3.6. Conclusion: The standard for 'artificial avoidance' of PEs in the OECD MC

The historical evolution of the PE concept shows that it was born and has evolved, like Janus, as a two-faced institution. It is a threshold permitting source State taxation but it is also a limit in favour of exclusive residence State taxation and, for the reasons explained above, has historically been interpreted with a meaning favouring the latter rather than the former. As a consequence, the PE has created a dissociation between the idea that a source State should tax 'substantial participation' within its economic life and the taxation rights that can be claimed upon that participation: if there is no fixed place of business or dependent agent with authority to conclude contracts, there will be no source taxation for business profits, regardless of the level of economic penetration in the life of the source State. In an economy based on immobile factors, there seemed to be more alignment between the PE tests and economic presence in the State of source; today, changes in economy, communication or business models have contributed to make dis-alignment between economic presence and PEs more acute.

Several conceptual assumptions contribute to disaggregate or fragment 'business presence' and taxation in the source country, therefore, contributing to distance PEs from the main goal of the BEPS Action Plan (ending the artificial segregation of taxes and activity). First, the so-called per PE principle and the configuration of PEs and business presences of a taxpayer or a group as, in principle, horizontally independent from each other. The application of the PE concept to a stream of income and not to a taxpayer makes it possible to have a considerable economic penetration in the source State without being taxed at source. It is enough that each stream does not meet the thresholds of art. 5 OECD to obtain that result. The per PE principle and the geographical coherence test, as applied especially with regard to art. 5.1., art. 5.3. and art. 5.4 (with regard to accumulation of activities), maximizes this effect. The legalistic interpretation of art. 5.4., on the possibility of accumulating different activities of the same taxpayer or a group, and art. 5.7, which enables a strict separation of companies of the same group if they are not in fact independent, has potentiated the residence bias of the PE institution.

Some guiding principles on how and when the per PE principle should not apply or dilution of the importance of legal independence and formal interpretation may contribute to achieve a result which is more aligned with the main goal of BEPS; these changes can be incorporated in the Commentaries, but require a substantial revision of them and, certainly, would not be coherent with the historical evolution of PEs in the OECD context.

Second, the system of attribution of profits admitted in the OECD MC, the OECD Transfer Pricing Guidelines and the Reports on Attribution of Profits have also helped create further distance between economic activity in the source State and taxable income there:

(1) Profits can only be attributed to a PE for the activities (risks and personal functions) of that specific PE without attracting other presences in the State of the same taxpayer of or others of the group. As mentioned, guidelines on when the per PE principle does not apply and a less formal interpretation of it may be useful in this regard.

(2) The special importance of risks and significant people functions in the attribution of profits make it possible to move people in order to obtain a desired result. Therefore, a more balanced focus on the contribution to the profits of all parts of a company or a group may help fight against the more usual tax planning devices.

(3) The traditional view of companies within a group as independent parties and remuneration of subsidiaries as service providers has had the effect of transferring 'residuum' of the profits of the group to the State of residence, making it possible to minimize the tax base in the State of source. Again recognition of the real contribution of the subsidiaries to the profits of the group, regardless of legal forms and distributions of risks in legal terms, may help align activity and taxable base.

Third, when conceptually adhering to the PE, the 'founding fathers' of the OECD MC made a deliberate choice between two competing goals: facilitating trade and reducing administrative burdens to international trade, on the one hand, and prevention of tax avoidance on the other. The history of PE reveals the clear 'bias' toward free trade and respect of business models it carries with it, as well as the limited role that was assigned to prevention of tax avoidance, which was conceived as a tool of very last resort. By making that choice, the anti-avoidance threshold was placed very high, at a level where only the most aggressive, exclusively tax driven structures, could be attacked. What BEPS reveals is that time is ripe for a more balanced consideration of the two goals after historically the OECD works have mainly promoted one of them.

Not all countries have readily accepted this status quo. Ambiguity and lack of clarity in the Commentaries to art. 5 OECD MC have fostered attempts to rebalance the alignment of economic presence and taxable rights with regard to PEs by, more or less, aggressive interpretation of the Commentaries to art. 5 OECD MC. In this respect, the Commentaries –unclear or contradictory as they may be after evolution of more than half a century-- give room for manoeuvre and might, if reformed, substantially, contribute to realigning the function of the institution (taxing economic presence in the source country) with its current form by watering down the impact of the per PE principle and the geographical coherence test (or laying down principles for horizontal consideration of activities in the source country). This would require admission of a less literal interpretation of art. 5.4. and art. 5.5., and, also, rethinking the concept of independence of the entities of a group. The choice made by some tax authorities of using the PE as a weapon is a reaction to the current unsatisfactory situation where PEs are described as a 'minefield'[134] or institutions that 'appear out of nowhere'.[135]

In a context where promotion of trade / administrative simplification have been the prevailing goals and reactions to avoidance of PEs is limited to extreme cases, it is difficult to say that there is artificial avoidance of PEs. However, a sort of benchmark could be the following:

A) With regard to a single enterprise:

- It should be assumed that with current thresholds in art. 5 OECD MC some business models cannot be captured by the PE threshold, especially in the service and digital economy sectors. This is not a problem of artificial avoidance since current business models may permit to work without long presence within a jurisdiction for strictly business motivated reasons.

- Once no legal title is required to carry on an activity through a place of business, the margin to include within art. 5.1. OECD MC non-permanent or entirely fixed activities increases (so have the doubts as to when a place is fixed).

- Aggregation of different fixed places of business of art. 5.1. OECD MC of the same enterprise to make them meet the PE threshold is the exception and not the rule. This will only occur if the activity is 'geographically ***and*** commercially coherent', which is not easy to interpret. Geographical coherence is a serious obstacle for aggregation of 'fixed places' on the one hand, and for aggregation of fixed places and agents (either dependent or independent), on the other.

- Literal interpretation of art. 5.4. OECD MC, especially after para. 27.1 Commentaries was reformed, is also a serious hurdle to aggregation of activities of the same taxpayer when all of them, if consider separately, may seem preliminary activities but together they meet a business cycle in the source State. Again, and contrary to the assumptions of the 2012 Draft on art. 5 OECD, geographical coherence is a serious hindrance for aggregation.

[134] Collier (2013).
[135] Muller (2011), p. 53.

- With regard to art. 5.3., it should be taken into account that changes regarding the computation of the period of 12 months for general contractors and supervisory activities may also have an important anti-abuse function (even if they are incoherent with the respect of business models proclaimed in the 1958 Report) because, in the end, attribution of the period of subcontractors or of supervisory and preparatory activities to the general contractor or supervisor avoids fragmentation of contracts in order not to meet the 12 months period or limits the possibility of stripping tax bases from the source country[136]. Even if the Commentaries refer to 'part of' the work, the changes proposed by the OECD in the discussion drafts on art. 5.3. that refer to subcontracting 'all' of the work could be read into the current Commentaries if the contract is fully fragmented to avoid source taxation. It is important to remark that not all countries (e.g. Germany, Austria) would accept the position proposed by the OECD that a general contractor subcontracting all of the work performed in the State of source would have a PE there[137].

- At least with regard to art. 5.3., the effects of this anti-abuse rule are reduced by para. 16 Commentaries to art. 5.3., which considers that where there is an office that serves several construction projects, it should be considered in isolation and profits should be attributed according to the functions, assets and risks assumed by the office in the country of source[138].

B) With regard to different taxpayers /associated companies:

- The strong presumption of independence in favour of associated companies in art. 5.6. and 5.7 OECD MC, together with transfer pricing rules, has permitted a reduction of taxable basis in source countries while keeping a strong business presence there, as long as the PE tests are not met by individual companies of the group. As a matter of fact, this situation has played in favour of fragmentation of activities of associated companies in a country and has facilitated tax motivated business restructuring and planning with commissionaires like agreements and contract-manufacturing. By far, together with the per PE principle, this is the most

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[136] There are multiple cases where this could occur either between associated or unconnected companies. For instance:

- Company R subcontracts company CR, both residents in country R to build a hotel in State S, company R spends there 7 months and company CR other 7 months.
- Company R sets up a subsidiary in State S and subcontracts part of the same project (hotel) to the subsidiary with the effect that Company R only spends at the site 7 months.
- Company R subcontracts all the work regarding the hotel with company CR and subsidiary in State S so that the company does not spend on the site more time than that strictly needed to supervise the work (e.g. an employer goes there once every two weeks and spends two days there).

[137] See Somare, Turcan and Zeiler (2014), p. 226-228, on the position of Austria, Czech Republic, Estonia, Poland.

[138] The paragraph refers to the case of an office or workshop that assumes functions that refer to projects of less than 12 months but the same can be assumed to apply in cases of different projects of more than 12 months as long as the risks, functions and assets of those projects are not functionally connected with the 'office'.

important factor that permits disaggregation between presence in a country and income taxed there.

- Art. 5.3. OECD is an exception to independence of associated companies and, for the first time as far as this author is aware, it recognized a case of abuse where 'contracts' were divided in several parts among companies of the group in order to avoid the 12 month threshold. This exception has a limited scope for the following reasons:

    - This limit applies within the context of a single project with commercial and geographical coherence, a test that is also required by art. 5.3. (with the same difficulties and problems of art. 5.1), but not with regard to other projects which are not connected geographically *and* commercially. This means that the Commentaries on art. 5.3. OECD MC on subcontractors and supervisory activities (para. 17-18), which as explained above, are a move in a more substantialist direction, only apply with regard to single projects, which means that there is a wide margin for planning for associated companies acting as contractors / subcontractor / supervisors as long as the projects are separated and art. 5.3. is applied to every project with geographical coherence in a separate manner.

    - Again, these considerations in the Commentaries should be read against the principle of respect of different parts of the same group of companies and business models, which further reduces the possibility of challenging the splitting of contracts.

- The 2012 OECD Draft on art. 5 has proposed to deal with fragmentation of activities to benefit from the exceptions in art. 5.4. with legislative or judicial anti-avoidance rules or, better with transfer pricing audits. However, in view of how business restructuring is protected by Chapter IX of the OECD Transfer Pricing Guidelines or in the 2002 OECD Report, or the principle of respect of business models and legal independence, attacks seem to be limited to cases where fragmentation is *exclusively* tax motivated. The same approach to art. 5.4. should apply for the interconnection of other paragraphs of art. 5 OECD MC and aggregation of different presences of associated companies not meeting the fixed place of business requirement or the dependent agent PE test.

- It is also surprising that, in view of the evolution and interpretation of art. 5.5. OECD MC, the 2012 OECD Draft suggested in para. 109 that an economic interpretation of art. 5.5. OECD MC was admissible.

The latter leaves a narrow scope for anti-abuse rules in the context of art. 5 OECD MC, since they cannot denature the historical configuration of the PE as it is currently defended by the OECD: if the PE concept, for the reasons explained, produced a dislocation between economic presence and taxation rights of the source country, the fight against artificial avoidance cannot align those concepts regularly in a manner not sought by the PE as an institution. Full alignment of source country economic presence and source country taxing rights can only be achieved through mutation of the concept of PE, or replacement of it by another one, being the former and not the latter probably the easiest option, as already explained.

No doubt, the Commentaries to art. 5 OECD MC are not binding for States neither in form -- they are not law of the land in individual States, if anything they are supplementary means of interpretation of tax treaties-- nor in substance -- contradictory statements and lack of clear policy orientation make them very vulnerable. But States should know that too aggressive 'interpretations' of art. 5 and its Commentaries may place them in an awkward situation from an international perspective (see below on the *Roche* and *Dell* decisions in Spain or above on the *Philip Morris* decision in Italy).

4. The UN Model and artificial avoidance of PE status

4.1 Differences between the UN and OECD MC

The differences between the UN and the OECD MC regarding the PE concept are well-known and this paper will only mention them very briefly:

- Art. 5.3 UN MC has two paragraphs[139]:

    - Art. 5.3.a) UN MC is broader than art. 5.3 OECD MC since it covers assembly projects and supervisory activities (even if a similar interpretation of art. 5.3. OECD MC is suggested by the Commentaries to art. 5) and the time limit for a PE to exist is shorter (6 months instead of 12).

    - Art. 5.3.b) UN MC includes a provision that permits the source State to tax the provision of services in source State, provided they refer to a project or connected projects, for a period aggregating more than 183 days in any 12-month period commencing or ending in the year concerned (a similar provision is included as an alternative in the OECD Commentaries to art. 5 OECD MC).

  A controversial issue, however, is whether the geographical and commercial coherence requirements apply to projects under both letters of art. 5 UN MC. Para. 11 of the Commentaries to art. 5 UN MC, however, explicitly accepts para. 18 of the Commentaries to art. 5 OECD MC, which means that the geographical and commercial coherence test also apply with regard to art. 5 UN MC. However, the effects of such a paragraph should probably be limited to letter a) since the main reason for the existence of art. 5.3.b) is precisely to avoid the geographical coherence test.

- Art. 14 UN MC refers to independent personal services, which may be taxed at source if they are connected with a fixed base or physical presence in the source country. This article may have some interaction and pose interpretative problems with both deeming provisions in art. 5.3 OECD MC. However, it extends the source country rights to cover not only the remuneration of the enterprise, as in art. 5.3.b) UN MC, but also the remuneration of the individual providing services to that enterprise. The

[139] As Arnold (2014), p. 36 points out with regard to art. 5.3.a) UN MC there is a much stronger argument that it is a deeming provision (does not have to meet the art. 5.1. requirements, fixed base) than art. 5.3. OECD MC.

differences between the PE and the fixed base concepts for some countries are also arguments to retain art. 14 UN MC in tax treaties.

- Art. 5.4. UN MC, unlike art. 5.4. OECD MC, excludes delivery of goods from the preliminary and auxiliary activities of letters a) and b). In this regard, the Commentaries to art. 5.4. UN MC, para. 17, explain that "[t]he deletion of the word 'delivery' reflects the majority view of the Committee that a 'warehouse' used for that purpose should, if the requirements of paragraph 1 are met, to be a permanent establishment". It seems, however, that the Committee defends that little income can be attributed to this activity (para. 21 of the Commentaries to art. 5.4. UN MC).

- Art. 5.5. UN MC adds to the normal dependent agency PE, a person not having authority to conclude contracts but habitually maintaining (in a contracting State) a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of an enterprise of the other contracting State. There seems to be some flavour of fighting commissionaires agreements with this provision when the Commentaries mention that: "Some countries believe that a narrow formula [on art. 5.5.] might encourage an agent who was in fact dependent to represent himself as acting on his own behalf". It is interesting to note that the Commentary to art. 5.5. UN MC, para. 26, still reflects that the former Group of Experts, with regard to the 1999 UN MC, thought that (1) 'if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a PE; (2) 'if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of goods or merchandise, a permanent establishment may exist'. The independent agent of art. 5.7 may be interpreted as an exception to this paragraph, which makes the effect of it very limited, especially if it is considered associated companies are, in principle, regarded as independent (this may explain why the Committee explained with regard to art. 5.4. that having a warehouse for delivery is to be attributed very little income).

- An insurance proviso (excluding reinsurance) is added in art. 5.6 UN MC whereby a PE is deemed to exist if the foreign enterprise collects premiums in the territory of the other State or insures risk there through a dependent agent.

- Art. 5.7. UN MC (the independent agent provision equivalent to art. 5.6 OECD MC) adds a sentence considering that the agent loses independence "when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their financial relations which differ from those which would have been made between independent parties".

- Art. 7.1 UN MC follows a limited force of attraction principle whereby the profits of a PE also encompass, apart from those connected with its activities, the (1) sales of good or merchandise of the same or similar kind sold through a PE and (2) other business activities carried on in the PE state of the same or similar kind as those effected through the PE are attributed to the PE. This is conceived of as an objective rule, as it is shown by the observation of some States that the limited force of attraction rule should

> not apply where an enterprise 'is able to demonstrate that the sales or business activities where carried out for reasons other than obtaining treaty benefits' which 'recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment' (para. 7 Commentaries to art. 7 UN MC).

Last but not least, the current work of the UN on the possibility of adding a service article in tax treaties is very relevant since, in the end, it will considerably lower the threshold for taxation of activities in the host State. The current work on connected projects for the purposes of art. 5.3.b) UN MC may also help accumulate several business presences in the source State.

4.2. The anti-abuse standard for PE avoidance of the UN MC

The first effect that can be observed in the UN MC is that by lowering the PE threshold the source country has more rights and less profits escape their tax net. Especially relevant in this regard are the insurance provision, the warehouse agent PE fiction and the service PE rule.

Art. 5.3.b) UN MC deserves a special mention. If adopted, this article reduces the problems of fragmentation of fixed places of business because the geographical coherence test is not relevant here, since this PE deeming rule is tied to the concept of physical presence and the 'same or connected project' [140]. Like art. 5.3.a) UN MC the rule, however, is vulnerable to avoidance through artificial splitting of the project so as not to meet the time threshold between associated companies. However, para. 11 of the Commentaries to art. 5 UN MC mentions that "measures to counter abuse would apply equally under Art. 5.3.(b)" and accepts analogous rules in this respect to those in para. 18 Commentaries to art. 5 OECD MC.

In terms of preventing abuse, two differences with the OECD MC also stand out: art. 5.7 UN MC and the principle of limited attribution of profits. Contrary to what it may seem at first sight, Art. 5.7 UN MC does not add much, if properly interpreted, to art. 5.6 OECD MC. The provision has a number of interpretative problems and can be easily avoided by having more than one principal, either related or unrelated or, even better, by avoiding agency in the jurisdiction altogether (which is not difficult to achieve)[141]. In fact, it may be argued that countries are worse off if this clause is added since it may make the application of anti-abuse provisions more difficult: it would be enough to establish remuneration at arm's-length of the agent to argue it is independent and reduce the possibilities of bring to the tax base of the source country profits accruing to non-resident entities. Unless 'arm's-length' is interpreted in a form different from the OECD's more orthodox way (as it happens in India, China or Brazil, see below section 5.5), this provision does not guarantee that the source country will increase its taxing rights over groups of companies and related parties. For instance, if cost plus is accepted as the method to remunerate activities of a subsidiary in the source country in case of a commissionaire / contract manufacturing agreement, this permits the residual value of activities in the jurisdiction to go to the country of residence of the principal, and, therefore, as long as the subsidiary does not assume risks and functions regarding, for instance, sales

[140] Arnold (2014), p. 67 suggests that the main goal of art. 5.3.b) UN MC is to overcome the problems of the geographical coherence test.

[141] Vann (2011).

in the same country by the parent (e.g. obsolescence, inventory, bad-debts etc.), the attribution of profit to the subsidiary may be very limited.

At the same time, one may wonder what the consequences would be of a non-arm's length remuneration. Basically, that the subsidiary is a dependent agent, but this finding would not guarantee that the parent / associated company is taxed within the source country as long as the PE tests are not met (fixed place, physical presence in the UN MC or habitually concluding contracts). In this context, the wording to art. 5.7 UN MC, in connection with art. 9 UN MC, suggests that simply adjusting transfer pricing paid to the subsidiary in the source country is enough, which may not be very satisfactory from the source country perspective, again, unless a non-orthodox approach to transfer pricing is applied.

The limited attribution of profits under art. 7 UN MC has an evident anti-avoidance flavour, but its effects are very limited, apart from the interpretative and administrative problems it presents.[142] First, it is conceivable that a company could organize its business to only carry out auxiliary activities in a jurisdiction and core activities could be performed through independent agents, the PE is avoided in such a case. Second, it is enough to incorporate the PE and the principle is short-circuited[143], which makes it possible to operate by fragmenting activities between subsidiaries in the jurisdiction which carry out preliminary or auxiliary activities, independent agents and other companies of the group that do not meet the PE threshold (legal independence of companies of a group is a serious limit to the limited attribution of profits principle).

The reduced thresholds for PEs in the UN MC make it more difficult to avoid the PE status because of the effects of art. 5.3.b) UN MC, although with regard to services there are doubts as to whether force of attraction can be of application in view of the fact that such an article triggers its effects on a project by project basis. The same applies to art. 5.3.a) UN MC. Anyhow, the force of attraction in both cases can be easily avoided by using separate entities for different projects[144].

The warehouse PE in art. 5.5.b UN MC also reduces the possibilities of avoidance of PE status, however, it is not difficult to avoid having the warehouse within the jurisdiction or meeting the 'habitually maintains' or 'regularly delivers' test to escape the PE clause.

Last but not least, para. 35 Comm. to art. 5.8 remark the following:

> ". . . determining whether or not a permanent establishment exists on a separate entity basis may entail vulnerability to abusive arrangements. Depending on the domestic law of States safeguards against purely artificial structures may be found through application of a rule according to which substance overrides form".

That statement does not add much to the interpretation of art. 5.7 OECD MC since, in the end, the principle of separate entities can also be questioned by applying anti-abuse legislation and the UN MC has accepted the principles added after 2005 by the OECD as a reaction to the *Phillip Morris* case. Respect of legal business forms and free trade also seems to form part of the foundations of the PE concept in the UN MC,

142 Sasseville and Vann (2014), section 3.3.2.
143 Skaar (1991), p. 339-340.
144 Sasseville and Vann (2014), section 3.3.2.

which limits the margin for application of anti-avoidance doctrines or regulations. The remark in para. 35, therefore, seems a reminder or clarification.

Therefore, despite the fact that the UN MC is clearly bent towards more recognition of source country rights and, in this regard, it may reduce vulnerability of source countries to artificial avoidance of PE status, it has inherent limitations, in line with the OECD MC, that make it also susceptible to be affected by the most frequent strategies of fragmentation / commissionaire-like agreements of company groups to avoid having a PE in the source State. As a consequence, also for countries using this model, an effective strategy to counteract these types of behaviours is relevant since the UN MC and the OECD MC share very similar problems. It also seems that the reaction to artificial avoidance in the UN context is also application of anti-avoidance doctrines and rules.

5. Strategies against 'artificial avoidance' of PE status

5.1 Introduction

Probably, the most relevant issue for developing countries is how to identify a PE, rather than sophistication in fighting the most challenging tax avoidance strategies. Any proposal in this regard, should follow the classic principle that, for a lot of those countries, "administration is tax policy". Special importance is therefore attached to administrative concerns in the critical review of the possible routes that can be proposed for developing countries: theoretical solutions that are difficult to implement or enforce should be discarded. The term 'difficult' is, obviously, relative and the correct strategy will finally depend on the specific situation of countries. As explained above, the preferred solution for the OECD to end PE tax planning seems to be the application of anti-avoidance rules or doctrines and / or transfer pricing legislation. The UN MC combines reduction of thresholds for taxation in the source country with anti-avoidance doctrines. This may also help developing countries, but can be complemented with other options.

Moreover, in the current international context of competition among jurisdictions, legal certainty is a very important asset. This should be taken into account seriously by developing countries. Being too aggressive with regard to foreign investors may be profitable for tax administrations in some cases, but it may have fatal damaging effects in reputational terms to attract and keep other investors. Therefore, any initiative developing countries may adopt should have legal certainty as a pre-condition and as a goal. This requires that any of the solutions be accompanied by clear administrative measures and legislation, if possible drafted in a process that ensures a certain level of quality and transparency.

Last but not least, there is probably no silver bullet to end with artificial avoidance of PEs in the context of current tax treaties. This means that a combination of all or some of the solutions proposed should be considered.

5.2 Tax treaty policy

5.2.1 Introduction

As explained above, much of the disaggregation between economic activity and taxation in the State of source can be attributed to the specific configuration and interpretation of PE as an institution, with a strong bias in favour of residence taxation. Evolution of business models has also made some enterprises not needing a continuous or substantial presence in the State of source to avoid easily, but without any trace of artificiality, the PE threshold. These problems can only be tackled by changing the tax jurisdiction of (developing) countries in tax treaties, and designing a tax treaty policy which seeks to realign economic presence and taxation in the source country.

This solution has an advantage over others, and especially, anti-avoidance norms or doctrines (the preferred solution by the OECD): if drafted clearly and having administrability in mind, they are often much easier to apply than anti-avoidance rules or doctrines or transfer pricing legislation.

There are several routes that should be assessed by developing countries. No preference is expressed in this regard since every country should reflect upon her tax treaty policy in view of the particular situation of that country.

5.2.2 Adopting the UN standard

No doubt, this option has the advantage that it represents a move away from the fixed place of business / dependent agent threshold in the direction of taxing at source significant economic presence, through art. 5.3.b) UN MC. The specific features of art. 5 and art. 7 UN MC, as explained above, also help prevent some typical avoidance structures, and taxation of royalties at source may also contribute to bring additional income to the budgets of developing countries[145].

However, there are some disadvantages that need to be taken into account by developing countries:

- Its similarity with art. 5 OECD MC may not ensure that the source country could tax all the relevant activities that take place within its borders.

- Art. 5.3.b) UN MC is neither easy to interpret nor to administer. First, it is relatively easy to avoid: presence of the service provider for more that 183 days has to be detected, which may not be that simple; associated companies may divide the ‘project’ to avoid meeting the 183 days threshold and, even if in this case, the Commentaries to the UN MC provide for the accumulation by applying a rule similar to that provided in the Commentaries to art. 5 OECD MC, para. 18 for art. 5.3.a) OECD MC, association needs to be detected and artificiality of the split needs to be proved. Some administrative measures may be needed to effectively apply this provision[146]. Apart from those problems, some developed countries (e.g. Germany) have abandoned this article because of the difficulty in deciding what profits could be attributed to this form of PE and disputes on this regard with other tax treaty partners. Its interaction with the limited attribution of profits principle in art. 7, or even art. 14 UN MC is not clear either when all these clauses are incorporated in the tax treaty.

- Art. 5 UN, by adopting a very similar anti-avoidance threshold as art. 5 OECD MC, is also vulnerable to the most important strategies of tax planning

[145] Royalty taxation at source is considered in the following section.
[146] See below section 5.2.4.b).

adopted nowadays, and, especially to fragmentation of activities / commissionaire agreements. As explained above, art. 5.7. UN MC does not add much and may even hinder the application of other anti-avoidance devices.

If the UN MC is the preferred option, developing countries may want to consider reducing the time period triggering the application of art. 5.1 or 5.3. (e.g. 90, 60 days). In view of the above mentioned disadvantages, developing countries may also want to consider adopting other measures.

5.2.3 Withholding taxes on services / royalties and other similar measures

Service taxation is not the object of this paper[147], but it certainly has an impact upon the topic studied here. The option of applying withholding taxes to services is also currently being studied by the UN. Whatever the source rule it is chosen, a withholding tax upon services is easy to apply and has the advantage that changes the function of art. 5 OECD MC: having a PE in the source country is the way out of the withholding tax. The same is true for withholding taxes on royalties, which are already permitted by art. 12 UN MC. In addition, withholding taxes allow tax administrations to monitor deductions of expenses paid to non-residents (although in presumptive systems used by some countries, e.g. Brazil, where it has an optional nature, this information may not be relevant).

Such a withholding tax at source for services / royalties, which requires clear source rules, has also disadvantages that should be carefully pondered. First, if fixed at high rates, it may be an entry barrier for the market, so it can discourage foreign enterprises from conducting business within a country or the tax may be shifted to local companies with the effect of increasing the costs of access to technology or high value services. Low rates may contribute to overcome this disadvantage.

Second, the well-known problem of withholding taxes is that they are usually levied on a gross-basis. Although an elective system of net taxation (non-final withholding tax) can be offered as an alternative to provide a fairer result for the taxpayer, it imposes compliance burdens on taxpayers and withholding agents, as well as on tax administrations to process the refunds and assess the deductibility of expenses. There are, however, several forms of making the system easier to apply for taxpayers and administrations:

- Withholding taxes may be fixed at a rate that takes into account a (presumptive) profit margin. Foreign investors and tax administrations sometimes prefer this simple system (some taxation at low rates) rather than the hurdle of having to submit further applications for refunds. The margin and rates need not be the same for all productive sectors, which makes the system fairer.

- Withholding taxes may be fixed at higher rates but presumptive deductions are granted and expressly provided for under domestic law or tax treaties. For instance, the Protocol to the Spain-China tax treaty (1990) provides, with regard to certain types of royalties, that the withholding tax rate of 10 will only be applied on 60 per 100 of the gross amount paid. Once again, presumptions may apply for all services or only for certain types.

[147] See Arnold, this book.

- A withhold and refund system may be designed but only certain expenses are permitted (e.g. those incurred in the source country, a closed list of most relevant expenses etc.) for all types of services or only some of them.

Since most of those systems require legislation that cannot be accommodated easily within a tax treaty, the latter could set up a limit (e.g. 10 per 100 of the gross income) and the national legislation could implement the system that should be applied within the limits of the treaty.

Obviously, withholding taxes on deductible payments (e.g. services or royalties) cannot be enacted where there are treaties in force that follow the OECD MC. In this case, denial of base eroding deductions or special surtaxes on payments causing base erosion may be an alternative. The configuration of these alternatives should be considered carefully so that they do not hit legitimate transactions, violate domestic constitutional / EU law principles and do not cause double taxation, while at the same time they should make sure that these measures are compatible with international obligations in tax treaties.

It should be kept in mind that some structures may not be affected by these measures, for instance, typical commissionaire agreements for the sale of goods in market countries, and, therefore, other options need to be considered. In addition, where there are withholding taxes upon services or royalties, it may be normal to find an increase in the selling price of goods to domestic subsidiaries that tries to avoid withholding taxes on services / royalties.

5.2.4 Lowering the PE threshold through adoption of specific clauses designed to regard significant presence as PEs or to counteract avoidance of PEs:

5.2.4.a) Opening remark

Whereas the service / royalties withholding tax or other similar measures may have a more general nature and effect, there are more targeted solutions for certain sectors or activities which are considered in the next sections. Therefore, the different types of clauses explained do not exclude the use of other categories.

5.2.4.b) Clauses for exploration and exploitation of natural resources

Some countries use specific clauses to capture income from extractive industries, where huge amounts of money are at stake[148]. An example can be found in art. 5.6. Spain-Ireland 1994 tax treaty:

> "6. A person engaged in a Contracting State in exploration of the seabed and its subsoil or in exploation of natural resources situated there, as well as in activities which are complementary or auxiliary to such activities, shall be deemed to exercise such activities through a permanent establishment in that State. However, this provision shall not apply where these activities are carried on in the other Contracting State for a period not exceeding 30 days".

[148] Arnold (2014) cites the following countries as using these clauses: Australia, Ireland, Japan, Norway, Russia, the UK and the US.

The clause –which admits several variations in drafting-- permits to overcome two problems: (1) the fact that these activities are often carried on by using mobile devices that may not be regarded as PEs under art. 5.1. because they are not fixed; (2) the fragmentation of activities between companies engaged in the same project in order not to meet the time threshold of the PE in the country concerned (this is why the clause refers to 'a person engaged' and establishes a very short period of time which triggers the effects of the clause: after 30 days).

Those clauses often pose interpretative problems. In the example used, for instance, how is 'engaged' defined and what type of activities are covered?, complementary or auxiliary activities are included within the scope of the clause, but how are they defined and what types of activities are not complementary? Interpretative issues may, however, be mitigated by protocols or mutual agreement procedures, but, since there are several types of these clauses in the international tax scene, those that are less difficult to interpret and administer should be preferred.

5.2.4.c) Clauses against fragmentation of contracts / projects

These clauses are also common in the international tax scene and often apply with regard to art. 5.3 UN MC. That is to say, when included, they also cover provisions equivalent to art. 5.3.b) UN MC, sometimes even other deeming provisions included within art. 5.3. (e.g. clauses on the provision of services by individuals). A common example of these clauses is the following, included in art. 5.3 in fine of the Spain-Chile (2003) tax treaty:

> "For the purposes of computing the time limits referred to in this paragraph, activities carried on by an enterprise associated with another enterprise within the meaning of Article 9 shall be aggregated with the period during which activities are carried on by the enterprise to which it is associated if the activities of both enterprises are identical or substantially similar".

It should be noted that the potential effects of these clause in favour of source country rights are more important if, as it happens with art. 5.3 Spain-Chile tax treaty, the service clauses are not linked to a particular project and simply provide for a physical presence test regarding the provision of services.

The clause simplifies para. 18 Commentaries of art. 5 OECD MC since it is not necessary to resort to anti-avoidance provisions for accumulating periods in order to find whether there is a PE. It has also a more far reaching effect: periods are accumulated regardless of whether there is avoidance or not and the splitting of the contract is done in the context of the business model of the group.

The clause has, however, several disadvantages:

- Tax administrations should have the resources to detect the presence of associated companies within their territory for more than the time threshold established in the treaty in order to accumulate the periods of presence of the associated enterprises. For implementation purposes, regulation of obligations in this regard by persons that act as clients can be considered (e.g. notification of projects lasting for more than the time threshold, withholding obligations, obligation to request presence records by employees from the contractor or other companies of the same group, liability of the client, etc.).

- The application of the clause to 'substantial or identical activities' leaves room for discussion of when this condition is met.

- The reference to art. 9 is not very fortunate since it only includes associated enterprises one in a contracting State and another one in the other, when, in these cases, the splitting is likely to take place between two or more non-resident companies, a situation that is not covered by art. 9 OECD MC. In order to avoid this problem some treaties provide a definition of associated companies for these purposes, e.g. art. 5.4.c) UK-Australia tax treaty (2003) or art. 5.5. Australia-Japan.

- Subcontracting by associated companies of non-associated companies should also be covered, although it may be interpreted that the period of subcontractors should be imputed to the principal contractor.

- The clause obviously does not reach fragmentation of activities covered by art. 5.1. or 5.4 OECD / UN MC (the limited force of attraction principle in art. 7 UN MC can help in this regard, although, as explained, it has very important limits, as explained above).

5.2.4.d) Clauses on substantial equipment

Australia often includes in tax treaties a clause deeming a PE to exist if a foreign enterprise has substantial equipment to be rented in a source country. For instance, art. 5.3.b) Australia-UK (2003) provides that a resident of the other contracting State will have a PE if that resident:

> "maintains substantial equipment for rental or other purposes within that other State (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months."

Once again this is a clause that relies on physical presence, in this case, of the equipment, within a country to extend the scope of art. 5.1 OECD / UN MC (under this article presence of equipment in a country does not give rise to a fixed place of business PE).

Developing countries should value whether it is worth including this clause in their tax treaties for a number of reasons:

- If tax treaties include a withholding tax at source for royalties, services, clauses on the exploitation or exploration of natural resources or the equivalent to art. 5.3.b) UN MC, income from rental activities may already be covered and taxed in the source country.

- Under the current approach to attribution of profits, where significant people functions play a very important part in this respect, presence of equipment only in a State may not attract to the source country a very relevant tax base. This is clearly a disadvantage of this clause.

- These clauses are not free either of interpretative problems, such as, the meaning of 'substantial equipment'.

5.2.4.e) Anti fragmentation and commissionaire clauses

Clauses against the most common avoidance structures of PE status have been used in tax treaties for a long time by some countries. In this respect, the Australian experience –one of the first countries which had judicial decisions on this type of tax planning transactions-- is a useful example[149]. Australia adds three different types of clauses:

- A deemed PE for non-residents having contract-manufactures / maquila services in the other country, which adopts two forms. It is either included in the equivalent of art. 5.3.[150] or in art. 5.6. OECD MC (in this latter case, to facilitate the application of the independent agent exception)[151].

- Art. 5.4. is drafted so that it is clear that the preliminary and auxiliary conditions apply to the whole paragraph and not only to letter f).

- The equivalent of art. 5.5. OECD / UN MC does not refer to the controversial 'in the name of' and only mentions 'on behalf' to refer to the conclusions of contracts. Whereas this change may have to do with specific features of agency law in Australia, it also certainly covers the case of commissionaire structures which was an early worry in Australia, as proved by the inclusion of a commissionaire clause in the 1967 Australia-UK tax treaty (art. 4.8)[152].

These clauses are a good option: they are rather comprehensive and define a PE threshold that substantially reduces the risks of abuse. Because they are included

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[149] For this section, the note by Richard Vann on Australian treaty practice on art. 5 in the context of the Global Tax Treaty Commentaries of the IBFD has been very useful to identify Austrian's practice.

[150] E.g. UK-Australia 2003: Art. 5.3. An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if: c) a person acting in a Contracting State on behalf of an enterprise of the other Contracting State manufactures or processes in the first-mentioned State for the enterprise goods or merchandise belonging to the enterprise.

[151] E.g. Finland-Australia 2006, art. 5.7.: "Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 8 applies – is acting on behalf of an enterprise and: a) has, and habitually exercises, in a Contracting State an authority to substantially negotiate or conclude contracts on behalf of the enterprise; or
b) manufactures or processes in a Contracting State for the enterprise goods or merchandise belonging to the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for that enterprise, unless the activities of such person are limited to those mentioned in paragraph 6 and are, in relation to the enterprise, of a preparatory or auxiliary character.

[152] "8. Where an enterprise of one of the territories sells to a person in the other territory goods manufactured, assembled, processed, packed or distributed in the other territory by an industrial or commercial enterprise for, or at, or to the order of, that first-mentioned enterprise and:

(a) either enterprise participates directly or indirectly in the management, control or capital of the other enterprise; or

(b) the same persons participate directly or indirectly in the management, control or capital of both enterprises,

then for the purposes of this Agreement that first-mentioned enterprise shall be deemed to have a permanent establishment in the other territory and to carry on trade or business in the other territory through that permanent establishment".

within a tax treaty, they make clear the anti-avoidance standard of PEs accepted in that treaty and prevent any potential discussion on it. However, separate consideration of PEs is still the rule, which leaves some room for avoidance that should be deal with domestic antiavoidance doctrines or rules or with other relevant clauses. The issue of attribution of profits to PEs / associated companies also needs attention in these cases and may cause some conflict. But, specially, any country opting for these solutions should be sure that the domestic legislation on PEs covers the cases at issue since if the tax treaty creates tax liabilities not foreseen in domestic legislation it may not be applicable.

5.3 Attacking avoidance of PEs through 'interpretation' of PE articles in tax treaties (special reference to the position of the Spanish tax administration and courts)

5.3.1 Opening remarks

As explained above, the OECD and the UN MC are based on premises that have an un-doubtful legal flavour, i.e. starting with the independence of the companies in a group. In the last two decades, but especially after 2002 and 2003, a more 'substantial' or 'economic interpretation' of the PE article (however limited) found its way into the Commentaries to the OECD MC. As explained, the effect of that trend is that there is increasing uncertainty on the concept of PE and a wider margin for tax administrations to attack structures of taxpayers designed to avoid PE status. Ambiguity in the Commentaries leaves room for different interpretations of the concept of PE and, therefore, artificial avoidance of PE status. It has been explained that some tax administrations have used the PE concept in a rather aggressive manner. This section provides an example (the position of the tax administration and courts in Spain) of one of such interpretations. After that, advantages and disadvantages of this position are assessed.

5.3.2 The position of the Spanish Tax Administration and Courts on artificial avoidance of PEs: the concept of complex operative settlement as a PE and the Borax, Roche, Dell and Honda cases

The origins of the position of the Spanish tax administration can be found, first, in two rulings of the Spanish Directorate General for Taxation ("DGT"). As a matter of fact, in one of them[153], the DGT answered to questions by a non-resident Swiss company with subsidiaries in Spain whether there was a PE in Spain after the conversion of a distributor into a commissionaire (one of the subsidiaries, S2) and of a full-fledged manufacturer into a contract-manufacturer (another subsidiary, S1). The answer was as follows:

1. *Contract manufacturing:* There is no PE as long as S2 acts according to the instructions to manufacture given by the foreign parent, which, in turn, keeps the property of the raw materials and finished products used by S2 in the maquila process if S2 only assumes the risks inherent to its activity. However, if the Spanish company assumes other risks or carries on other

[153] Ruling by Spanish Directorate General of Taxation of 20 November 2008, V2192/2008, the Ruling of the same date, V2191/2008, reached a similar conclusion with regard to a 'commissionaire agreement' only. See Carmona Fernández (2013).

functions different to those inherent to the maquila process, there may be a PE.

2. *Commissionaire:* If S1 acts in its own name but on behalf of the foreign parent and receives and arm's-length remuneration like any other distributor, there would be no PE as long as S1 is independent (it was acting on behalf of several companies of the group) and its activity is not controlled by the Swiss parent. If, however, S1 is not independent anymore and its acts are binding for the Swiss company within the meaning of para. 32.1 of the Commentaries to art. 5 OECD, there may be a PE.

3. *Combination of activities:* the Spanish Directorate General for Taxation closed its Ruling by saying that "the sum of activities [it refers to contract manufacturing plus commissionaire] can give rise to a PE if they form a 'complex operating settlement' with economic coherence. This will occur when, after a factual and functional analysis of the Spanish situation, there are functions or risks assumed by S1 and S2 above and beyond those of the contracts signed, by themselves or through the group organization and even if services are provided by third parties. This is permitted, the DGT ruled, by para. 27.1 Commentaries to art. 5 OECD MC[154].

The *Borax* decision by the Audiencia Nacional[155] ("AN", a central court of justice in Spain), very recently confirmed by the Spanish Supreme Court,[156] went a step further. In this case, the Spanish subsidiary, which previously imported minerals, processed and sold them to third parties, was transformed into a service provider (contract-manufacturer) without any apparent change in its size and functions. It signed two separate contracts with the UK parent, one of warehousing and provision of services and another one of agency. Under the first contract, the minerals purchased by the parent would be stored and processed by the subsidiary, which would also provide some other relevant services (unloading, transportation, milling, packing and other administrative services that might be needed like receiving orders, sending invoices to clients, accountancy). Under the second contract, the Spanish subsidiary would promote sales of the minerals in Spain but the prices and conditions were fixed by the UK company, the subsidiary would only send orders to the parent, which was not bound to accept them, it could not accept orders in the name of the parent or receive the price paid.

The tax auditors detected that, in practice, there was a high degree of overlapping between the activities carried out by the parent and the subsidiary to the extent that it was difficult to differentiate when one or the other were acting: in fact, the parent imported the products into Spain, but the remaining substantial activity was done in Spain by the subsidiary which acted as a 'sales channel'. In this context, the tax inspectors presumed that there was a fixed place of business of the parent at the premises of the subsidiary (the warehousing, service and promotion of sales activities could not be considered separately) and, therefore, there was a PE in Spain since the activities of the parent were not preparatory or auxiliary and an economic business cycle is closed in Spain.

[154] Obviously, the DGT did not consider that para. 27.1 Commentaries to art. 5 OECD MC was only applicable to a single taxpayer and ruled that it could cover the situation of a group of companies.
[155] Judgment of 9 February 2011, rec. n. 80/2008.
[156] Judgement of 18 June 2014, rec. 1933/2011.

For the AN, art. 5.3. UK-Spain tax treaty, equivalent to art. 5.4. OECD MC, is not applicable in this case because the activities carried on by the subsidiary cannot be considered in isolation (e.g. warehousing) but should be regarded as parts of a chain that closed an economic cycle in Spain[157]. The Supreme Court basically shared the position of the AN but added several considerations that do not reveal a very sophisticated reading of art. 5 UK-Spain tax treaty, at least not one in line with the OECD Commentaries to art. 5[158]. Basically, it seems that the AN and the Supreme Court "considered the existence of an 'established, permanent and complete business structure' as a type of a fixed place of business". In itself, this theory is roughly identical to the 'complex operating settlement' doctrine of the Spanish DGT[159].

The (in)famous judgment of the Supreme Court in *Roche*[160] is about a very similar structure to those considered above in which a Swiss company ("Swiss Co") concluded two contracts with a Spanish subsidiary ("Spanish Co") of the same group: the first was, again, a contract of manufacturing whereby Spanish Co would produce and package the products indicated by Swiss Co, which would buy all the products, Spanish Co would receive a remuneration of the cost incurred plus a 3,3 per 100 margin. The second contract referred to the designation of Spanish Co as an agent of Swiss Co in Spain to promote the products of the latter (those produced by Spanish Co and others sent to Spain by Swiss Co) and the leasing of a warehouse owned by Spanish Co were Swiss Co would deposit the merchandises produced by the former and bought by the latter. In this second contract the prices were fixed by Swiss Co, which also sent the invoices to the clients, but orders of the product were processed by either Swiss Co or Spanish Co, without the latter having the power to alter the sale conditions. The remuneration of Spanish Co was a 2 per 100 of the sales plus the costs incurred, and a fixed amount for the leasing of the warehouse.

Prior to concluding the two contracts, Spanish Co was a full-fledged manufacturer and distributor, after the restructuring, it was a simple service provider, a contract manufacturer and a commissionaire. In part, the position of the Spanish Tax Administration, confirmed by the Central Administrative Court[161], was very similar to that in *Borax* (there is no auxiliary or preparatory activity, a fixed place is present in Spain through which a main activity is carried on) but with a very relevant difference, that is, Spanish Co was also regarded as a dependent agent of Swiss Co. According to the tax administration, the two tests of art. 5 of Spain-Switzerland tax treaty for finding a PE were met.

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[157] The old tax treaty between Spain-UK 1975 does not have the equivalent of para. f) of art. 5.4. OECD MC.

[158] For the Supreme Court (1) the contract between the parent and subsidiary is not a simple warehousing agreement, it seeks the transformation of products and, since it is done by the subsidiary in the name and on behalf of the parent, which, in the end, has finished products, this excludes the activity from the scope of art. 5.3. UK-Spain tax treaty; (2) the service agreement excludes any possibility of independence of the Spanish subsidiary which has to abide by the terms of the contract imposed by the parent company; (3) the activitites carried out in Spain after the restructuring are the same as those before with the only difference that the legal owner of the minerals is the parent company. If this is so, the Supreme Court cites the AN, there has not been any variation in the place where the activity is carried out and it continues to close a business cycle in Spain.

[159] Carmona Fernández (2013), in his commentary to *Borax*.

[160] Judgement of the Supreme Court of 12 January 2012, rec. 1626/2008. For a very good commentary of the case, see Calderón Carrero (2013), pp. 158-161.

[161] TEAC 20 April 2006.

The AN[162] ruled that Spanish Co was a dependent agent of Swiss Co under art. 5.4. Spain-Switzerland tax treaty (equivalent to art. 5.5 OECD MC, but, since it is an old treaty, it took as a model the 1963 OECD Draft MC). For the AN, the dependent agent PE exists not only where there is a person with authority to enter into contracts in the name of the foreign principal, but also when, taking into account the nature of its activities, this person 'involves the foreign principal in the national market.' Spanish Co not only received orders of the products sold by Swiss Co but also promoted the sales of them. The manufacturing contract reinforces that Swiss Co was somehow present in the Spanish market because Spanish Co only worked for Swiss Co and was not economically independent. Its activity –the AN continued-- was controlled and directed by Swiss Co, it only assumed the risks inherent to the manufacturing process; further, it only existed to manufacture the products indicated by Swiss Co and promote them in Spain. Instead of viewing the contracts separately, the AN linked both of them to affirm that the only reason for the existence of Spanish Co was to provide services (manufacturing and promotion) to Swiss Co.

However, the reasoning of the AN rested upon an erroneous assumption on the threshold for PE agents. It thought a dependent agent PE can exist in cases where there is no authority to habitually conclude contracts. This is because the AN ruled that since the activities of the agent were not preparatory or auxiliary, they could not be covered by art. 5.3 Spain-Switzerland tax treaty, and, therefore, there was a dependent agent under art. 5.4 of that treaty (equivalent to art. 5.5. OECD MC). The equation is erroneous since identification of a dependent agent does not automatically mean that there is a dependent agent PE in a State under art. 5.5. OECD MC if the agent does not habitually signs contracts in the name of the foreign principal.

The Supreme Court, first, confirmed the ruling of the AN, but also added that there might be a fixed place of business of art. 5.1. Spain-Switzerland tax treaty. As a matter of fact, the Supreme Court referred to and confirmed the ruling of the Administrative Court (TEAC) according to which Swiss Co had a fixed place of business in Spain because, although all the manufacturing activities were carried on by Spanish Co, the first managed and controlled the activity of the second. In fact, the Administrative Court concluded and the Supreme Court confirmed that Spanish Co was insulated from all the risks inherent to the economic activity taking place in Spain, all the human and material resources of the Spanish Co were serving the activity of Swiss Co, and, therefore, the premises of Spanish Co were at the disposal of Swiss Co. After creating the fiction of the 'manufacturing PE', the Supreme Court also confirmed that not only the profits of the manufacturing activity should be attributed to the PE but also those of marketing and commercialization activities in Spain.

Apart from the obvious mistake in interpreting the concept of dependent agent PE by the AN and the Supreme Court[163], the approach to the fixed place of business PE is not very different in substance from the one in *Borax*: a substantial activity in Spain, with a subsidiary which only serves a foreign associated company by producing merchandise in Spain and promoting sales in Spain is carrying out a business activity through the Spanish subsidiary. For the Supreme Court, this

[162] Judgement of 24 January 2008, rec. n. 894/2004.
[163] The dependent agent PE presumption, as explained above, is based on the wrong assumption that this type of PE can exist by performing a substantial activity (manufacturing) even if there is no authority to conclude contracts.

'employee'[164] or 'dependent agent' subsidiary' is a fixed place PE (art. 5.1. OECD MC). The fixed PE reasoning is based, however, on another even more-far reaching presumption. Despite the legal independence of the Spanish subsidiary, its economic dependence from Swiss Co was crucial to create the fiction that there was a fixed place of business in Spain at the disposal of the parent. Again, this reasoning goes beyond art. 5.7. in connection with art. 5.1. OECD MC (especially after the changes in the Commentary to art. 5 OECD C after the *Philip Morris* decision in Italy). The reasoning is also slightly different from the one in Borax –where the 'complex operating settlement' was decisive to create a fixed place PE-- although in practice it leads to the same result.

Last but not least, *Dell Spain* is a very relevant case, mainly because it represents the opposite extreme to *Dell Norway.* Whereas in Norway the Supreme Court concluded that there was no dependent agent PE, in *Dell Spain* the Central Administrative Court (TEAC)[165] decided that the same group and structure[166], gave rise to a PE. The structure was as follows:

- Dell Ireland was an Irish entity of the Dell Group in charge of commercializing computers in Europe. The products were bought from another Irish entity of the group, but Dell Ireland had no personnel or other material resources.

- The Dell Group had 17 commissionaire subsidiaries in different European countries, Spain among them, that sold Dell products in their own name but on behalf of Dell Ireland. At least in Spain, until 1995, Dell Spain distributed and commercialized the products of the group as a full-fledged distributor. After 1995, Dell Spain turned into a commissionaire. Because of this change, the portfolio of clients was transferred to Dell Ireland, which also assumed all the risks of inventory, clients and guarantee. Dell Spain also acted as commissionaire for other local products to service the Spanish clients.

- The Spanish market was divided in two segments of clients: big companies and administration, which was serviced by Dell Spain; and homes and small companies, which were serviced by a call centre of Dell Ireland located in France –the service was provided by the French subsidiary of Dell-- and the web page of Dell Ireland.

The Tax Administration concluded that there was a fixed place of business PE in Spain according to art. 5.1. Spain-Ireland tax treaty because Dell Ireland had a 'complex operating settlement' in Spain, which means that more than auxiliary or preparatory activities are carried on within Spanish territory. The reasons to reach that conclusion were:

- Dell Ireland has no human or material resources, which basically means that all its activity in Spain is conducted through other entities.

- The concentration of activity in Spain forms a complex operating settlement since the main economic activity of Dell Ireland is carried on by Dell Spain

[164] Carmona Fernández (2013).
[165] TEAC 15 May 2012, R.G. 2107/2007.
[166] Supreme Court 2 December 2011, *Dell Products v. Tax East*, HR-2011-02245-A, sak 2011/755.

with its own resources (market control, promotion of sales, marketing, logistics, virtual shops, technical assistance and guarantee etc.).

- There is a high degree of confusion in the activities of Dell Ireland, Dell Spain and France, since there is no clear distinction of when one entity acts in a given segment of clients or contract, the client does not know with whom the contract is concluded until the invoice is received, personnel of Dell Spain and Dell France is used interchangeably for the activities in Spain, payments for activities of both companies go to the same account etc. This degree of functional confusion means that sales concluded in Spain by Dell France are attributed to Dell Spain.

- The web page for the Spanish market may give rise to a virtual PE if considered together with all the other activities carried on by the group in Spain through Dell Spain and Dell France, even if there is no server located in Spain (maintenance of the web page is done in Spain, the dominion name is owned by the Spanish subsidiary, Dell Spain processes orders made through the web page etc.).

In addition, the tax administration concluded that Dell Spain was a dependent agent PE of Dell Ireland in accordance with art. 5.5. Spain-Ireland tax treaty. Despite the fact that Dell Spain acts in its own name, for the Tax Administration there was no doubt that Dell Ireland was bound by the contracts concluded by Dell Spain. A number of factors were taken into account:

- Dell Ireland was the owner of the computers which were delivered directly from that company to the client.

- According to the contract between Dell Ireland and Dell Spain, it was clear that the latter was a dependent agent of the former. It is relevant in this regard that Dell Spain was part of the Dell Group and bound by its policy and it only acts for a single principal.

- Dell Spain defined the contracts and acted on behalf of Dell Ireland. The high degree of confusion in the activity of both companies proves that.

The tax administration decided to attribute to the PE in Spain of Dell Ireland also the profits of Dell France linked with sales in the Spanish market, the commission paid to Dell Spain and Dell France were admitted as deductible expenses for the PE.

The Central Administrative Court ruled that the interpretation of the fixed place of business should not be too rigid, it must adapt to the circumstances of the case, to the commercial and geographical coherence of the activity and always take into account the final goal of art. 5.1. OECD MC / Ireland-Spain tax treaty. That final goal, the Court follows, is to decide when there is a degree of penetration of the economic activity of a non-resident taxpayer in a territory that legitimizes that country to tax the profits of the taxpayer in a stable and continuous manner. Since the premises and human resources of Dell Spain are de facto, in a continuous and stable manner, serving the business needs of Dell Ireland, it has a fixed PE within the meaning of art. 5.1. Ireland-Spain tax treaty. For the Court, Dell Ireland used in Spain a 'complex business structure', that is an 'operating settlement' with enough substance, meaning and stability to be regarded as a PE (it is proved that the activities are not auxiliary or preparatory)[167].

It is also remarkable the part of the decision that refers to the virtual PE. The Court attributed relevance to the web pages for the Spanish market that were maintained and fed by personnel in Spain (even if the server was not located in Spain). The Court took notice of the Spanish position, as expressed in the observation to the software additions –para. 42.1 through 42.10-- to the Commentary to art. 5 OECD MC in para. 45.6, without noticing that this observation was withdrawn by Spain in 2010. It finally concluded that since the activity was significant, the commercialization of Dell products in Spain through the web page must be attributed to the activity of Dell Ireland in Spain.

The Administrative Court pointed out that, if the stable organization of Dell in Spain was not regarded as a PE, this would be tantamount to accepting that an economic activity performed in Spain can disappear by fragmenting the formal title of the different elements needed to carry it on, and, therefore, omitting that the essential part of the activity is still carried out in the same territory. The Court explicitly rejected that a title was needed to affirm that Dell Ireland disposed of the premises of the subsidiary, it was enough for that purpose to prove, as the tax administration did, that Dell Ireland operated in Spain through the structure of Dell Spain. The Court presumed that the premises of Dell Spain were 'used' by Dell Ireland.

Dell Spain was also regarded as a dependent agent of Dell Ireland. The Court affirmed that even if Dell Spain formally acts in its own name, it binds Dell Ireland. The Court (incorrectly) brought in support of its reasoning para. 38.7 Commentaries to art. 5.6. and, again, reaffirmed the fact that Dell Spain was a dependent agent of Dell Ireland since it acted under the direction and control of the latter and its activities are not of an auxiliary or preliminary nature. For the Court, the fact that Dell Ireland was the only principal of Dell Spain was also an indication that the latter is not independent of the former. Once more, the Court displayed a reasoning based on economic dependence that is hardly compatible with art. 5.7. OECD MC.

Finally, the Court concluded that all the sales in Spain by Dell France must be included within the tax base of the Spanish PE of Dell Ireland.

The Dell Ruling was confirmed later on by the Administrative Central Court in the Honda case[168].

5.3.3 Assessment of the advantages and disadvantages of adopting a 'substantialist or economic interpretation' of the PE concept to fight against artificial avoidance of the PE status

It was explained above that the PE concept was usually used by some tax administrations to obtain more attribution of profits to local subsidiaries in transfer pricing disputes. The Spanish tax administration, in the cases studied, did not follow this approach. It simply concluded that there was a PE and proceeded to attribute profits to such a PE.

[167] The decision explained and listed all the activities that Dell Spain did for Dell Ireland.
[168] Ruling by the TEAC 20 December 2012, R.G. 221/ 2009 (the facts and reasoning are analogous to Dell Spain).

Business restructurings in which the same activity remained in Spain with a contractual shift of risks to the foreign entity was the common thread of all the cases decided in Spain. In all of them, there was a flavour of predominant tax reasons behind the restructurings and a certain element of artificiality: the same outcome as before was reached by stripping risk at the stroke of a pen by simply signing a contract with the local subsidiary.

Contrary to what has drawn the attention of international scholars[169], the economic interpretation of the PE dependent agent, the activism of the Spanish administration and courts is more important because of their creative interpretation of art. 5.1. OECD MC with use of the concepts of 'complex operating settlement' and closure of a business cycle in Spain, as well as the presumption that the premises and human means of a subsidiary are at the disposal of the foreign parent.

That is not to say that the interpretation of art. 5.5 OECD is not relevant: beyond the mistakes made by the Courts (AN and Supreme Court) on the interpretation of that article, there is a clear view that a legal interpretation of in the name / on behalf of is not valid in Spain since what the tax administration and courts will look at is whether, in the end, the activity of the Spanish Co determines the sale activity in Spain and if the configuration of the transaction and activities in Spain mean that, in fact, the parent company is acting through the Spanish subsidiary.

In the end, the reading by the tax administration of art. 5.1. and art. 5.5 OECD MC has a perfect symmetry: substantial activity in Spain through a subsidiary, which concentrates a contract-manufacturing and commissionaire function, will imply that there is a PE in Spain that will attract within its tax base all the activities carried on within the jurisdiction. In this context, it seems that activities of a subsidiary above and beyond contract manufacturing plus warehouse (e.g. package and handling, managing stock, warranty, issuing invoices etc.) may give rise to a PE.

Will the splitting of the activity among several dependent and independent parties (one acting as contract manufacturer, another one as commissionaire, another, perhaps an independent party providing warehouse services) work to avoid a PE? All the cases considered referred to cases of a single subsidiary in Spain, and the result may vary if the activities are further disaggregated. The conclusions reached by the tax administration (DGT) and the substance of the decisions does not provide reasons to be optimistic about further fragmentation of activities. However, other cases have supported the fragmentation of some activities in different places of business and / or with independent agents[170].

Is the Spanish position in line with the Commentaries to art. 5 OECD MC? Clearly, the Spanish position is not orthodox, it goes beyond the (legal) conception of the relationship between companies of the same group admitted in the Commentaries, and is contrary to the current Commentaries to art. 5.1, 5.4, 5.5. and 5.7 OECD MC. But this answer is probably too simple. If the Commentaries are literally read, according to their history, it is clear that the Spanish position is wrong. If a more –probably desirable-- substantialist reading of the Commentaries is done, the answer

[169] See, for instance, Obuoforibo (2013), p. 72.

[170] TEAC 6 February 2014, RG 2871-10 and 17 October 2013, RG 2872-10. These cases are also more in line with the (formal approach) by the Supreme Court decisions of 12 July 2012, rec. 4174/2010 and 1862/2010, to dependent agent cases, as opposed to the 'material or economic' approach of the Roche or Dell cases.

is probably more nuanced. As explained above, the OECD historical materials provide support for application of tax avoidance norms when exclusively tax reasons dominate the structure or transaction. Therefore, inasmuch as tax and artificial elements could be identified in the transactions considered by the tax administration, its position is probably not as exotic as it may seem in a cursory reading of the decisions.

There is, however, a very important problem in the form the Spanish administration and courts have made a substantive reading of the PE concept. By using interpretations that are either simply wrong in reasoning or are at odds with the more orthodox reading of the Commentaries, they are transmitting a wrong message internationally: that Spanish authorities and Courts are overtly aggressive, technically not very sophisticated, and that legal certainty is at risk when transactions are done in Spain[171]. Having that experience, it is difficult to recommend that developing countries follow the same path because being too creative in interpreting the PE clause may be more risky in terms of attracting or keeping investment than tumbling down a few 'creative' structures implemented by taxpayers.

In the end, if Spain had used its domestic GAAR to attack the dual structures of contract-manufacturing and commissionaire agreements, probably the outcome would have been the same but more saleable and acceptable from an international perspective. And this is a lesson for other countries to learn. If artificial structures regarding PEs are to be attacked, it is probably more advisable to do so, as the OECD and UN recommend, under the anti-avoidance principles commonly accepted in a jurisdiction or the antiavoidance clauses generally admitted in that country. After all, this is the reaction that the Commentaries to art. 5 OECD / UN MC admit.

However, the merits of substantialist interpretation of art. 5 OECD / UN MC should not be downplayed in certain circumstances. From the historical study in the first part of this paper, it can be inferred that art. 5.4. OECD MC could be interpreted in a non-literal way, according to its goals, to limit its application to true preliminary and auxiliary activities. As a matter of fact, most of the paragraphs of the Commentaries come from a document that excluded the existence of preparatory or auxiliary activities when there was an economic business cycle or substantial economic activity carried out, in the same place of business, by the taxpayer in the source country. It is true that the effects of a substantilist interpretation of art. 5.4. OECD MC can have less impact with regard to complex structures where two or more companies or independent parties are used in the State of source, but it is not impossible to propose an alternative interpretation of para. 27.1 Commentaries to art. 5 and establish the principle of horizontal accumulation or aggregation of activities in domestic legislation or instructions unless it is proved that the structure answers to legitimate business purposes.

A substantialist interpretation of art. 5 OECD / UN MC can offer opportunities to attack several artificial / fragmentation structures used to avoid PE status, but, at the same time, a balanced approach should be adopted. Countries that decide to use this route to attack some artificial avoidance structures should consider establishing the following mechanisms to provide more legal certainty:

[171] For instance, Sengupta (2013) referred to the Roche and Dell cases in Spain to prove that there is one tax administration that is more 'creative' than the Indian one in finding a PE; Obuoforibo (2013) refer to these cases as "Spain goes its own way"; Sprague (2012) spoke of "Spanish Court gores the taxpayer".

- The substantialist interpretation should be applied in a special procedure, such as the one usually used for GAARs, or in the context of GAARs.

- A clearance procedure to give the foreign taxpayer a preliminary opinion on whether the structure used is a PE or not. This sort of advance agreement on whether there may be a PE or not is also a risk-management tool that permits countries to concentrate on taxpayers that have not approached the tax authorities. In several developing countries, compacts with taxpayers are admitted so, for these countries, it should be easy to expand the procedures to PEs / attribution of profits to PEs.

- Tax legislation or administrative instructions or circulars should announce and fix the main principles regarded as the correct interpretation of, at least, the most severe cases. This strategy has several advantages: (1) provides legal certainty to foreign investors; (2) unifies the criteria of the different offices in a country; (3) depending on its form, may also have an important effect upon courts when interpreting tax treaties; and (4) if consulted with treaty partners (competent authorities), also provides certainty in the application of tax treaties and reduces conflicts with those jurisdictions.

5.4 GAARs and artificial avoidance of PE status

As explained, applying anti-avoidance rules or doctrines has been the preferred option for the OECD to fight PE avoidance, together with the sacrosanct respect of business models. Therefore, in this regard, domestic anti-abuse rules and doctrines should take into account the standard of avoidance internationally accepted or followed by the tax treaty being applied, which may reduce their efficacy[172].

However, since less formal interpretations of the art. 5 OECD / UN MC than the one defended by the OECD are possible, there is some scope for using domestic anti-avoidance rules or doctrines, for instance, for giving a more economic view of independence and groups of companies. In this context, GAARs should be preferred to administrative or judicial doctrines[173]. Although this is not the place to study the advantages and disadvantages or GAARS, which are often (a bit unfairly) charged with creating uncertainty, suffice it to say that they have proved their effectiveness in developing countries, which already have experience in their application or are on their way to testing there usefulness (India)[174]. And, certainly, there are devices to reduce the charges of uncertainty that GAARs are often alleged with creating by regulating an appropriate administrative framework for their application[175]. Apart from advance rulings or administrative circulars fixing the position of a country already referred to in the previous section, for instance, in the case of PEs, uncertainty may be reduced by making public the administrative opinions on when

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[172] As Vann (2010), p. 342, suggests substance over form rules "could be applied to transfer pricing avoidance strategies where nothing of economic substance happens, such as risk shifting by contract within the corporate group. In many cases, however, there is economic substance . . . corporate restructures often have commercial purposes as well as tax purposes. In that event the application of general anti-avoidance rules becomes more problematic."

[173] See on this Freedman (2014).

[174] On this issue, see Silvani (2013).

[175] See, for instance, Freedman (2014).

there is artificial avoidance of PEs, or the decisions taken by administrative boards in charge of deciding whether there is avoidance of domestic rules. Special procedures / boards for application of GAARs may also help achieve this goal.

It should be remembered, however, that GAARs are there to fight against too literal interpretations of laws and treaties, but not to create completely new rules, so they cannot be used to turn art. 5 OECD / UN MC into a completely new and different rule.

5.5 Transfer Pricing Rules

Certainly, transfer pricing rules have a role to play in this respect, albeit a limited one unless they are reformed or reinterpreted. As explained above, the current framework of transfer pricing and attribution of profits to PEs and subsidiaries promotes, rather than prevents avoidance of PE taxation in source countries. Like with PEs, developing countries need a clear agenda with regard to the implementation and application of the arm's-length principle that they currently do not have[176]. Because of that, transfer pricing rules, as they are today in some countries, are of limited use in the context of artificial fragmentation of operations or transactions in order to avoid having a PE in a jurisdiction. As explained, it can be said that current orthodox transfer pricing analysis can frequently be used as a shield to defend artificially fragmented structures, even if this result is more and more questioned by tax administrations.

Apart from the complexity of transfer pricing (and the need to have adequate legislation and experts within the tax administration), inefficiency of transfer pricing analysis may explain why tax administrations have avoided to attack business restructuring with transfer pricing rules and have resorted to the thread of PE,[177] either as a bargaining tool to obtain more reasonable attribution of profits to local subsidiaries or as a last resort device which is relatively easier to apply than transfer pricing: as explained, if substantial risks are singled out in a jurisdiction, tax administrations are presuming that most of the benefits of the foreign company attributable to the source State are located in the PE and only a minor part is attributed to the head office (e.g. on a cost-plus basis).

However, if fixed, transfer pricing rules can help a country retain a part of the tax basis that might be allocated to the residence country. Several options are open. But, for these purposes, probably the cases cited in the UN Transfer Pricing Manual are the most interesting, apart from the proposals from different angles to make a more aggressive use of profits splits[178]. Probably the Brazilian approach is the easier one: a presumptive return for distributions of products within the country is fixed (that is to say, resale minus a fixed margin, or cost-plus plus a fixed margin, see, for instance, the case of Brazil, UN Manual). A similar 'presumptive approach' with some corrections is adopted in the Dominican Republic to attribute profits to all-inclusive hotel resorts[179]. The advantages of this solution is that it is relatively easy to implement -- it avoids the use of comparables and information that it is not easy to obtain, it reduces disputes and frees human resources and gives legal certainty

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[176] See, for instance, IMF (2014), especially p. 32-34.
[177] See, for instance, PwC (2014).
[178] IMF (2014), Vann (2010).
[179] See Velayos and Barreix (2013), section 3.C, on how this presumptive method is applied in the Dominican Republic to the tourist sector.

('safe-harbors') to taxpayers[180]--, the main disadvantages are that it may give rise to double taxation if the outcome is not accepted by the other States and may produce unfair results in some cases, i.e. transactions with higher or lower margins can be over-valued or mispriced, therefore, creating obstacles to trade between countries and unfair results[181]. These disadvantages can be overcome by allowing distributors and companies to proof that structures are not designed to maximize profit allocation to low tax jurisdictions or to strip income from the source country, for instance, in the context of specific APAs. If standard margins are somehow agreed with specific sectors, this will also contribute to (1) obtain information about the margins and (2) make them more acceptable in general, therefore, avoiding disputes[182].

Other tax administrations, i.e. China, may take a more horizontal view of what the foreign group is doing within the jurisdiction and tend to consider all the entities (presences) or multiple functions of an entity within the source country together. It has been identified that multinationals tend to (1) overprize purchases by local subsidiaries and (2) underestimate the sales, marketing and distribution functions performed in developing countries. This has an impact in the transfer pricing methodology used with the local subsidiaries to correct the tendency to undervalue activitites in the source country, especially sales, marketing and distribution functions of local subsidiaries of a group (i.e., adjustment of toll manufacturing contracts by using contract manufacturing profit margins with some adjustments, adjusting location savings, giving preference to profit split instead of cost-plus, making comparability adjustments when TNMM is used etc.) or to property value the contribution of the local subsidiary to the supply chain of the group, which requires abandoning a risk based approach in order to focus on the contribution of the local subsidiary to the supply chain of the group (which, in turn, may mean attributing residual values to local subsidiaries instead of the foreign headquarters by using different methodologies: assessing the relative weight of assets and people present in the local subsidiary in comparison with the headquarters, determining the proper return for the headquarters and assigning the residual value to the source country presence, evaluating the return of the Chinese manufacturer by using the accounts of the group as a comparable)[183].

A similar approach is followed by India, where it is assumed that limited risk subsidiaries cannot be remunerated on a cost-plus basis. To the extent they carry on core functions of the group they are attributed substantial risks and functions, and, therefore, more profits, for instance, by recognizing the efforts of distributors to create marketing intangibles (either they should be reimbursed of expenses made or participate in the benefits of the intangible)[184]. It seems that South Africa may be following a similar route to that of China and India, especially on location savings, location specific advantages and market premiums[185].

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[180] See UN TP Manual, p. 370.
[181] UN TP Manual, p. 371.
[182] See Velayos and Barreix (2013), section 3.C, on how this presumptive method is applied in the Dominican Republic to the tourist sector.
[183] See, on the Chinese approach, UN TP Manual, p. 374-388, and Ainsword and Shact (2014). It seems that countries from developed countries are also using similar approaches, for instance, Desai and Goradia (2014), p. 50, cite the Canadian authorities are also using an aggressive approach to define 'location savings' and attribute higher margins to local subsidiaries and remark that, more and more, the application of cost plus may not always lead to an arm's-length result.
[184] See, on the Indian approach, UN TP Manual, p. 388-409.
[185] See, on the South-African approach, UN TP Manual, p. 409-415.

The main advantage of this interpretation and application of transfer pricing rules and methodologies is that more tax base is attracted to (usually) low-risk entities located in developing countries. But this requires a legislation prepared for this, as well as sophistication in transfer pricing analysis that not all countries have. For these reasons, the IMF has suggested that developing countries should develop a specific agenda for building transfer-pricing capability while transitionally applying other measures[186]. In this connection, the options explained above, and especially the menace of PE, may have a role to play for developing countries.

It should not be forgotten either that transfer pricing rules may also be applied in the moment the business restructuring of a group is executed to compensate distributors or manufacturers for their loss of benefits, activity in the creation of intangibles, transfer of know-how etc. However, rules in this respect are probably too complex to be applied by countries with limited resources and knowledge of transfer-pricing or a less sophisticated tax legislation.

5.6. Administrative measures tailored to identify PEs

Last but not least, identification of PEs may be a challenge for those administrations with fewer resources. This means that, for less developed tax administrations, probably the priority is to have rules that would permit them the early detection of PEs. On this front, tax administrations may consider implementing some measures aimed at detecting PEs. For instance, India has introduced, effective from 1st April 2012, reporting obligations for liaison offices (conducting auxiliary activities in India) which seek to obtain information from the activity in India of the foreign entity to which the liaison office belongs and other entities of the same group operating in India (e.g. sales and purchases and services to and from India; details of the products sold, agents used by the group in India; identification and activity in India of other companies of the same group or other liaison offices of the same group; other group entities operating from the same premises etc.), the human resources used by the office or visiting it (e.g. number of employees and salaries), or the clients and projects in India. The reporting form must be signed by the chartered accountant in India of the company or the person authorized on this behalf by the non-resident person[187]. Similar information is to be reported to the Reserve Bank of India before setting up the office. Developing countries may consider establishing this obligation with regard to foreign entities with a fixed place of business within their territory that claim the benefits of art. 5.4. of any tax treaty.

Reporting obligations, penalties and liabilities, may also be established for clients, subcontractors, of non-resident companies claiming not to have a PE in the source country in specific sectors that are more vulnerable to tax avoidance (e.g. large construction works and engineering projects, exploitation and exploration of natural resources, distribution of specific foreign products), for specific service providers to non resident entities (e.g. maquilas, distributors etc.) and / or subsidiaries of foreign companies. The contents of those reporting obligations should be limited to the information that can be provided by those subjects and aimed to discover any relevant business activity performed by the foreign head office / group within the source country (e.g. clients and subcontractors can only inform about specific

[186] IMF (2014), p. 33-34.
[187] I am thankful to D. P. Sengupta, Principal Consultant, National Institute of Public Finance and Policy, New Delhi, for his help to know the scope of this specific obligation in India.

contracts; distributors about their activity, products distributed, and links with other entities of the same group in the same jurisdiction; subsidiaries can provide information about other activities of the group in the same jurisdiction that are similar to those requested in India for liaison offices).

Additionally, country-by-country reporting and transfer pricing documentation, currently being studied under Action 13 BEPS Action Plan, may be very relevant risk managing tools for developing countries with regard to PE issues and may even relief from establishing some specific reporting obligations. This is one of the reasons why not only the country of residence of the parent company of a group should have access to Country-by-Country Reporting. If local authorities do not have access to such a documentation, they may feel the temptation to request reporting obligations locally, which may add administrative burden for groups of companies. Any local documentation should be tailored to identify the real activity of a group of companies and PEs within the jurisdiction of the source State and be accompanied by fair sanctions to be effective, but it should not create undue burdens for taxpayers.

Specific audit programs may also be established for subsidiaries of foreign companies (e.g. the accounts of the subsidiaries of foreign companies will easily reveal whether there was a shift of risks outside the jurisdiction), in general or for specific sectors or transactions (e.g. business restructuring). In this regard, a recent decision in India has accepted Linkedin profiles of employees of a foreign entity as relevant evidence to conclude, in the context of a tax audit, that there is a PE in India[188].

Effective exchange of information with other administrations within the same country (e.g. exchange controls, social security, visa authorities etc.) is also crucial in this respect to identify business activities taking place within a jurisdiction.

Specific administrative measures will depend on the situation of each country and, needless to say, should be proportionate and adequate to the goals they intend to achieve, without creating undue burdens for, specially, good faith taxpayers.

[188] Income Tax Appellate Tribunal Decision dated 4 July 2014, *GE Energy Parts Inc. v. ADIT* (ITA No. 671/Del/2011) (reported in TNS 14 August 2014).

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