Jean Schaffner

How Fixed Is a Permanent Establishment?

Series on International Taxation

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Series on International Taxation

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to Sandrine and Claire

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Introduction

(A) CONTEXT

It is generally accepted that a physical permanent establishment is characterised by three components: (i) it has to be permanent (not temporary); (ii) it has to be fixed (geographic or territorial link to the ground); and (iii) it has to be at the disposal of the business undertaking which uses it to carry out its activities.

The purpose of this study is to analyse whether these three criteria are equally important for the qualification of a permanent establishment and whether, in the context of economic evolution over the last few years, of case law in the various countries that has analysed double tax treaties and of technological improvements, these criteria are still appropriate.

We will see that the geographic criterion, requiring a fixed link to the ground, may be interpreted in a very broad manner, under the condition that the permanence and the disposal tests are met. The geographic criterion may, in our opinion, be assigned a less prominent role.

Indeed, in the current economic environment, activities may be carried out in a jurisdiction by a foreign entrepreneur and result in significant economic gains, without the need to have a fixed place of business anchored to the ground. Certain activities are by their very nature mobile, such as that of a consultant or a taxi driver, and others may be exercised from a distance, via the internet for instance, and it would be detrimental to the country where the activity occurs if it were precluded from taxing such profits.

We believe that it is not necessary to fundamentally change the OECD Model Convention to enable the taxation of such profits. Indeed, the Model Convention and its Commentaries already offer the basis for the evolution of the analysis of the permanent establishment concept. The OECD has clarified that where activities form a coherent whole, both commercially and geographically, a permanent establishment may be deemed to exist between various locations, even in the absence of a single fixed connection to the ground. Places of activity which are part of a coherent whole may be linked together and constitute a permanent establishment.

We will demonstrate that commercial coherence prevails over geographic coherence, i.e., if activities are commercially linked, they may be viewed as a whole. Similarly, if activities may be bundled together to form a coherent whole from a

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commercial perspective, a permanent establishment will usually be deemed to exist, even in the absence of a fixed connection to the ground, under the condition that the activities operate within a given spatial delimitation, the extent of which may vary depending on the nature of the activity itself.

We will therefore propose minor amendments to the Commentaries of the OECD Model Convention, to clarify the interpretation of the definition permanent establishment in the OECD Model. This clarification should be capable of being implemented immediately and also apply to existing treaties that are drafted along the lines of the current OECD Model. These amendments are aimed at taking into account both the interests of developing economies wishing to maximise taxation on imported capital and of developed economies, which will be able to increase fiscal safety and favour the development of new business. They are not deemed to change the Model Convention but only to adapt it to economic reality and current trends in jurisprudence.

Finally, these changes avoid the need to adopt more drastic approaches that we will briefly outline, in particular in the context of e-commerce, for which it is unlikely that a consensus can be found.

(B) GENERAL OVERVIEW

'The question "Is there a permanent establishment?" is probably the most frequent tax treaty issue that advisers, government officials and courts have to deal with. It is also a question that has a large number of ramifications and on which much has already been written.'[1]

1. Jacques Sasseville, Arvid Skaar, Is there a permanent establishment? General Report, Cahier de droit fiscal international, volume 94a, Sdu Uitgevers, 2009; see also Lee Sheppard, Tweaking the permanent establishment concept, Tax Notes International, 4 January 2010, 18; J. Ross Macdonald, 'Songs of Innocence and Experience': Changes to the scope and interpretation of the permanent establishment article in US income tax treaties, 1950-2010, The Tax Lawyer, vol. 63, n° 2, 285; Oliver Heinsen in Ulrich Löwenstein, Christian Looks, Oliver Heinsen, Betriebsstättenbesteuerung, C.H. Beck, 2011 (they insist on the importance of the concept in international taxation: '*eine herausragende Rolle*' [free translation: 'a prominent role']).
Arvid Skaar, Permanent Establishment, Erosion of a Tax Treaty Principle, Series on International Taxation, Kluwer law and taxation publishers, 1991 writes on the importance of permanent establishments: 'The notion of permanent establishment [...] is one of the most important issues in treaty-based international fiscal law, perhaps the single most important one. This statement is confirmed by the fact that virtually all modern tax treaties use PE as the main instrument to establish taxing jurisdiction over a foreigner's unincorporated business activities'.
John Huston, Lee Williams, Permanent establishments – a planning primer, Kluwer 1993, state in this respect: 'Prior to reaching the crucial point of economic penetration, the foreigner enjoys exemption as to his business income and is subject to reduced rate of taxation of his income from investments. Precisely when the foreigner arrives at the crucial point becomes a question of enormous financial significance. The acquisition of "permanent establishment" is the language in which treaties describe the event.'
This has also been recognised by the Luxembourg tax administration in its comments on the France-Luxembourg double tax treaty (Code fiscal, volume 1, title 10): 'La définition de l'établissement stable constitue le problème le plus important d'une convention contre les doubles impositions. L'établissement stable représente en effet le critère servant de base à la répartition du droit d'imposition du revenu et du capital des entrerpises.' (free translation: 'The

The International Fiscal Association ('IFA') devoted part of its 2009 Vancouver congress to the permanent establishment issue. It is, however, not the first time that the IFA has focused on this issue[2], as this is a recurring topic, and it is expected that the OECD will revisit the permanent establishment concept in the not too distant future.

The importance of the permanent establishment ('PE') definition for the taxation of business income has been highlighted[3,4], as business profits of a resident in one contracting state are taxable in the other contracting state if they are generated by a permanent establishment located therein[5].

Further, the permanent establishment concept is used in several provisions of the OECD Model Convention, for instance as a source rule with respect to interest and royalties[6], as a rule granting the right to tax to the jurisdiction of the *situs* of the permanent establishment (for instance, for dividends, interest and royalties, capital gains and other income [plus of course business income], as well as for the taxation of capital), or in the course of a base erosion test, where employment income is taxable under certain circumstances in the jurisdiction of activity, if borne by a permanent establishment that the employer has in that jurisdiction. The permanent establishment concept is also found in Article 24.3 of the OECD Model Convention, prohibiting

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definition of the permanent establishment is the most important issue in a double tax treaty. The permanent establishment is indeed the criterion to allocate taxation right on income and capital of an enterprise.')

2. In particular, at the IFA Stockholm congress in 1967, where the topic was 'The development in different countries of the concept of permanent establishment, notably from the point of view of harmonisation in future double taxation agreements', with the General Report presented by Raoul Lenz.
3. See Public Discussion Draft of 10 April 2007, Revised commentary on Article 7 of the OECD Model Tax Convention, paragraph 1: '[this Article 7] is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxable in the country from which it originates, but the criterion does not in itself provide a complete solution to the problem of double taxation of business profits ...'.
4. A groundbreaking study on permanent establishments was written in 1991 by Arvid Skaar (Arvid Skaar, Permanent Establishment, Erosion of a Tax Treaty Principle, Series on International Taxation, Kluwer law and taxation publishers, 1991). Skaar's book is still fully up-to-date today even though the OECD Model and Commentaries have been changed on the issue of permanent establishments half a dozen times since its publication and he of course did not include concepts which were non-existent almost 20 years ago, such as electronic commerce. He covered, however, already the issues related to the dematerialisation of commerce, resulting for example from the emergence of mail order companies, able to ship goods from one country to another, with orders passed via post or phone. His study is also immensely valuable to understand the origin of the concept of permanent establishment.
5. One could imagine several alternative thresholds for business taxation, where the fixed place of business thresholds would be (i) physical presence, (ii) nature and level of activity, or (iii) a monetary amount, corresponding to gross revenue realised in the country; see Brian Arnold, Jacques Sasseville, Eric Zolt, Summary of the proceedings of an invitational seminar on the taxation of business profits under tax treaties, Bulletin for International Fiscal Documentation, 5 (2003), 187; according to the participants at this seminar, there are four types of threshold requirements for source taxation of business income: (i) a permanent establishment, (ii) physical presence, (iii) nature and level of activity and (iv) a monetary amount, usually expressed as a gross revenue.
6. For a very comprehensive description of issues arising in this respect, see Franz Philipp Sutter, Ulf Zehetner, Triangular tax cases, Linde Verlag 2004 (Michael Lang, editor), 80 ff and 180 ff.

discrimination to the disadvantage of a permanent establishment in the country of situation, by comparison with other enterprises originating from that state[7].

Although much time and energy has already been devoted to the concept of permanent establishment, and this concept has been present in double tax agreements almost since the first treaties signed at the beginning of the twentieth century[8], it is also a notion which is impacted significantly by technological changes, and hence the conditions for the creation of a permanent establishment have been under scrutiny a lot recently.

As the existence of a permanent establishment is based on a *factual analysis*, the issue of interpretation of its various components is key. Different countries, with different legal traditions, may come to diverging conclusions. The conclusions on precise facts may of course also differ depending whether an inbound situation (foreign enterprise investing into a country) or an outbound situation (domestic enterprise investing abroad) is being analysed[9], as countries attempt to maximise their tax revenue.

Several scholars and practitioners have either expressed the view that the concept of permanent establishment has already been eroded too much and that this trend should be stopped[10], while others have indicated that the concept actually operates satisfactorily and does not need to be revisited[11]. Finally, some call for a revision of the concept[12].

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7. Ekkehart Reimer, Nathalie Urban, Stefan Schmid, Permanent Establishments – A domestic taxation, bilateral tax treaty and OECD perspective, Wolters Kluwer, 2010, 14.
8. See below, Chapter 1 section §1.01; the first double tax treaty which is currently supposed to be the one of 16 April 1869 between Prussia and Saxony granted the right to tax profits of a commercial undertaking to the jurisdiction where the activity was exercised (Article 2: '[...] in welchem dieses Gewerbe ausgeübt wird').
9. Max Beat Ludwig, The taxation of enterprises with permanent establishments abroad, IFA Congress 1973 (Lausanne), General Report, I/57; J. Ross Macdonald, 'Songs of Innocence and Experience': Changes to the scope and interpretation of the permanent establishment article in US income tax treaties, 1950-2010, The Tax Lawyer, vol. 63, n° 2, 285.
10. IFA yearbook 2009, Report on subject 1 (Is there a permanent establishment?) of the Vancouver congress proceedings; Michael Wichmann, The taxation of services: is the permanent establishment the appropriate threshold? Bulletin for International Fiscal Documentation, 5 (2004), 201. The opposite view is expressed by J. Ross Macdonald, 'Songs of Innocence and Experience': Changes to the scope and interpretation of the permanent establishment article in US income tax treaties, 1950-2010, The Tax Lawyer, vol. 63, n° 2, 285, who believes that the concept has remained relatively stable since its first appearance in the US double tax treaties in 1932.
11. Dick Hund, Towards a revised OECD Model Tax Treaty, Intertax, 6 (1989), 212: 'As for the notion of "permanent establishment" as such, the article in practice seems to operate quite satisfactorily.'
John Huston, Lee Williams, Permanent establishments – a planning primer, Kluwer 1993, expresses a more nuanced view: 'True enough, the concept of PE causes few problems for mobile industries, and among countries with corresponding economic interests and fiscal policies. The picture seems to be quite different, however, for the mobile enterprises engaged in business within countries possessing natural resources of some dimension.'
Arvid Skaar, Permanent Establishment, Erosion of a Tax Treaty Principle, Series on International Taxation, Kluwer law and taxation publishers, 1991, 3: 'The leading hypothesis for the present work is, however, that neither the OECD-based general definition of PE nor the special inclusions and exclusions in relation to the basic-rule (in the present work called "PE fictions"), have managed to harmonise the application of PE in practice. The reasons for this are, according to the hypothesis, that the concept of PE is inadequate for the allocation of taxing jurisdiction over modern, mobile international business, because it infringes neutrality and equivalence in taxation.'
12. Daniel Lüthi, Das Betriebstättenprinzip im Lichte des technologischen und gesellschaftlichen Wandels – Überlegungen zur Reform des OECD-Musterabkommens, in Gassner/Lang/

One of the most surprising things one can discover when examining the first double tax treaties and the first model conventions is that some of the concerns which are today at the top of the agenda of the OECD Committee on Fiscal Affairs were already discussed almost a century ago[13]. Historically, the concept of permanent establishment was being developed in the late nineteenth century in the context of the industrial revolution. While trade had already been international for some time, a new trend at that particular moment was investment in plant, machinery and infrastructure outside of the country of origin of an enterprise. This made it necessary to develop certain rules for allocation of the right to tax and elimination of double taxation.

A parallel may be drawn with the 1929 holding company creation in Luxembourg. Prior to that law, there was in Luxembourg no particular rule for the elimination of double taxation on dividends. This of course blocked the creation of international groups of companies. In the context of the financial crisis in 1929, and in view of the success encountered by holding company structures in other jurisdictions, in particular the canton of Zug in Switzerland, Luxembourg passed on 31 July 1929 a law on holding companies, to eliminate such double taxation[14]. Holding companies could be set up and operated without being subject to significant taxation. Hence, the legislation of 1929 was a response to an emerging trend, which favoured international business development. Similarly, the concept of permanent establishment promoted international trade.

Another factor was the improvement in international transport, by rail or sea, decreasing transportation time and cost and of course enabling international commerce.

The League of Nations devoted a lot of time to the question of allocation of profits to companies and to their various branches. In 1930, the Rockefeller Foundation granted USD 90,000 to finance a study on international taxation[15]. Subsequently, an additional amount of USD 50,000 was awarded. The League of Nations, which benefited from this grant, decided to concentrate on allocation of profits among various

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Lechner, Die Betriebstätten im Recht der Doppelbesteuerungsabkommen, Linde 1998, 15: 'In den letzten Jahren ist das seit Jahrzehnten bestehende Betriebsstättenprinzip vermehrt in das Schussfeld der Kritik geraten. In dem sich stark gewandelten Geschäftsumfeld kann die Anwendung dieses Prinzips zu ungewöhnlichen oder gar sinnwidrigen Ergebnissen führen. Auch nehmen die Schwierigkeiten bei der Anwendung des Prinzips auf besondere Situationen zu. Der Grund liegt vor allem darin, dass das bestehende Konzept auf die heutige Vielfalt der Geschäftstätigkeit nicht genügend Rücksicht nimmt.' (free translation: 'In the past the concept of permanent establishment that had been prevailing for decades has been heavily challenged. In the current fast-changing business environment, the implementation of the concept may lead to unusual or even absurd results. Difficulties may also increase when the concept is applied to specific situations. The main reason for this lies primarily in the fact that the existing concept does not sufficiently take into account today's diversity of business activities.')

13. For a general overview of the evolution of the OECD Model Convention, one may consult the special issue of 22 September 2008 of Tax Notes International, featuring several articles and interviews on the occasion of the 50th anniversary of the OECD Model (actually of the first report, dated 1958, which led to the 1963 model).
14. For more information on the 1929 holding company and its background, see Bernard Delvaux, Edmond Reiffers, Les sociétés 'holding' au Grand-Duché de Luxembourg, Sirey 1969.
15. League of Nations Fiscal Committee: Report to the Council on the work of the second session of the Committee; C.340.M.140.1930.II., 7; see Chapter 1 section §1.01 below.

branches of the same company. Mr Mitchell B. Carroll, a former legal adviser to the US treasury department, was instructed to conduct this study. He visited twenty-seven countries and prepared an extensive survey on taxation rules in France, Spain, Italy, Germany, the US and the United Kingdom.

More recently, the Committee on Fiscal Affairs of the OECD has issued several draft studies on apportionment of income, including in relation to several specific businesses, such as financial institutions, which already had been analysed by the League of Nations. The question has for instance been raised whether the concept of permanent establishment should be given up altogether, because in the context of e-commerce this concept has to be interpreted completely differently[16]. As pointed out by Arvid Skaar, a 'PE is a compromise between residence state taxation and source-state taxation'[17].

A certain number of studies have also been conducted on consumption tax, such as Value-Added Tax ('VAT'), and e-commerce. However, these studies have not been considered in the context of the present analysis, as the concept of a permanent establishment of the provider of e-commerce services is less relevant in this context than the place of consumption of the services provided electronically[18,19].

A further diagnosis is that there has been *little evolution* in the wording of tax treaties since 1963, the date of the first OECD Model, until today[20]. The OECD is keen to introduce its changes in the Commentaries to the Model Convention and/or to explain the model in studies devoted to certain issues, which address economic and technical developments, such as e-commerce. The OECD tries, in general, to change the Model Convention itself as little as possible. The explanation given is that the Model is based on almost a century of knowledge gathered in the field of international

16. OECD, Commerce électronique et fiscalité, mise en oeuvre des conditions cadres d'Ottawa sur la fiscalité, 2001, 92.
17. Arvid Skaar, Erosion of the concept of permanent establishment; electronic commerce, Intertax 5 (2000), 188.
18. Consumption tax aspects of electronic commerce, a Report from Working Party n° 9 on Consumption Taxes to the Committee on Fiscal Affairs, February 2001.
19. When locating services for VAT, services rendered to a permanent establishment located in a jurisdiction other than the seat of the taxpayer are located in the jurisdiction of the permanent establishment. For that purpose a permanent establishment has to offer a sufficient degree of permanence and an adequate structure (see for example in Luxembourg, a circular letter by the indirect tax administration (*Administration de l'Enregistrement et des Domaines*), circulaire n° 745bis of 17 December 2009); see below Chapter 2 section §2.01[B].
20. The OECD Model Convention serves as the basis for most double tax treaties today. A first model was published in 1928 by the League of Nations. This model had been adapted regularly and was followed by two models of 1943 and 1946, respectively known as the Mexico Model and the London Model. While the Mexico Model was more tailor-made for developing countries, the London Model tried to take into account the concern of developed economies. In 1963, the OECD adopted a new model, which was replaced in 1977. From 1992 onwards, the OECD has published the Model and its Commentaries in the form of a loose-leaf service to facilitate regular amendments.
The OECD model is, however, not the only multilateral draft for the preparation of double tax treaties. The United Nations have worked out their own draft which focuses more on developing economies and, for instance, the South American (ASEAN) countries have drafted the Asean model. Several countries, such as the US, have their own model on which they rely when negotiating double tax treaties.

taxation, starting in the 1920s, with the first League of Nations' model conventions. Hence, the OECD is of the view that changes to the Model itself should be avoided, as long as the existing rules provide satisfaction and are able to cope with the changes in the economic environment[21]. It may indeed be difficult to reach a consensus between OECD members, which should further be shared by major non-member countries[22] and a change in the Model itself is slow to adapt to existing tax treaties drafted on the basis of a previous version of the Model. The OECD is, however, prepared to implement changes to the Commentaries to the Model on a more frequent basis. Sometimes, these changes are only minor. These changes are usually of an interpretative nature, to clarify the meaning of certain provisions of the Model, so that they may be applied immediately[23].

While today's version of the Model Convention dates back to 1963, it was first amended in 1977 and 1992. Following 1992, amendments to the Model and, in particular, the Commentaries became more frequent, occurring in general, every two to three years including those in 1994, 1995, 1997, 2000, 2003, 2005, 2008 and 2010.

Changes to the Model are considered to need a very broad consensus, as there are currently more than 3,000 double tax treaties in effect which are inspired by the OECD Model Convention. If the rules of the game change, such changes must be universally agreed[24]. Certain commentators have expressed concern about the race to the bottom of the permanent establishment definition, which should make us prudent when suggesting changes to the definition of the permanent establishment concept itself[25].

However, on the occasion of almost every amendment, the OECD has given consideration to the Model Convention and its Commentaries to address the definition of permanent establishment[26]. Often, the amendments were only minor, such as in the 2005 update, when it was explained that the fact that a person participated in negotiations was not sufficient to create an agency permanent establishment[27], and

21. OECD Report of 19 December 2005, Are the current treaty rules for tax on business profits appropriate for e-commerce?
22. Carol Dunahoo, Gary Sprague, 2008 OECD Model: Changes to the Commentary on Article 5 regarding the treatment of services: more choices, less clarity, Bulletin for International Taxation, 5/6 (2009), 191.
23. If, on the contrary, the changes to the Commentaries go beyond mere clarification, then a more static approach is usually adopted when interpreting double tax treaties; treaties are then interpreted in view of the Commentaries in force at the time such treaties were negotiated and signed (as opposed to an 'ambulatoy' interpretation); see Tigran Mkrtchyan, CFE Forum 2011: Permanent establishment in direct tax, TNS Online, 26 April 2011 and European Taxation, 6 (2011), 256.
24. Carol Dunahoo, Gary Sprague, 2008 OECD Model; Changes to the commentary on Article 5 regarding the treatment of services: more choices, less clarity, Bulletin for International Taxation, 5/6 (2009), 191; these authors emphasise the consensus driven approach by the Committee on Fiscal Affairs, together with a trend to better accommodate minority views. An impressive list of reservations on the permanent establishment Article (23) also illustrates this.
25. See IFA yearbook 2009, Report on subject 1 (Is there a permanent establishment?) of the Vancouver congress proceedings; Lee Sheppard, Tweaking the permanent establishment concept, Tax Notes International, 4 January 2010, 18.
26. See n° 89 of part II of the 2005 tax policy study on 'E-commerce: Transfer pricing and business profits taxation', under the title 'Treaty rules and e-commerce: Taxing business profits in the new economy'.
27. Paragraph 33 of the Commentaries on Article 5.

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