

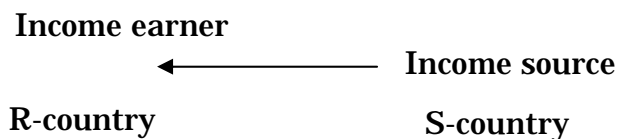
Key Issues relating to Permanent Establishment

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1. Why we need PE concept?
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3. Finding source income & trigger of source tax
4. PE & taxable income
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1. Why we need PE concept?

1.1. Why we need “source” concept for international income taxation?



There are two kinds of tax jurisdiction on income: residence tax jurisdiction and source tax jurisdiction.

Suppose that a person residing in R-country receives income from S-country. The person is a resident of R-country, so R-country can impose tax on his income regardless whether his income is derived from R-country or foreign country. S-country can impose tax on domestic source income regardless whether the income belongs to domestic person or foreign person.

By the way, I imprudently used some phrases; “income from S-country” or “domestic source income”. However, it is sometimes said that source of income is illusion. And this argument is “logically” true, because income is defined as “income = consumption + change in wealth” (so called, Schanz-Haig-Simons income) and this definition of income only looks at personal situation, not at geographical situation. Income is an artificial concept in order to allocate tax burden among people along with each person’s richness. It is logically impossible to deduce a geographical factor from the definition of income.

Even though income has no geographical source in logic, can we abandon a concept of source of income in actual international tax policy? In other words, can we allocate tax authority only according to residence?

For example, suppose that a person residing in R-country has land in S-country and receives rents from the land. This rent income belongs to the person who is a resident of R-country, and logically the rent income has no geographical source. If we

abandon a concept of source of income and allocate tax authority only according to residence, then this rent income shall be taxed only in R-country, not in S-country even though this rent income is derived from the land in S-country. Logically we can. However, such allocation of tax authority would not be supported by people. Even though the definition of income has no factor of geographical source, I guess that people tend to imagine geographical source of income.

In another example, suppose that R₁-Co which is a resident company in R-country has a subsidiary named R₁-Sub in S-country and suppose that R₂-Co which is also a resident company in R-country has a branch named R₁-Br in S-country. Needless to say, R₁-Sub is a resident company in S-country and R₂-Br is a part of a non-resident company from the view point of S-country. If we abandon a concept of source of income and allocate tax authority only according to residence, then R₁-Sub's income is taxable in S-country and R₂-Br's income is non taxable in S-country even if R₁-Sub and R₂-Br do similar business activities. Logically we can. However, such allocation of tax authority relying only on residence would not be supported by people. If so, then corporations might transfer their residence to low tax countries. Even if refinement of criteria of residence can prevent corporations to transfer their residence to low tax countries and R₁-Co and R₂-Co remain to be residents of a high tax country, people would not support the extremely different tax treatment between R₁-Sub and R₂-Br such above. People will say that S-country should be permitted to execute tax authority on income of R₂-Br too. People will roughly imagine that R₂-Br's income is geographically allocated to S-country, not to R-country¹.

Seeing two examples above, people will accept that S-country should have tax authority on domestic source income regardless whether the income belongs to a resident or a non-resident. Even though the definition of income has no geographical source, people will imagine a concept of geographical source of income in order to allocate tax authority among countries rightly.

1.2. Role of PE concept

PE concept is justification of source tax jurisdiction from the view point of section 1.1. At the same time, PE concept is limitation on source tax jurisdiction, as discussed in chapter 3. Source tax jurisdiction should not be unlimited because residents of R-country will be confronted by difficulty of tax compliance in S-country. If R-Co which is a resident company of R-country does not have a PE in S-country, then S-country cannot impose tax on R-Co's income.

2. PE & FE (fixed establishment)

PE concept is used for income tax purpose and FE (fixed establishment) concept is used for value added tax purpose. PE and FE concepts do similar functions. If R-Co which is a resident company of R-country does not have a FE in S-country, then S-country cannot impose value added tax on R-Co's sales amount. If R-Co has a FE in S-country, then S-country can impose value added tax on the FE's sales amount.

Even though functions of PE and FE concepts are similar, PE threshold is generally lower than FE threshold. For example, a gaming machine or vending

¹ Please note that this is a rough image. As discussed in later chapters 3-5, we will see the relation between source of income and profit attributable to a PE.

machine without human intervention can be a PE², but it cannot be a FE. A FE needs to have human and technical resources³.

This difference of criteria between PE and FE concepts might be related with difference of tax base between income tax and value added tax.

The lowness of PE threshold will have little problem for income tax purpose. When R-Co which is a resident company of R-country has a small facility in S-country and the small facility is recognized as a PE in S-country, S-country is permitted to impose income tax on this PE, but S-country's tax base is limited to the profit attributable to this PE. Therefore generally a small PE will raise only small tax revenue in S-country for income tax purpose. The profit not attributable to this PE is not taxable in S-country; therefore the tax base of R-country (residence country) is not eroded seriously.

On the other hand, if FE threshold is low, then the lowness will make not little problem for value added tax purpose. If R-Co which is a resident company of R-country has a small facility in S-country and the small facility is recognized as a FE in S-country, then S-country imposes value added tax on this FE, and S-country's tax base is the sales amount of this FE regardless whether the business functions of this small FE (in other words, the added value of this small FE) are big or small. Therefore generally even a small FE might raise not small tax revenue in S-country for value added tax purpose. Not only R-country (exporters' country) refrains from imposing value added tax on the sales amount of the FE, but also R-country refunds domestic value added tax amount which is related with the sales amount of the exported goods through the FE. Therefore the tax base of R-country would be eroded seriously if a small facility is recognized as a FE.

3. Trigger of source tax jurisdiction

As stated in section 1.2, PE is justification of source tax jurisdiction, and at the same time, PE is limitation on source tax jurisdiction. Two types of trigger of source tax jurisdiction are known; German type and US type.

3.1. German type

PE (*Betriebsstätte*) concept is an indication of domestic businesses of non-residents. Business income attributable to a domestic (German) PE is domestic source business income and is subject to source tax jurisdiction according to domestic tax law and also according to tax treaties.

In this type, PE is a key factor of finding domestic source business income, and at the same time, PE is a trigger of source tax jurisdiction.

3.2. US type

In US domestic tax law, PE is not a key factor of finding domestic source income. Source rule is designed in transaction-by-transaction base.

A non-resident's domestic business, which is called as trade or business in the

² See, OECD Commentary (2008 version) on Article 5, paragraph 10.

³ See, *Günter Berkholz v. Finanzamt Hamburg-Mitte-Altstadt*, ECJ, case 168/84, 4.7.1985, ECR 2251.

United States, is subject to domestic (US) source tax jurisdiction regardless whether a PE is recognized in US in relation with the trade or business or not. “Trade or business in the United States” concept and PE concept are somewhat resemble but not exactly same. Trade or business in the United States with or without a PE is, to some extent, benefited by US’s administrative services so such income is subject to US source tax jurisdiction according to US domestic tax law. In this situation, PE is not a key factor of a trigger of source tax jurisdiction.

However, under tax treaties, US cannot tax a non-resident’s business income if he has no PE in US, even if he might be recognized as carrying trade or business in the United States according to the criteria of US domestic tax law. In this situation, PE is a key factor of a trigger of source tax jurisdiction.

4. PE & taxable income

Chapter 3 saw the relationship between finding domestic source income and triggering of source tax jurisdiction. This chapter will see the relationship between recognizing a PE and limiting taxable income. These discussions in chapters 3-4 are somewhat confusing.

4.1. Entire income principle (Old US, Japan)

If R-Co which is a resident company in R-country has a PE in S-country, then all domestic source income in S-country is subject to source tax jurisdiction at the hand of the PE, regardless whether the income is derived by the PE or not. For example, even if R-Co has a PE in S-country but R-Co’s head office located in R-country makes transactions with customers in S-country directly and not through the PE in S-country, the income of these direct transactions can also be taxed at the hand of the PE when the income of these direct transactions are recognized as domestic source income. This phenomenon is called as “force of attraction”.⁴

4.2. Attributed income principle (Germany)

Domestic source business income is income attributable to a domestic PE. In other words, business income not attributable to a PE is not domestic source business income and not subject to tax at the hand of the PE⁵. For example, suppose that R-Co which is a resident company in R-country has a PE in S-country, but at the same time, R-Co’s head office located in R-country makes transactions with customers in S-country directly and not through the PE in S-country. The head office’s income of these direct transactions is not taxable at the hand of the PE under attributed income principle.

Needless to say, OECD Model Tax Convention Article 7 (1) adopts this principle. Japanese domestic tax law adopts the principle in section 4.1, but under tax treaties, Japanese tax authority complies with the principle in this section.

⁴ Since 1966, US applies “effectively connected income” principle, and this principle is somewhat resembled to attributed income principle of Germany than entire income principle of US before 1966.

⁵ Withholding tax on capital income, such as dividend income, interest income or royalty income, is a different context.

5. Attribution of profits to a PE

A PE is a part of a non-resident and does not have legal personality. We do not recognize a legal transaction within one legal personality. When my left hand transfers some goods (for example, pens) to my right hand, we do not imagine a transaction of pens between my left hand and my right hand. However, if there is a national border between my body and my right hand, issues are not simple.

OECD uses a phrase; “functionally separate entity” approach⁶. In the context of PE taxation, we must “hypothesise” a PE as a “distinct and separate enterprise” and we must recognize “dealings” between the PE and other parts of the non-resident enterprise even though there are no “transactions” from the strict legal view point. Historically it has sometimes been argued that hypothesizing dealings between a PE and other parts of the non-resident enterprise is logically impossible because the PE is not a separate entity in actual law settings. However historically it has also been argued that we must do such hypotheses.

A PE is deemed as a separate entity; therefore even if total profit of the non-resident enterprise is, for example, 100, the PE’s profit can be more than 100 if the PE did good jobs. The PE’s profit is not capped by the total profit of the non-resident enterprise. A PE is deemed as a separate entity; therefore even if the non-resident enterprise makes positive profit in total, the PE’s profit can also be minus if it did bad jobs.

In order to execute functionally separate entity approach, we must determine some factors as follows:

- Functions of activities of the PE
- Risks attributed to the PE
- Assets, obligations and capital of the PE

These issues have too much quantity to discuss in one seminar.

Basically profit attributable to a PE is determined with reference to “arm’s length principle” which is applied to transactions between affiliated companies who have separate legal personalities. However the lack of legal personality in PE contexts might raise differences. For example, a PE’s creditworthiness and a subsidiary’s creditworthiness might be different even when the PE and the subsidiary do similar business functions and have similar assets. The relationship between arm’s length principle and the lack or existence of legal personality will continue to be discussed more widely and deeply.

OECD’s new “functionally separate entity” approach will make some changes in Commentary. For example, old version of OECD Commentary did not recommend recognizing intra-payments of royalties of intangible rights from/to a PE to/from foreign parts of the non-resident enterprise⁷. On the other hands, new version might recommend recognizing intra-payments of royalties in some situations⁸. However some issues remain to be resolved: for example, issues of withholding tax on such intra-payments are blank.

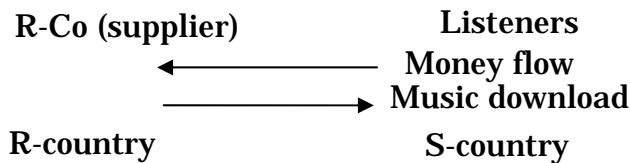
⁶ See, OECD, Report on the Attribution of Profits to Permanent Establishments (17 July 2008) (<http://www.oecd.org/dataoecd/20/36/41031455.pdf>).

⁷ See, OECD Commentary on Article 7, paragraph 17.4 (2005 version); paragraph 34 (2008 version).

⁸ See, OECD, *supra* note 6, page 59-62.

6. PE & electronic commerce

6.1. Server-PE recognition & profit attributable to a server-PE



Suppose that R-Co which is a resident in R-country sells music via internet. Listeners residing in S-country download music from R-Co's website and pay money to R-Co. If the payment is royalty, then S-country can tax under some tax treaties⁹. However if the payment is business income and R-Co has no PE in S-country, then the S-country cannot impose tax on the income flow paid by S-country's listeners. Generally listeners' payments will not be royalty income, so PE recognition is a critical issue.

OECD said that a computer server can be a PE¹⁰. We remember that in chapter 2, a vending machine can be a PE. If R-Co has a computer server in S-country and if the server, like a vending machine, stores music data, treats orders from S-country's listeners and carries on money transfer, then the server will be recognized as a PE. Even though R-Co can easily relocate the server physically from S-country to another country, the existence of the server can constitute a PE.

However, profit attributed to the server-PE would be very small, if not zero, I guess. For example, suppose that R-Co has no server. S-Co which is a resident company in S-country and is not affiliated with R-Co has a server such as above in S-country. R-Co requests S-Co to sell R-Co's music with the S-Co's server to listeners in S-country with an arm's length fee. S-Co will make business profit with R-Co's fee and will pay income tax to S-country, but the tax amount will be small. In a next example, suppose that R-Co has a subsidiary in S-country and the subsidiary's business asset is only a server such as above. This situation can be called as server-subsiary. The server-subsiary will make some business profit and will pay income tax to S-country, but the tax amount will be small, if not zero. In a third example, even if a server such as above is directly owned by R-Co and the server is recognized as a PE, the server-PE must be hypothesized as a separate entity. There might be some differences between the server-subsiary and the server-PE, but I feel difficulty in estimating that the tax amounts of the server-PE be drastically larger than that of the server-subsiary. Therefore electronic commerce will give little (if not zero) tax revenue to listeners' country (S-country) even if a server-PE is recognized.

Needless to say, if R-Co has no physical facilities in S-country, it is impossible to find a PE in S-country.

However some people might think that such allocation of tax authority between R-country and S-country in electronic commerce contexts is unfair. Then, next issue will arise: PE threshold or criteria of income source be amended?

⁹ For example, Japan-US tax treaty does not allow withholding tax on royalty income; on the other hands, Japan-Germany tax treaty allows withholding tax on royalty income.

¹⁰ See, OECD Commentary (2008 version) on Article 5, paragraph 42.2.

6.2. Should we amend PE threshold or criteria of source?

We can say that PE threshold should be amended if business circumstances are significantly changed. Historically it has sometimes been said that PE concept is not sacred. PE is not a genuine product with robust logic. PE is a crystal of compromise among countries. And electronic commerce with little need for physical facilities can be seen as raising significant changes in business circumstances.

However, should listeners' country (S-country, in other words, customers' country) be permitted to have tax authority? As discussed in chapters 1-4, PE is an indication of income source in one aspect. What is source of income? Should customers' country (S-country) be considered to have source of business income? I discussed in section 1.1 that source of income is a product of people's imagination. Then how people imagine geographical source of income?

I analyzed peoples' imagination of geographical source of income in my doctoral thesis¹¹. I think that there are two types of imagination of income source: place of suppliers' business or place of customers' demand. Typical case of the former is PE taxation and typical case of the latter is royalty taxation.

Historically PE taxation has been executed along with an imagination in which geographical source of income is located at the place of suppliers' business. From this view point, S-country is not the place of suppliers' business if R-Co has no physical productive factor in S-country; therefore S-country should refrain from taxing business income of R-Co. If only existence of electronic commerce in S-country can be a PE (sometimes called as a virtual-PE), tax practices would not be workable. For example, we do not have expenditure allocation rule in the contexts of such virtual-PE.

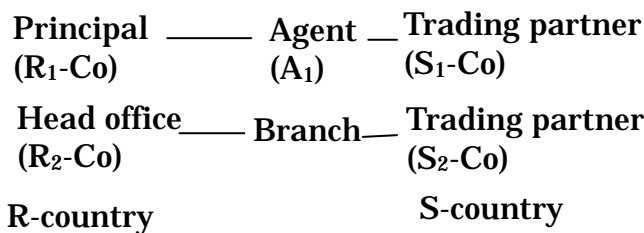
However, tax treaties allocate source tax jurisdiction not only looking at suppliers' business, but also looking at customers; the typical example is royalty taxation. I guess that historically royalty taxation has been executed along with an imagination in which geographical source of income is located at the place of customers' demand¹². From this view point, S-country can be seen as having geographical source of income even if R-Co has no physical facilities in S-country. It is not ridiculous to claim that also demand country should have tax authority in contexts of electronic commerce. However PE taxation on electronic commerce would be impractical as discussed above. If people politically agree that also demand country should be permitted to have some tax authority, then practical instrument of S-country's taxation would be new withholding taxation. Needless to say, whether people can agree as such is a matter of politics and diplomacy, so this issue is out of range of this article.

7. Agent PE

¹¹ This is written in Japanese. Asatsuma Akiyuki, *The Criterion for source of income and the relationship between net and gross income (Part I - III)*, Hogaku Kyokai Zassi, vol. 121, no. 8, pp. 1174-1284; no. 9, pp. 1378-1488; no. 10, pp. 1507-1606 (2004).

¹² Even though S-country gives legal protection for copyrights of R-Co in S-country, R-country is seen as the place of production if R-Co has made music in R-country. However the economic value of the copyrights in S-country is supported by the fact that S-country's listeners like R-Co's music; in other words, the royalty income is based on listeners' demand in S-country. In the context of royalty taxation, S-country is source country not because S-country is the place of suppliers' business but because S-country is the place of customers' demand.

7.1. Raison d'etre of agent PE



Suppose that R₁ which is a resident in R-country makes transactions with S₁ in S-country through an agent, named A₁. Suppose that R₂ which is a resident in R-country makes transaction with S₂ in S-country through R₂'s branch.

Not only a branch but also an agent can be a PE, because both R₁ & R₂ participate in S-country's market through the agent or the branch.

However, if A₁ is an independent agent¹³, we can say that A₁ does not do R₁'s business but do A₁'s own business; therefore an independent agent tends not to be an agent PE. On the other hands, if A₁ is a dependent agent, traditionally it is taught that A₁ can be said as doing R₁'s business and can be a PE.

By the way, does R₁ really do its business in S-country through A₁? Certainly S-country provides market in both cases, but R₁ physically exists only in R-county. Providing market or demand has historically been non justification for PE taxation, as discussed in section 6.2.

In case of R₁, S-country's taxing power should be limited on income attributed to A₁'s activity. Next question arises: can A₁'s activity yield income not only attributable to A₁ but also attributable to R₁?

These questions are also explained as follows: do we still need agent PE concept?

If A₁ is not compensated along with arm's length principle by R₁ because A₁ is dependent, then Article 7 (2) increases tax revenue of S-country. On the other hands, if A₁ is compensated along with arm's length principle, do we still apply Article 7 (2)?

Some people say that in such cases R₁'s agent PE would have no income because income attributed to A₁'s activity will all be compensated as arm's length fee of A₁. I think so too. But OECD concluded that income of A₁ and income of R₁'s agent PE are different¹⁴. Does OECD consider providing market as base for PE taxation?

7.2. Italian Case

Philip Morris group was an American tobacco maker and Philip Morris GmbH was a resident company in Germany. PM-GmbH made transactions with Intertaba SpA which was a resident company in Italy through an Italian affiliated company of Philip Morris group. In this case the issue was whether the affiliated company was an agent PE and Italian supreme court¹⁵ concluded that it is an agent PE of Philip Morris

¹³ For the criteria of independence, see, Taisei Fire and Marine Insurance Co., Ltd, et al. v. Commissioner, 104 T.C. 535 (1995).

¹⁴ See, OECD, supra note 6, page 66-70.

¹⁵ Ministry of Finance (Tax Office) v. Philip Morris GmbH, Corte Suprema Di Cassazione (Sezione

group.

However, agent PE of multinational group enterprises concept was not supported in OECD¹⁶, and people also suspected that PM-GmbH or Philip Morris group really did its business in Italy if the affiliated company only did a role of liaison.

8. Profit sharing & PE

8.1. Japanese Case

Guidant group was an American medical equipment maker and Guidant group had affiliated companies in the Netherlands and Japan, named N-Co and J-Co. N-Co and J-Co made a silent partnership arrangement according to Japanese Commercial Law which is broadly known as “TK” (*Tokumei-Kumiai*) arrangement (which is imported from a German concept, *stille Gesellschaft*). In this TK arrangement, N-Co was a silent partner, J-Co did business in Japan, and J-Co made distribution of the business profit to N-Co along with the TK arrangement.

Generally in other countries, distributions of profit to foreign partners or foreign silent partners along with partnership arrangements or silent partnership arrangements are not tax free in source countries. However, in practice¹⁷, distributions along with TK arrangements from Japan to the Netherlands are treated as “other income” under Japan-Netherlands tax treaty, which is similar to OECD Model Tax Treaty Article 21. Of course, J-Co was able to deduct the distribution from its taxable income. Therefore Japanese TK arrangement is known as a source tax free structure.

Moreover, in this case, Dutch tax authority had not imposed tax on N-Co, because N-Co was considered as having a PE in Japan from the view point of Dutch tax law.

In Japanese court, Japanese tax authority argued that N-Co had a PE because the arrangement between N-Co and J-Co was not a typical TK arrangement but an untypical TK arrangement resemble to Civil-Law-partnership arrangement (*Nin'i-Kumiai* arrangement). However Tokyo high court concluded that the arrangement between N-Co and J-Co was a typical TK arrangement and that N-Co did not have a PE in Japan¹⁸.

8.2. Profit milking & entity/contract characterization

Shareholder	_____	Corporation
Partner	_____	Partnership
Creditor	_____	Debtor
R-country		S-country

Profit sharing or profit milking takes some patterns of legal relationships.

Tributaria), Rome, 7 March 2002, reported in 4 International Tax Law Reports 903-946 (2002)

¹⁶ See, OECD Commentary (2008 version) on Article 5, paragraph 41.1.

¹⁷ Some Japanese tax scholars (and also I) have questioned the legality of the following practice.

¹⁸ Nihon Guidant case, Tokyo high court, 2007 June 28, Hanrei-Jihou No. 1985 Page 23. The appeal to the supreme court was not accepted on 2008 June 5.

Needless to say, a corporation is a taxable entity. When a shareholder residing in R-country owns shares of a corporation which is a resident company in S-country, S-country impose income tax on the corporation's income and the non-resident shareholder also bears tax on dividend income from the corporation.

In the second line, a partnership is a transparent entity. When a partner residing in R-country owns interest of a partnership located in S-country, S-country does not impose income tax on the partnership's income but the partnership is usually seen as a PE of the non-resident partner, so the non-resident partner bears income tax directly in S-country.

In the third line, a debtor tends to be a taxable entity. However if a creditor residing in R-country has lent money to a debtor residing in S-country, the debtor can deduct the interest payment to the non-resident creditor from the debtor's taxable income. Interest payments are not usually seen as profit sharing or profit milking but as cost; however economic reality of a certain interest payment might have a nature of profit sharing or profit milking in some cases. And the creditor is not considered as having a PE in S-country. Creditor is only subject to low rate withholding tax.

Even though Japanese tax practices with distributions under TK arrangements are eccentric and we ignore TK issues, there are many typical types for profit sharing or profit milking and tax treatments (deductibility of payment, withholding tax or PE taxation) are seriously different among those typical types. We will not be able to resolve tax avoidance or too heavy taxation completely without rethinking the relationship between profit sharing or profit milking and PE taxation.