Classes #4 & 5 (January 29 & February 5). Permanent Establishment and Business Profits

Please read and consider:

1. Int'l Tax Primer, 3rd Edition (2008 DRAFT) (attached).

2. Michael J. McIntyre, *U.S. Tax Treatment of Income Earned through a Permanent Establishment* (attached).

3. Articles 5 and 7 of the OECD and UN Model Treaties.

4. Revised OECD Commentary on Article 7.

5. The following Notes and Questions.

Notes and Questions

1. The concept of a permanent establishment (PE) is key to the taxation of business profits under the OECD and UN Model Treaties. The concept establishes the minimum threshold connection that a resident of one contracting state must have with the other contracting state before the other state can tax the business profits earned by the resident.

The concept of a PE is also relevant for the purpose of Articles 10, 11, 13, 15, 21, and 22. Moreover, for purposes of Article 14 (now eliminated from the OECD Model Treaty), a fixed base is largely synonymous with a PE.

2. The importance of the concept of a PE is reflected in the large number of cases involving the issue. Summaries of these cases are found in Michael Edwardes-Ker, *The International Tax Treaties Service* (Dublin: In-Depth Publishing) (looseleaf).

3. The concept of a permanent establishment is not well suited to certain types of businesses. For example, modern technology has enabled a country's markets to be penetrated by nonresidents without the establishment of any fixed place of business in the country. Electronic commerce is the most recent and serious threat to the PE concept; however, mail order businesses have presented similar problems for many years. The OECD Model Treaty itself recognizes that the PE concept is sometimes inappropriate. For example, the concept of a PE is largely irrelevant for the taxation of profits from shipping and air transport businesses under Article 8.

4. A PE is generally a fixed place of business. Therefore, at its most basic level, a PE must have some degree of permanence, both in terms of geographical location and time. The examples of PEs in Article 5(2)—office, factory, workshop, mine—generally demonstrate this permanence. It would be possible, nevertheless, for a taxpayers to have a branch or office in a country and not to have a physical presence in that country. A question arises, therefore, as to whether such a branch or office constitutes a PE of the taxpayer.

It is a question of fact in each case whether a taxpayer has a PE, and the nature of the business may mean that even a temporary business location may constitute a PE. For example, paragraph 4 of the OECD Commentary to Article 5 seems to indicate that a taxpayer who regularly occupies space at a fair or market may have PE despite the fact that the fair or market runs for only a few weeks each year. Similarly, a temporary field office used to supervise construction or other activities may constitute a PE even if it is shifted periodically as the construction activities progress (e.g., a pipeline or highway).

Even the examples listed in Article 5(2) present difficulties of application. If a lawyer or accountant visits another country and does business from his or her hotel room or from the resident office of the firm, is there a PE? The answer depends on the actual facts of each case. It has been suggested that taxpayers who regularly visit a country to do business should use different hotels and conduct meetings in the offices of unrelated parties to avoid having a PE.

Is a place of business listed in paragraph 2 of Article 5 a PE, or does that place of business also have to meet the requirements of paragraph 1? What is the OECD's position on this issue? Note that the OECD and UN model conventions use the phrase "includes especially" in Article 5(2). In Article 5(3), dealing with a construction site, the UN model convention provides that a PE "also encompasses" a construction site lasting for at least 6 months. Must a construction site also meet the requirements of Article 5(1) to be a PE under the UN language?

5. Is a farm a PE?

6. Is a building which is rented to tenants a PE of the nonresident owner of the building?

7. Is a vending machine or video gambling machine a PE?

8. Under the OECD Model Treaty, a construction project or building site may constitute a PE if it lasts more than 12 months, even if it is not a fixed place of business. The UN Model Treaty provides for a 6-month period. Article 5(3) raises many questions concerning the meaning of the term "building site." For example, at what point does a place become or cease to be a building site? See paragraphs 18 and 19 of the Commentary to Article 5. If building takes place on two adjacent city blocks, are there one or two building sites? How are planning or supervisory activities dealt with? Paragraph 17 of the Commentary to Article 5 indicates that these activities are covered if carried out by the building contractor but not if carried out by others.

9. The specific exclusions in Article 5(4) are very important because they permit nonresidents to engage in various "preparatory and auxiliary activities" through a fixed place of business in the other country without having a PE there. Preparatory and auxiliary activities include the purchase, storage, display, and delivery of goods, collecting information (for example, market surveys), and processing of goods by someone else. What is the purpose if these exceptions? Do they make good sense? Should there be a time limit on "preparatory activities"? If so, how long? Is a month enough? A year? Ten years?

10. XCo, a resident of Country X, is engaged in compiling data about new technology firms which it sells to interested parties. It has an office in Country Y to collect data about firms in Country Y. Does XCo have a PE in Country Y?

11. By virtue of Article 5(5), a dependent agent can constitute a PE of the agent's principal despite the fact that there is no fixed place of business. For example, a restaurant on a ferry which traveled regularly between Germany and Denmark was held to be a PE in Germany because restaurant staff had the authority to conclude contracts. The requirement that the agent have and habitually exercise the authority to conclude contracts is essentially a question of fact in each case. The major difficulty is in distinguishing between soliciting orders and making contracts. Independent agents do not constitute PEs unless they are not operating in the ordinary course of their business. In general, an independent agent is a person who is operating his or her own business independently, both from a legal and an economic perspective.

12. X is the sales representative of a nonresident firm. X visits customers and arranges for orders. All of the terms and conditions of an order — price, quantity, delivery, etc. — are settled by X. However, the order is then faxed to the firm's head office for official approval. The orders are approved as a matter of course. Is X a PE of the firm?

13. FCo is a French company engaged in providing package adventure vacation tours in Europe and Asia. It opens a representative office in New York to provide brochures and other information to potential clients. The office is staffed by 2 employees of FCo. FCo also has an arrangement with a small New York travel agency under which clients can book trips with FCo. Does FCo have a PE in the United States?

14. In some older treaties, the existence of an agent with a stock of goods from which orders are regularly filled constitutes a PE. This type of provision is often avoided by having the "agent" purchase and resell the goods for its own account (consignment sales). This rule is included in the UN Model Treaty (2011).

15. Note that partnerships present serious PE problems because under many countries' law, a partner has broad authority to bind the other partners. Therefore, a resident partner may constitute a PE of the nonresident partners.

16. Although a subsidiary is not necessarily a PE of its nonresident parent corporation (Article 5(7)), it may be a PE if it acts as an agent on behalf of its parent. Is the agency rule the only way for a subsidiary to be a PE of its parent?

17. The language of the OECD and UN model conventions provides that one company controls another "shall not of itself constitute either company a permanent establishment of the other." This language seems to open up the possibility of an affiliate becoming a PE of the parent if more than control is present. In the *Philip-Morris, G.m.b.H.* case (2002), the Italian Supreme Court found that a "company resident in Italy can be considered as permanent establishment of various foreign companies belonging to the same group and pursuing a unitary business strategy." Is this result proper under the UN or OECD model conventions? Note that the U.S. Model Treaty (2006) provides that the existence of control "shall not be taken into account in determining whether either company has a permanent establishment in that other State."

18. Foreign insurance companies can often engage in significant activities in a country without having a PE there. For example, dependent agents can be used to arrange policies (subject to head office approval), collect premiums, and settle claims, or independent agents can be used to

write policies. The UN Model Treaty specifically states that dependent insurance agents or employees are PEs if they collect premiums or insure risks. What is the status of such agents under the OECD Model Treaty?

19. Even if a resident of one contracting state has a PE in the other state, that state is entitled to tax only the business profits attributable to the PE. See Article 7. In other words, there is no force-of-attraction principle in the OECD Model Treaty. The existence of a PE arguably does not justify the source country's taxing all of the income earned by the nonresident in the source country. For example, if a taxpayer carries on two businesses in a foreign country, one business through a PE and the other not through a PE, the foreign country is not permitted to tax the profits of the second business under Article 7. Does that rule make sense? What does it suggest about the function of the PE rule?

Assume that FCo has an office in Country G (constituting a PE) that is engaged in the sale of automobiles. FCo also sells automobiles in Country G directly. Does it make any sense for Country G to be prohibited from taxing those latter profits?

Note Articles 10(4), 11(4), and 12(3), dealing, respectively, with dividends, interest, and royalties that are effectively connected with a PE. In such cases, the dividends, interest, and royalties, as the case may be, are taxable on a net basis under Articles 5 and 7.

20. The UN Model Treaty gives the source country the right to tax profits from sales of goods in the country similar to those sold through a PE and from activities in the country similar to activities carried on by the PE. Is this rule a good one?

21. The computation of the business profits of a PE under Article 7 raises many issues. Article 7 does not contain any detailed rules for the computation of a PE's profits, although whatever method is chosen should be used consistently. Articles 7(2) and (3) establish 3 fundamental principles, although the relationship among these principles is unclear:

1) The profits of the PE are to be determined as if it were a distinct and separate enterprise (the separate entity principle).

2) The profits of the PE are to be determined as if it were dealing wholly independently with the head office (the arm's length principle).

3) Expenses incurred for the purposes of the PE, whether or not incurred in the source country, must be allowed as deductions.

The fundamental difficulty here is that a PE is legally part of an enterprise rather than a separate entity. When does the separate entity assumption control and when does the actual legal relationship between the PE and the head office control? The issue often arises with respect to "payments" between the PE and the head office with respect to interest, royalties, and other amounts. In a failed attempt to clarify the issues, the Commentary to Article 7 was amended in 1994 after the publication of an OECD *Report on the Attribution of Income to Permanent Establishments.* The OECD recently has applied the arm's length transfer pricing principles in Article 9 to PEs. A working paper on the topic was issued in 2001, and new Commentary was adopted in 2007 and 2008.

22. Note that originally, Article 7(3) was simply intended to clarify that countries should not deny deductions to PEs because the expenses were incurred outside the country or were not incurred exclusively for purposes of the PE.

23. XCo, a resident of Country X, has a PE in Country Y. Depreciable equipment is moved from XCo's headquarters to the PE for use in the business carried on by the PE. After being used for several months, the equipment is moved back to Country X. The amount of depreciation attributable to the use of the equipment by the PE is nominal. Instead, the head office charges the PE notional rent equal to the fair rental value of the equipment for the period during which it was used by the PE. Which is deductible in computing the profits of the PE, the depreciation or the notional rent?

Arnold & McIntyre, Int'l Tax Primer, 3rd ed. (2008), (*Draft*)

Chapter 8. Tax Treaties

Tax treaties represent an important aspect of the international tax rules of most countries. Well over 2,000 bilateral income tax treaties are currently in effect, and the number is growing. The overwhelming majority of treaties between developed countries are based in large part on the OECD Model Treaty. Treaties between developing countries or between developed and developing countries tend to rely on the UN Model Treaty. The two treaties have many common features and tend to differ mostly in detail. In general, the UN model is more favorable to source countries and the OECD model is more favorable to resident countries. Both of these models are discussed below.

In addition, the OECD has developed a Model Agreement on Exchange of Information on Tax Matters (2002). As the name suggests, tax treaties based on this model deal only with information exchange. Most tax treaties that follow this model are between OECD countries and certain low-tax countries that are thought to operate as tax havens. These low-tax countries are not themselves seeking information from their treaty partners. They generally enter into these treaties to avoid the international pressures that may be applied to countries thought to facilitate international tax evasion, money laundering, and other fiscal crimes.

Some multilateral income tax treaties have been negotiated, although their impact so far has been modest. The Nordic nations have entered into a multilateral agreement on matters of tax administration. In addition, the OECD and the Council of Europe have sponsored a Multinational Convention on Mutual Administrative Assistance on Tax Matters, which had 15 signatories as of 2007. The General Agreement on Tariffs and Trade (GATT), as renegotiated in 1994, and the General Agreement on Trade in Services, both of which were consolidated as part of the Agreement Establishing the World Trade Organization in 1994, contain some important provisions relating to income taxation. The provision in those trade agreements are designed primarily to prevent the use of income tax provisions as disguised trade barriers or as export incentives.

Section 8,A, below provides an overview of the legal nature of tax treaties, their relationship with domestic law, their objectives, and the interpretation of treaties. The main features of the OECD Model Treaty are described in some detail in section 8,B, in order to give readers a basic understanding of a typical tax treaty. Features of the UN Model Treaty that are not included in the OECD Model Treaty are also discussed. Some special topics, including treaty shopping and nondiscrimination, resolution of disputes, administrative cooperation, and tax avoidance through tax treaties are analysed in section 8,C.

B. Contents of a Typical Tax Treaty

This section describes some of the major provisions of a typical bilateral tax treaty based on the OECD and UN Model Treaties. Section 8,B,1 identifies the parties to the treaty and the persons whose tax obligations are affected by it, describes the scope of the treaty, and summarizes the rules governing its ratification, termination and amendment. Sections 8,B,2 — 8,B,6 describe the treatment of various categories of income under the typical tax treaty. Section

8,B,7 describes certain rules designed to promote cooperation and fair play between the treaty partners.

Every tax treaty includes some provision for relieving or mitigating double taxation. In the OECD and UN Model Treaties, relief from double taxation is provided either by Article 23A (Exemption Method) or Article 23B (Credit Method). Methods of providing double taxation relief are discussed in Chapter 5,C.

To prevent fiscal evasion or avoidance, the domestic tax laws of most countries give the tax authorities the power to adjust prices set by a taxpayer with respect to a transaction with a related person to reflect the prices that would have prevailed if the transaction had taken place at arm's length with an unrelated person. Article 9 (Associated Enterprises) of the OECD and UN Model Treaties provides that the Contracting States are permitted (indeed expected) to recompute the profits of related enterprises in accordance with this so-called arm's length standard. The arm's length standard and the many problems that arise in applying it are described in Chapter 6.

B,1. Coverage, Scope, and Legal Effect

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2. Business Income

The taxation of business income is governed by Articles 3, 5, and 7 of the OECD and UN Model Treaties. Article 7 (Business Profits) provides that "an enterprise of a Contracting State" generally is exempt from tax on its profits derived from business carried on in the other Contracting State unless those profits are attributable to its permanent establishment (PE) located in that other Contracting State. This major limitation on a country's source jurisdiction is discussed in Chapter 2,C, above. The definition of a PE is provided in Article 5 (Permanent Establishment). Article 3 (General Definitions) describes "an enterprise of a Contracting State" as "a resident of a Contracting State."

An enterprise of a Contracting State that has a PE in the other Contracting State is taxable only on the taxable income attributable to the PE. Article 7(2) of the OECD and UN Model Treaties provides that the profits of a PE should be determined under the arm's length principle. The difficulties that arise in applying the arm's length principle to determine the gross income and deductions properly attributable to a PE are addressed in Chapter 6,C.

Article 7(1) of the UN Model Treaty employs a limited force-of-attraction principle in determining the income attributable to a PE. Under that principle, if an enterprise has a PE in a Contracting State, it is taxable not only on the income earned through that PE but also on income derived in that state from the sale of products similar to those sold through the PE or from business activities similar to those activities conducted through the PE. The approach taken in the UN Model Treaty introduces some uncertainty for companies seeking to minimize their taxes in the source country. The advantages of the rule from the government's perspective are that it simplifies administration somewhat and reduces significantly the opportunities for tax avoidance.

Under Article 5(1) of the OECD and UN Model Treaties, a PE generally is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." This language is used in essentially identical form in almost all tax treaties. The OECD and UN Model Treaties provide in paragraph (2) that the following examples of business premises are included especially in the definition of a PE:

- a place of management
- a branch
- an office
- a factory
- a workshop
- a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources

The OECD Commentary takes the position, noted without approval or disapproval in the UN Commentary, that the examples listed above constitute a PE only if they meet the requirements of paragraph (1). This interpretation seems at odds with the language of paragraph (2), which states that the listed examples are "included especially" in the definition of a PE. The issue has little importance for items like a factory or workshop, which undoubtedly would constitute a PE under paragraph 1 in just about any conceivable situation. The issue does have some importance, however, in determining whether a set of activities characterized as a "branch" or "place of management" constitutes a PE.

According to the OECD Commentary, an enterprise has a "fixed place of business" in a Contracting State only if it operates at a specific geographical location and its activities at that location endure for more than a temporary period (generally for more than 6 months). The place where equipment, such as an oil pumping machine, is used can constitute a place of business even if that machine is unattended by human agents of the enterprise. For a place of business to be "fixed," it is enough that it has a specific geographical location. For example, a marketplace can be the fixed place of business of an enterprise if the enterprise operates a movable stall within that marketplace on a regular basis. It is immaterial whether an enterprise rents or owns its premises in determining whether the premises constitute a PE.

In the UN Commentary on Article 5, it is suggested that fishing vessels might constitute a PE if the enterprise uses those vessels for commercial fishing within the territorial waters of a Contracting State. That issue, however, remains controversial. Many difficult issues arise in determining whether an enterprise has a PE in a Contracting State as a result of engaging in electronic commerce in that State. Those issues are addressed in Chapter 9,C.

The definition of a PE in the OECD Model Treaty includes certain dependent agents of an enterprise that act on behalf of the enterprise and have, and habitually exercise, an authority to conclude contracts on behalf of the enterprise. Most tax treaties treat such agents as PEs of their principals.

The agency rule in the UN Model Treaty is more expansive, extending to dependent agents that maintain a stock of goods from which they make deliveries on behalf of their principals. Some tax treaties follow the UN Model Treaty on this point. Some commentators argue that the definition of a PE should also be expanded to include most dependent agents carrying on substantial business on behalf of an enterprise whether or not they have the authority to conclude contracts. These commentators argue that the power to conclude contracts has little commercial significance because modern methods of communication permit nearly instantaneous contact between agents and their foreign principals.

In addition, the UN Model Treaty provides that an enterprise engaged in the sale of insurance in a Contracting State shall be deemed to have a PE in that State if it collects premiums in that State or ensures risks located in that State. This rule does not apply, however, if the insurance activities are conducted by an independent agent.

Most treaties provide that a building site, drilling operation, or other temporary project location constitutes a PE if the project continues for some minimum period. In the OECD Model Treaty, the minimum period is one year. The UN Model Treaty uses a minimum period of six months and defines the activities covered by the provision broadly enough to include an assembly site and supervisory activities conducted in connection with a building or assembly site. Developing countries typically adopt a six-month period or an even shorter minimum period in their tax treaties. For example, the minimum period in the India-United States treaty is four months. A few treaties between developed countries extend the minimum period beyond one year. The Japan-United States treaty, for example, has a twenty-four month period.

The UN Model Treaty provides that an enterprise has a PE in a Contracting State if it performs personal services in that State through employees or other personnel for a period of six months in any 12-month period. This provision is intended primarily to guarantee that management and consultancy activities may be taxable in the source state if those activities continue for an extended period. The OECD Model Treaty has no comparable provision.

Under the UN Model Treaty, income from the performance of independent personal services is taxable under Article 14 and not under Articles 5 and 7. This approach also was followed under the OECD Model Treaty until Article 14 was dropped from that model in 2000. The taxation of independent personal services is discussed in section 8,B,3, below.

The OECD and UN Model Treaties generally provide that a facility used primarily for the purchase of goods for export, for the storage or display of goods, or for storage of goods for processing by another enterprise will not constitute a PE of that enterprise. The OECD Model Treaty allows a facility to be used for the delivery of goods without it being a PE. The UN Model Treaty does not provide for that exception in order to permit the source country to tax income derived from the operation of a warehouse. Certain facilities are also excluded from the definition of a PE under both models if they are maintained for activities “of a preparatory or auxiliary character.”

A major flaw in both the OECD and UN Model Treaties is that they do not impose any time limit on activities claimed to be preparatory or auxiliary. A fixed time limit of a year or two would provide greater certainty, reduce conflicts between the tax officials and taxpayers, and limit opportunities for tax avoidance. some exemption for activities that are genuinely preparatory is consistent with the treaty goal of removing obstacles to cross-border trade. The exemption for auxiliary activities, however, is best explained by history rather than by sound tax policy.

A subsidiary does not constitute a PE of its parent company simply because the parent controls it. Similarly, a parent company is not automatically a PE of its subsidiary. These important rules have encouraged most multinational enterprises to operate outside their home country through affiliated companies rather than through foreign branches or PEs whenever their activities in a foreign country are likely to be substantial. When a multinational enterprise anticipates only minor contacts with the foreign country, it typically avoids having a PE in that country by operating through independent distributors.

The use of subsidiaries by multinational enterprises to penetrate foreign markets has become so widespread that the PE rules, as they apply to corporate branches, have limited practical significance for most types of multinational enterprises, despite the attention the PE rules are given in model tax treaties and in tax treaty negotiations. The PE rules are quite important, nevertheless for some types of business, notably banks and insurance companies. Foreign branches are commonly used by banks and other financial intermediaries because of their need to report high capital reserves. They are also used by insurance companies for similar reasons.

A branch also may be used by a foreign corporation when it is first entering a foreign market if it anticipates that it will be incurring losses that it can utilize to reduce taxes in its country of residence. Branches also are commonly used by small businesses operating in a country that is contiguous to the country in which they are resident.

The treaty language that prevents a company from automatically having a PE if an affiliated company has a PE does not mean that the affiliated company cannot be its PE. For example, the affiliated company would constitute a PE of the company if it serves as the company's dependent agent (and no other exception applies). Indeed, the actual treaty language provides only modest protection; that language merely prevents an affiliate from being a PE of a company "solely" because of its affiliate status. In practice, nevertheless, the exemption has been interpreted very broadly.

The taxation of business income derived from the operation of ships or aircraft is limited under Article 8 (Shipping, Inland Waterways Transport and Air Transport) of the OECD and UN Model Treaties. The OECD Model Treaty and alternative A of Article 8 of the UN Model Treaty assign the exclusive right to tax such income to the country where the shipping or aircraft operation is effectively managed, even if the shipping or aircraft enterprise has a PE in the source country. Other treaties assign the exclusive right to tax to the country of residence of the enterprise. Most treaties allow the source country to tax income derived from the purely domestic operation of ships and aircraft. For example, the taxation by the source state of income derived from the operation of river barges and ferry boats plying internal waters is not limited by Article 8. Alternative B of Article 8 of the UN Model Treaty permits the source country to tax income derived from shipping and aircraft activities if such activities are "more than casual."

Rental income derived from movable property is considered to be business profits under the OECD Model Treaty. Therefore, such income is subject to tax by a country only if the taxpayer has a PE in the country and the rent is attributable to the PE. In both the 1963 and 1977 versions of the OECD Model Treaty, rental income from the use of movable property was included in the definition of royalties for purposes of Article 12 so that the source country was precluded from taxing such income. That provision was removed from the OECD Model Treaty in 1992, although it remains in many tax treaties. Article 12 of the UN Model Treaty, which permits taxation of royalties in the source country, includes income from equipment rental in the definition of royalties. The UN Model Treaty also treats income derived from the rental of audio and video tapes as royalty income.

Rent derived from immovable property is taxable by the source country in accordance with Article 6 of the OECD and UN Model Treaties. For example, income derived from renting an apartment building would be taxable in the Contracting State where the building is located.

U.S. Tax Treatment of Income Earned through a Permanent Establishment

by Michael J. McIntyre (2003, with some 2007 revisions)

For residents of a treaty country, U.S. effectively connected income is generally exempt from U.S. tax unless the taxpayer has a permanent establishment (p.e.) within the United States. In general, a permanent establishment is a fixed place of business, such as an office or a factory. The treaty rules limiting U.S. taxation of income that is effectively connected with a U.S. business are discussed in § 1.1, below. The rules for allocating deductions to effectively connected gross income are addressed in § 1.2.

§ 1.1. General

Under the typical U.S. tax treaty, the business profits of a foreign person entitled to treaty benefits cannot be taxed by the United States unless that person has a permanent establishment (p.e.) located within the United States and the profits are attributable to that permanent establishment.[1] According to the U.S. Model Treaty (2006), the profits attributable to a permanent establishment are the profits that the permanent establishment "might be expected to make" if it were an independent juridical entity acting on its own behalf.[2]

A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on.[3] It would include an office, a branch, a place of management, a factory, a workshop, or a mine.[4] A construction site or drilling rig located within the United States for an extended period—typically 12 months—also would be a p.e.[5] The activities of an agent could cause a foreign person to have a p.e. within the United States if the agent had certain powers to act on behalf of its principal[6] and was not an independent agent acting in the ordinary course of its business.[7] A foreign taxpayer would not be deemed to have a

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[1] See, e.g., U.S. Model Treaty (2006), Art. 7(1).

[2] U.S. Model Treaty (2006), Art. 7(2).

[3] See, e.g., U.S. Model Treaty (2006), Art. 5(1).

[4] See, e.g., U.S. Model Treaty (2006), Art. 5(2); U.S./India treaty, Art. 5(2)(f) (plantation constitutes a p.e.), 5(2)(l) (furnishing of services for 90 days or for a related person constitutes a p.e.).

[5] See, e.g., U.S. Model Treaty (2006), Art. 5(3) (12 months). See also U.S./Australia treaty, Art. 5(5)(f) (9 months); U.S./Barbados treaty, Art. 5(2)(j) (183 days generally but 120 days for dredging site); U.S./Belgium treaty, Art. 5(2)(h) (12 months); U.S./Canada treaty, Art. 5(3) (12 months); U.S./China treaty, Art. 5(3) (6 months generally but 3 months for natural resources site); U.S./Egypt treaty, Art. 5(2)(g) (6 months); U.S./France treaty, Art. 5(3) (12 months); U.S./Hungary treaty, Art. 5(3) (24 months); U.S./India treaty, Art. 5(2)(k) (120 days); U.S./Japan treaty, Art. 9(2)(g) (24 months); U.S./Mexico treaty, Art. 5(3) (6 months); U.S./Philippines treaty, Art. 5(2)(i) (183 days); U.S./ Thailand treaty, Art. 5(3)(a) (120 days); U.S./U.K. treaty, Art. 7(2)(c) (12 months).

[6] See, e.g., U.S. Model Treaty (2006), Art. 5(5).

[7] See, e.g., U.S. Model Treaty (2006), Art. 5 (6). See *Taisei Fire and Marine Insurance Co. v. Comm'r,* 104 T.C. 535 (1995) (holding that a U.S. agent acting as a reinsurance underwriting manager on behalf of several Japanese insurance companies was an "agent of an independent status" within the meaning of Article 5 of the U.S./Japan treaty and thus not a p.e. of its Japanese principals). It appears from the facts of that case that the U.S. agent also avoided U.S. tax on at least a portion of its profits by shifting those profits to a captive tax-haven reinsurance company organized

p.e. within the United States simply because it engaged in purchasing activities or certain activities of a preparatory or auxiliary character through a fixed place of business or through an agent.[8] The p.e. rule in U.S. tax treaties is generally in accord with the p.e. rule recommended in Article 5 of the OECD Model Treaty.

Under the standard treaty rule, a foreign taxpayer may engage in very substantial activities in the United States without becoming subject to U.S. tax. Some commentators contend that the exemption provided by the current p.e. rule should be narrowed. In their view, a dependent representative of a foreign taxpayer, including an affiliated company, should be treated as the p.e. of that taxpayer if the representative carries on substantial business on behalf of the taxpayer, such as, for example, generating $100,000 of sales. The current rule would not treat a dependent agent as a p.e. if it does not have the authority to conclude contracts on behalf of the taxpayer. Using the power to conclude contracts as the test is criticized on the ground that it has little commercial significance in a world where communication between an agent and its foreign principal can be nearly instantaneous.

Activities carried on by a foreign taxpayer within the United States that would cause that taxpayer to have a p.e. generally would also cause that taxpayer to be engaged in a trade or business within the United States. It is possible, however, for a foreign taxpayer to be engaged in business within the United States without having a p.e. For example, purchasing activities, however extensive, generally would not cause a taxpayer to have a p.e., although they could cause it to be engaged in business. Similarly, a construction site present in the United States for a short period would not be a p.e. but would cause a taxpayer to be engaged in business.

The Code imposes U.S. tax on a foreign person engaged in business within the United States with respect to all of its U.S. source income, other than periodical income not effectively connected with the conduct of a U.S. business. Thus the Code would tax a foreigner with respect to U.S. source income that is unrelated to the activities that cause the foreigner to be engaged in business within the United States. The typical treaty rule, however, would prohibit the United States from taxing under the so-called force-of-attraction rule.[9] A few tax treaties with developing countries retain some small element of the force-of-attraction rule by providing that income derived from sources within a Contracting State that is similar in nature to income earned through a permanent establishment in that state can be taxed by that state.[10]

Whether an activity constitutes a p.e. typically depends on the facts and circumstances of the particular case. Depending on the nature of the taxpayer's business, even a temporary business location may constitute a p.e. For example, a taxpayer that regularly occupies space at a fair or market may have a p.e. despite the fair or market running for only a few weeks each year.

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in Bermuda.

[8] See, e.g., U.S. Model Treaty (2006), Art. 5(4).

[9] IRC § 894(b) provides that a foreign person will be deemed not to have a permanent establishment within the United States for the purpose of determining whether that person is entitled to an exemption or a special tax rate with respect to periodical, etc., income that is not effectively connected with a U.S. business. That section was adopted in order to remove the force-of-attraction rule contained in some older U.S. tax treaties.

[10] See, e.g., U.S./India treaty, Art. 7(1)(b); U.S./Philippines treaty, Art. 8(3); U.S./Thailand treaty, Art. 7(1)(b). See also UN Model Treaty (2001), Art. 7(b).

Similarly, a temporary field office used to supervise construction of a pipeline or highway may constitute a p.e., even if the office is shifted periodically as the construction activities progress.[11]

Under Code section 864(c)(6) and (7), income earned through a p.e. but received after the p.e. ceases to exist is taxable as income effectively connected with a U.S. business. For example, if PCo earns consulting fees in year one, when it has a U.S. office, and gets paid those fees in year two, after it has closed that office, the fees are taxable as business income effectively connected to the office. The United States takes the position that the statutory rule is consistent with the permanent establishment clause of its tax treaties. That is, in the above example, the fees would be treated as earned through a p.e. Article 7(8) of the U.S. Model Treaty provides as follows:

> [A]ny income or gain attributable to a permanent establishment or fixed base during its existence is taxable in the Contracting State where such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.

The position taken in the U.S. Model Treaty is also taken in the Technical Explanation to that model[12] and in a U.S. reservation to the OECD Commentary.[13] Some recent U.S. tax treaties make the point explicitly.[14] Commentators have also supported the U.S. position.[15] any other position would simply invite tax avoidance and make a mockery of the p.e. rule.

§ 1.2. Income and Deductions Attributable to a P.E.

The rules for attributing gross income and deductions to a p.e. are underdeveloped. The language of Article 7(2) of the U.S. Model Treaty (2006), repeated exactly or with minor variations in most actual U.S. treaties,[16] provides as follows:

> Subject to the provisions of paragraph 3 [dealing with deductions attributable to a p.e.], where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits

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[11] See OECD Commentary on Article 5, para. 4.

[12] See Art. 7, Para. 8 of the *Technical Explanation of* U.S. Model Treaty (2006).

[13] OECD Commentary on Article 7, para. 45. Article 7, para. 9 of the Commentary sanctions general anti-avoidance rules in domestic legislation to prevent the use of a p.e. for fiscal evasion.

> It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched.... It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

[14] See, e.g., U.S./France treaty, Art. 7(8); U.S./Denmark treaty, Art. 7(8); U.S./Estonia treaty, Art. 7(9). See also U.S./Ireland treaty, Para. 4 of Protocol to 1997 convention.

[15] See, e.g., Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* 316-17 (3d ed. 1997).

[16] See, e.g., U.S./Canada treaty, Art. VII(2) (identical language except at the end of the clause, but before the period, the following language is added: " and dealing wholly independently with the resident and with any other person related to the resident (within the meaning of paragraph 2 of Article IX (Related Persons)"); U.S./France treaty, Art. 7(2) (identical language); U.S. Lithuania treaty, Art. 7(2) (identical language); U.S./ Mexico treaty, Art. 7(2) (essentially identical language); U.S./Spain treaty, art. 7(2) (identical language); U.S. Thailand treaty, Art. 7(2) (identical language); U.S./U.K. treaty, Art. 7(2) (identical language except at the end of the clause, but before the period, the following language is added: "and dealing wholly independently with the enterprise of which it is a permanent establishment").

that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment.

The apparent purpose of this rule is to carry over to branches the arm's length principle contained in Article 9 (Associated Enterprises) of the OECD Model Treaty. As a general guideline for determining profits attributable to a p.e., the treaty language quoted above is reasonable and uncontroversial. For example, if a foreign corporation engaged in business in the United States through a p.e. is buying goods from unrelated persons and selling them to U.S. customers, the U.S. tax authorities obviously should look at the real prices paid for the goods in determining the profits attributable to the p.e. According to the OECD Commentary on Article 7, the profits determined under this language normally "would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy."[17]

The extension of the arm's length principle more generally can present some difficulties. For example, assume that BCo, a corporation resident in Country B, is manufacturing goods in Country B and selling them in Country A through a p.e. Applying the arm's length approach in this situation is easy enough if BCo also makes sales to unrelated distributors or if unrelated manufacturers produce substantially identical goods and sell them to unrelated distributors. In the more typical case, however, goods sold on international markets embody trademarks and other proprietary intangible property rights, making comparable sales difficult or impossible to identify. The arm's length principle has been adapted, with limited success, to deal with cases of this type in the context of sales between related corporations. The special methods employed give great weight to the respective ownership rights of the related corporations to the intangible property. Those methods cannot be used properly for branch accounting, however, because the various branches of a corporation do not have ownership rights distinct from the rights of the corporation itself.

The United States typically uses a profit-splitting formula in cases like the one illustrated above.[18] The use of that formula is sanctioned by paragraph 4 of Article 7 of the OECD Model Treaty. No comparable language is included in the U.S. Model Treaty (2006). Formulas are sanctioned by the OECD Commentary to Article 7.[19]

Some commentators have suggested that the language of Article 7(2) quoted above should be read as requiring a Contracting State to tax a p.e. as if it were an entity having an independent juridical status. Article 7(2), however, does not state or suggest that a branch should be taxed as an entity. What is does say is that the profits of the branch should be computed by reference to the profits that would be earned by "a distinct and independent enterprise engaged in the same or similar activities." The clear implication is that profits should be attributed to the branch, using the arm's length principle, with respect to activities of the branch that actually occurred. To treat a branch as a legal entity, however, the tax authorities would need to construct a series

[17] OECD Commentary on Article 7 (1997), para. 11.

[18] Reg. § 1.863-3(b) (1996) (generally applying a 50/50 splitting formula to allocated profits between the place of manufacture and the place of sale).

[19] See OECD Commentary (1997) to Article 7, para. 25 (noting a preference for an arm's length method but authorizing countries that have customarily used profit-splitting formulas to continue doing so).

of hypothetical activities between the branch and the rest of the corporation that in fact never occurred.[20]

Treating a branch, which has no capacity to own property or to enter into contracts, as if it were a legal entity having that capacity would lead to anomalous results. Assume, for example, that a foreign corporation having a p.e. in the United States owned a valuable trademark that was being used by all of its branches. Relying on the separate entity analogy, the company might assign ownership of the trademark to a branch located in a tax haven and record on the books of the various branches, including the p.e. in the United States, an "arm's length charge" for the use of that trademark. The result would be that profits would be stripped out of the U.S. branch (and branches located in other countries that tax the business profits of foreign corporations) and transferred to the tax-haven branch.

The example above illustrates the possible use of a separate-entity analogy to deplete profits in the source country. An aggressive source country could use the same approach, however, to inflate the income of a p.e. operating within its borders. The tax authorities of that country might readjust the company books on the assumption that the p.e. located within its borders was the owner of the company trademark. Under that assumption, the taxable income attributed to the p.e. would be inflated by hypothetical payments to it from the various other branches of the company.

As the examples above suggest, the separate-entity approach to branch taxation is fundamentally flawed because it requires arbitrary assumptions about the allocation of ownership rights among the branches of a company when the assets are actually owned by the company as a whole. Treating a branch as a separate juridical person is actually inconsistent with the arm's length principle because, in the real world of commerce, a company does not pay another company for the right to use property when the other company does not own that right. The United States has never interpreted its tax treaties as requiring it to treat branches of a company as if they were separate legal entities.[21]

In general, a foreign taxpayer having a p.e. within the United States is taxable on its U.S. source income derived through the activities and assets of the p.e. This approach is specifically sanctioned in some U.S. tax treaties.[22] An arm's length approach would be used in appropriate

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[20] In *North West Life Assurance Company of Canada v. Comm'r*, 107 T.C. 363 (1996), the Tax Court held that the United States could not impose the formula contained in IRC § 842(b) to compute the income of the taxpayer attributable to its U.S. p.e. That section requires a foreign insurance company to treat a minimum portion of its net investment income as income effectively connected with its U.S. business. According to the Court, para. 2 of Article VII of the U.S./Canada precludes "the fictional allocation of business profits to [North West's] permanent establishment." In a concurring opinion, Judge Halperin states as follows:

> Section 842(b) is inconsistent with paragraph 1. The imputation to a foreign insurance company of a *notional* amount of investment income under section 842(b) . . . contravenes the threshold requirement in paragraph 1 that the business profits attributed to a permanent establishment come from the pool of business profits of the resident carrying on business through the permanent establishment.

[21] For discussion of the difficulties that would arise in attempting to treat a p.e. as a separate juridical entity, see H. David Rosenbloom, "The Source of Interest Payments Made by Nonresidents," 30 *Wayne Law Review* 1023, 1030-1038 (1984). See also Brian J. Arnold & Michael J. McIntyre, *International Tax Primer*, 2d ed. (2002), chapter 4/C.

[22] See U.S./Canada treaty, Art. 7(7) ("the business profits attributable to a permanent establishment shall include only those profits derived from the assets or activities of the permanent establishment"). See also U.S. France treaty, Art. 7(6) (similar statement); U.S. Mexico treaty, Art. 7(5) (similar statement); U.S./Netherlands treaty, Art. 7(5)

cases to compute the amount of gross income items attributed to the activities of the p.e. and to determine the amount of the expenses of the foreign corporation attributed to a p.e.

The principles that the United States applies in attributing U.S. source income to the p.e. of a foreign taxpayer are the principles developed in the regulations for determining whether various items of periodical income are effectively connected with a U.S. trade or business. In accordance with those principles, substantial reliance is placed on the books and records of the p.e.[23] The Service would adjust the gross income and deductions shown on the books of the p.e., however, if the amounts shown were improper. For example, the Service would adjust the books if U.S. source income derived from activities of the p.e. within the United States or from assets held by the p.e. within the United States was not included on those books. Nothing in Article 7 of the OECD model can fairly be read as being inconsistent with the U.S. approach.

U.S. tax treaties require the United States to allow a p.e. taxable in the United States to take deductions properly allocated to it. Article 7, paragraph 3, of the U.S. Model Treaty (2006) contains the following language:

> In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, *including a reasonable allocation of* executive and general administrative expenses, research and development expenses, *interest*, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere. (Emphasis added.)

Similar language, with some significant variations and embellishments, is included in most U.S. tax treaties.[24]

As required by its tax treaties, the United States permits foreign taxpayers to deduct from the gross income of its U.S. p.e. the actual expenses incurred by the foreign taxpayer to earn U.S. source gross income. For example, if a foreign corporation makes sales into the United States through a U.S. office, it could deduct the salaries for the local office manager and the sales staff from the gross income generated by the U.S. office in computing its U.S. taxable income. The

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(similar statement).

[23] The records must be kept in a consistent manner. See Art. 7(5), U.S./Canada treaty.

[24] See, e.g., U.S./France treaty, Art. 7(3) ("In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with such profits, including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere."); U.S. Lithuania treaty, Art. 7(3) (identical language except that the following sentence is added: "A Contracting State may, consistent with its law, impose limitations on deductions, so long as these limitations are consistent with the concept of net income."); U.S./Mexico treaty, Art. 7(3) ("In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of such amounts, if any, paid (otherwise than toward reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents or other rights, by way of commission, for specific services performed or for management, or except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment."); U.S./Spain treaty, art. 7(3) (identical language); U.S./U.K. treaty, Art. 7(3) (identical language).

foreign taxpayer also would be allowed to deduct a reasonable portion of the expenses of its head office that related to the management of the U.S. office.