

# From Storefronts to Servers to Service Providers: Stretching the Permanent Establishment Definition to Accommodate New Business Models

By  
**Sandra P. McGill**  
and  
**Lowell D. Yoder**

*Sandra P. McGill and Lowell D. Yoder are Partners in the Chicago office of McDermott, Will & Emery. Mr. Yoder is also the Editor-in-Chief of CCH's JOURNAL OF TAXATION OF GLOBAL TRANSACTIONS.*

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### I. Introduction

Multinational corporations (MNCs) are increasingly using business structures that allow them to shift manufacturing and sales profit away from the countries in which they manufacture and sell products (“the source country”) to a low-taxed affiliate. They are doing this by changing their business structures in a way that avoids creating a permanent establishment (PE) for the low-taxed affiliate but without materially changing the level of activities the multinational group conducts in the source country. Foreign countries are reacting to these income shifting business structures unilaterally by interpreting the PE provision of bilateral treaties broadly to tax profits that they believe should properly be taxable in their country. As a result, there is increasing uncertainty concerning how PE provisions will be interpreted and applied by different countries to structures which may be viewed as income shifting.

In the e-commerce area there is substantial uncertainty about how to apply the current PE definition, and there has been much discussion and commentary debating whether there is a need for a new PE definition to address the special nature of e-commerce. This article suggests that outside the e-commerce area—*i.e.*, in the context of income shifting manufacturing and sales structures, which may be even more pervasive than e-commerce—there also may be a need to reconsider the traditional PE definition in order to provide more uniformity and predictability among treaty countries.

This article first discusses the history of the PE provision and the current PE thresholds set forth in the Organisation For Economic

Co-Operation And Development (OECD) Model Treaty. Next, it describes traditional manufacturing and sales business models which result in full source country tax on profits and compares these traditional business models to new manufacturing and sales business models which result in shifting income away from the source country under the PE rules. This article then briefly discusses how the OECD has proposed to apply the current PE definition to e-commerce (which is essentially a type of sales business model that allows MNCs to sell products into a source country without any source country tax) and how countries have reacted to this proposal. Finally, this article describes alternative ways in which foreign countries have attacked income-shifting structures through an expansive interpretation of the PE rules, concluding that reconsideration of the PE definition may be necessary in this context to prevent erosion of the essential purpose of tax treaties to provide uniformity in taxation of cross-border income.

### II. Background

#### A. Genesis of PE Concept

The PE concept was developed to address the problem of international double taxation that exists when “income is earned in one country by a citizen or resident of another country [and] both the country where the income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income.”<sup>1</sup> The definition of a PE was designed to provide a uniform standard for determining which country has priority to tax such cross-border income.

The purpose of the PE requirement was to establish a particular threshold for determining when a foreign enterprise providing goods and services had established a sufficient taxable presence or connection with a jurisdiction to entitle that jurisdiction (*i.e.*, the source country) to tax the transaction including the business profits generated by it.<sup>2</sup>

The PE concept first appeared at the end of the 19th century in a bilateral Treaty between Austria-Hungary and Prussia that has been recognized as the first international tax treaty.<sup>3</sup> This Treaty introduced the concept that business profits earned through a PE in the other country were to be taxed in the other country and also introduced the concept that a fixed place of business was necessary in order to create a PE.<sup>4</sup> The definition of a PE in that early Treaty, however, was much broader than the current definition found in most treaties in that it resulted in all “fixed places of business [being] a PE if they serve a business activity of a foreign enterprise, his partner or an agent of these.”<sup>5</sup> Therefore, for example, a fixed place of business used solely for the purpose of purchasing goods or storing goods would have constituted a PE under that definition.

The legal concept of a PE developed in earnest at the beginning of the 20th century after the second industrial revolution at a time when many new manufacturing based industries were developed. The economic assumption at the time that the PE concept was developed, therefore, was that production factors (*i.e.*, production, labor and capital) were mobile within countries but relatively immobile between countries.<sup>6</sup> The focus of the PE definition was on industrial estab-

lishments such as factories, plants and other commercial establishments with a fixed location (main or head office). Little attention was given to service industries or to enterprises performing business without a fixed place of business in a host country.<sup>7</sup> Because the PE concept emerged at a time when production factors were relatively immobile, taxation based on PE determinations rarely led to controversies between the source and residence states since PE taxation was virtually identical with source state taxation of all significant industries.<sup>8</sup>

In the 1930s, the League of Nations determined that “uniform law” was the superior method of preventing uniform double taxation rather than independent bilateral treaties with different PE definitions in each treaty.<sup>9</sup> The League of Nations developed three model Treaties during the 1930s and 1940s. The first model Treaty did not contain a definition of PE but simply provided examples of what constituted a fixed place of business.<sup>10</sup> The subsequent model treaties, however, contained the basic definition of a PE that an enterprise must have a fixed place of business that must contribute to the profits of the enterprise.<sup>11</sup> The work of the League of Nations was continued by the OECD (initially called the OEEC), which issued a draft model Treaty in 1963 (the 1963 OECD Model Treaty) that contains the essential definition of a PE found in most treaties today.<sup>12</sup>

The United States has entered into Income Tax Treaties with 64 countries, most of which are based on the 1977 OECD Model Treaty and its commentary, as revised.<sup>13</sup> As a result, the OECD Model Treaty and its commentary<sup>14</sup> will be used in this article as a surrogate for a

general discussion of the application of U.S. income tax treaties.

### *B. Fundamental PE Definition*

The PE concept contained in the OECD Model Treaty essentially determines which of the two contracting states has the primary right to tax the business profits of an enterprise. The enterprise’s home country, or country of residence, is generally given the primary right to tax an enterprise’s income. If the enterprise has a PE in the other country (the source country), however, then that country is given the primary right to tax the enterprise’s business profits that are attributable to such foreign country’s PE. In order to prevent double taxation of the enterprise’s income, the enterprise’s home country will either exempt the income taxed in the other country from tax or will grant a credit for the foreign taxes paid on the income attributable to the foreign country PE.

In general, the PE concept requires some type of physical presence in the other country such as a building or persons. Thus, a PE exists if the company has a “fixed place of business” in the country (*e.g.*, an office) through which its employees or other dependent agents carry out business activities.<sup>15</sup> Alternatively, a PE exists even if the company has no fixed place of business in the country, if the company has a person (other than a person acting as an independent agent) that has the authority to conclude contracts on its behalf and habitually exercises such authority.<sup>16</sup> No PE will be considered to exist, however, if the nature of the activities conducted by the fixed place of business (or by the person with contract signing authority) are considered preliminary or auxiliary to the main functions of the business.<sup>17</sup>

### *C. Attribution of Business Profits to PE*

Once it is determined that an enterprise has a PE in a treaty country, the next issue to consider is what business profits are attributed to that PE and are thus taxable by the treaty country. Article 7 of the OECD Model Treaty provides that when an enterprise carries on a business through a PE in another country, that country may tax the profits of the enterprise but only so much of them as are attributable to the PE. This principle “is based on the view that in taxing the profits that a foreign enterprise derives from a foreign country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test.”<sup>18</sup>

In general, Article 7(2) of the OECD Model Treaty provides that the profits attributed to a PE are those which an enterprise “might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.” The Commentary elaborates on this rule stating that “the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market ... Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy.”<sup>19</sup>

For purposes of computing the business profits of a PE, deductions are allowed for expenses that are incurred for the purposes of the PE.<sup>20</sup> These expenses include general and administrative expenses, research and development expenses and interest incurred by the home office, to the extent that they are attributable to the PE.<sup>21</sup>

### D. U.S. Trade or Business and Effectively Connected Income Concepts

In the absence of a tax treaty, U.S. federal income tax law governs the determination of when a foreign enterprise is subject to U.S. tax and how much of such enterprise's income is subject to U.S. tax.<sup>22</sup> In general, under U.S. federal income tax law, a foreign corporation will be subject to U.S. federal income tax on its net income that is "effectively connected" with a U.S. "trade or business."<sup>23</sup>

The Code and regulations provide little guidance as to what constitutes a U.S. trade or business.<sup>24</sup> Under U.S. case law, the determination of whether a foreign corporation is engaged in a U.S. trade or business is based on all the facts and circumstances of the particular case.<sup>25</sup> A foreign corporation generally is considered to be engaged in a U.S. trade or business if its activities in the United States (either directly or through an agent) are "considerable, continuous, and regular."<sup>26</sup> The threshold for establishing the existence of a U.S. trade or business may be lower in certain instances than the threshold for determining the existence of a PE.<sup>27</sup>

If a foreign corporation has a trade or business in the United States, it will be subject to U.S. federal income tax on the income that is "effectively connected" with its U.S. trade or business. In general, three categories of income

may be considered effectively connected: (1) U.S. source investment income if certain additional criteria are satisfied,<sup>28</sup> (2) all noninvestment U.S. source income,<sup>29</sup> and (3) some types of foreign source income.<sup>30</sup> The treatment of all noninvestment U.S. source income as effectively connected income once the foreign person is found to have a U.S. trade or business, even though items of such income are not connected with the U.S. trade or business, is often referred to as the "limited force of attraction" rule.

The U.S. tax principles for determining what income is effectively connected with a U.S. trade or business are relevant for purposes of determining the amount of business profits attributable to a foreign corporation's U.S. PE. The Treaty "attribution of business profits" rules, however, generally are narrower than the U.S. effectively connected income rule.<sup>31</sup>

## III. The PE Thresholds

### A. Fixed Place of Business Test

**1. Assets/Activities Test.** The OECD Model Treaty defines a PE as a "fixed place of business through which the business of an enterprise is wholly or partly carried on."<sup>32</sup> The OECD Model Commentary elaborates on this definition by providing that the following requirements must be satisfied: (1) a "place of business" must exist, (2) the place of business must be "fixed," and (3) the business of the enterprise must be carried on through this fixed place of business.<sup>33</sup> A branch, office, factory or workshop are listed as *prima facie* examples of what constitutes a PE (provided that they satisfy the three requirements set forth above).<sup>34</sup>

A "place of business" is defined to include "any premises, facilities or installations of the entity ... whether or not they were used exclusively for that purpose," and whether they are owned or rented.<sup>35</sup> In addition, even if a foreign enterprise does not own or rent facilities, it may have a place of business if it has at its constant disposal certain premises owned by another enterprise. For example, a place of business may "be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g., for the storage of dutiable goods)."<sup>36</sup> Gaming and vending machines that are operated and maintained by the company or its agent for its own benefit are also considered to create a fixed place of business (and, therefore, a PE) for a company.<sup>37</sup>

The second requirement is that the place of business be fixed, meaning that there must be a link between the place of business and a certain geographic location, and it must not be temporary in nature.<sup>38</sup> This means that the place of business must be established at a distinct place and with a certain degree of permanence.<sup>39</sup>

Finally, the enterprise using the PE must carry on its business wholly or partly through such PE.<sup>40</sup> The business of an enterprise is carried on mainly by the enterprise's personnel, including employees and dependent agents who receive instructions from the enterprise.<sup>41</sup> Therefore, if the enterprise has dependent agents who conduct the business of the enterprise where the fixed place of business is located, the fixed place of business will constitute a PE. For purposes of satisfying the fixed place of business PE test, it is unnecessary that the personnel have the authority to conclude contracts

in the name of the enterprise if the personnel work at the enterprise's fixed place of business.<sup>42</sup> The Commentary to the Treaty also recognized that the business activity of an enterprise does not have to involve employees so long as a business activity is performed if the business is fully automated (e.g., in the case of the gaming machines described above).<sup>43</sup>

**2. Exception for Preliminary or Auxiliary Activities.** Certain activities even if conducted through a fixed place of business will not constitute a PE. These activities, generally considered "preliminary or auxiliary" activities, include (1) use of facilities solely for storing, displaying or delivering goods or merchandise belonging to the enterprise; (2) maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; (3) maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another enterprise; (4) maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise for the enterprise or collecting information for the enterprise; (5) maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise any other activity of a preparatory or auxiliary character; and (6) maintenance of a fixed place of business solely for any combination of the above-mentioned activities, provided that the overall activity of the fixed place resulting from this combination is of a preparatory or auxiliary character.<sup>44</sup>

The fact that one place of business combines any of the above activities listed as preparatory or auxiliary activities does not mean that a PE exists. If the combined activity of such a fixed place of

business is merely preparatory or auxiliary, no PE should be deemed to exist.<sup>45</sup> On the other hand, activities that are merely preparatory or auxiliary when considered separately may constitute a PE when considered together.<sup>46</sup>

The purpose of this provision is to exclude from the source country's tax jurisdiction places of business whose activities "may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question."<sup>47</sup> The decisive characteristic in determining whether an activity is preparatory or auxiliary is whether the activity of the fixed place of business forms by itself an essential and significant part of the activity of the enterprise as a whole.<sup>48</sup> Therefore, a fixed place of business whose general purpose is identical to the general purpose of the whole enterprise is not considered engaged in a preparatory or auxiliary activity.<sup>49</sup>

Examples of preliminary or auxiliary activities include fixed places of business that are used solely for the purpose of advertising, for the supply of information, for scientific research or for the servicing of a patent or know how contract if such activities have a preliminary or auxiliary character for the enterprise in question. Also, "back-office" type functions such as invoicing, collections, accounting and similar activities are generally considered preliminary or auxiliary activities.

A fixed place of business which has the function of managing an enterprise or only part of an enterprise is not preliminary or auxiliary, however, since managing an enterprise constitutes an essential part of the business

enterprise.<sup>50</sup> In addition, fixed places of business which engage in post-sales activities, such as supplying spare parts to customers for machinery sold to customers and maintaining and repairing such machinery, are not preliminary or auxiliary activities because they form an essential and significant part of the services of an enterprise to its customers.<sup>51</sup>

## B. PE Through Activities of Agents (Dependent Agent Test)

**1. Person (Other Than Independent Agent) with Authority to Conclude Contracts on Behalf of Enterprise.** An enterprise which does not have a fixed place of business in a Treaty country may still have a PE in that country if there is a person (either an individual or an entity), other than an independent agent, in that country who acts on behalf of the enterprise and "has and habitually exercises" in that country the authority to conclude contracts in the name of the enterprise (other than contracts which relate to activities which are of a preparatory or auxiliary nature).<sup>52</sup> This test is often referred to as the "dependent agent PE test," even though, as described below, it is not necessary to establish under agency rules that the person acting in the foreign country is in fact an agent of the foreign enterprise.

This test only applies if the enterprise does not have a PE under the fixed place of business test.<sup>53</sup> For example, if an enterprise has employees located in a fixed place of business in a Treaty country, the enterprise will be considered to have a PE in the Treaty country under the fixed place of business test, regardless of whether the employees have the authority to conclude contracts in the name of

the enterprise, unless the activities of the employees are of a preliminary or auxiliary nature.

A “person,” for purpose of this PE definition, is defined as any person, whether an employee or not and whether an individual or a corporation, who is not an independent agent as defined in Article 5(6) of the Treaty.<sup>54</sup> There is no requirement that such person be an agent under agency principles. For example, under U.S. law, a person will be considered an agent only if there is an agency agreement in place between the parties and the agent holds itself out to third parties as acting for the benefit of its principal, not on its own behalf.<sup>55</sup> For purposes of the PE definition, if the person has the authority to conclude contracts on behalf of the enterprise and regularly exercises such authority, such person may create a PE for the enterprise, even if such person is not considered an agent for U.S. tax purposes (*e.g.*, such person is an undisclosed agent).<sup>56</sup>

The person must have the authority to conclude contracts on behalf of the enterprise. This includes contracts that are binding on the enterprise, even if not literally in the name of the enterprise (*i.e.*, contracts entered into by an undisclosed agent).<sup>57</sup> A person is considered to conclude contracts on behalf of an enterprise in a Treaty country if the person is authorized to negotiate all elements and details of a contract in a way binding on the enterprise, even if the contract is signed by another person outside the country.<sup>58</sup> The 2002 Draft OECD Model Commentary provides that:

Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be

considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalize) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.<sup>59</sup>

The requirement that an agent must “habitually” conclude contracts on behalf of the enterprise reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory before it can be considered to have a PE.<sup>60</sup> Whether the authority to conclude contracts is habitually exercised in the other country must be determined based on the commercial realities of the situation (*i.e.*, the nature of the contracts and the business of the principal).<sup>61</sup> In addition, the authority to conclude contracts must cover contracts relating to operations that constitute the business proper of the enterprise.<sup>62</sup>

If an enterprise has a person other than an independent agent in a Treaty country that has the authority to conclude contracts on its behalf but the activities of the person are limited to the preliminary or auxiliary type activities which would not give rise to a PE if conducted through a fixed place of the business, no PE will be considered to exist by reason of that person’s activities.<sup>63</sup>

### **2. Independent Agent Defined.**

The issue of whether an enterprise has an agency PE in a Treaty country often turns on the question of whether the person acting on its behalf in the Treaty country is an independent agent or not. Article 5(6) of the OECD Model Treaty provides that “[a]n enterprise shall not be deemed to have a perma-

nent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their trade or business.”

An independent agent is defined as a person that is (1) independent of the enterprise both legally and economically, and (2) acts in the ordinary course of its business when acting on behalf of the enterprise.<sup>64</sup> The Commentary to the OECD Model provides that a person is considered to have legal independence if the person’s commercial activities are not subject to detailed instructions or to comprehensive control by the enterprise.<sup>65</sup> The 2002 Draft OECD Model Commentary also provides that another factor to be considered in determining independent status is the number of principals represented by the agent: “Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time.”<sup>66</sup>

A person is considered to have economic independence if the person bears entrepreneurial risk.<sup>67</sup> The 2002 Draft OECD Model Commentary further provides that “the character of the remuneration which an agent receives may provide a useful indication of whether (or to what extent) the agent bears the commercial risk of his activities.”<sup>68</sup> For example, if the agent is contractually protected from losses and guaranteed a stream remuneration (*i.e.*, through a cost-plus service arrangement), that is indicative of dependent agent status. This factor is not decisive, however, if the agent can show that it has a real possibility of loss as a consequence of risk borne in the conduct of its business.<sup>69</sup>

**3. Related Business Entities.** The existence of a subsidiary company does not, by itself, cause the subsidiary company to be treated as a PE of its parent or of another affiliated company.<sup>70</sup> “This follows from the principle that, for the purposes of taxation, such a subsidiary company constitutes an independent legal entity.”<sup>71</sup> This is true even if the trade or business carried on by the subsidiary company is managed by the parent company.<sup>72</sup> A subsidiary will constitute a PE of its parent, however, if it cannot be regarded as an independent agent and if it has and habitually exercises an authority to conclude contracts in the name of the parent company (*i.e.*, if it acts as a dependent agent PE for its parent).<sup>73</sup>

## IV. Comparing Traditional Manufacturing Business Models to New Models That Shift Manufacturing Profit out of the Source Country

This section describes the traditional cross border manufacturing models that were contemplated at the time the PE definition was drafted, focusing on a foreign multinational corporation conducting manufacturing operations in the United States producing products for sale outside the United States. This section analyzes the U.S. tax consequences of these traditional manufacturing business models, and then compares the traditional models to new manufacturing business models which may be used by an MNC

to reduce the amount of its overall tax by reducing the amount of manufacturing profit allocated to the United States under the PE rules and shifting this income to a low-tax jurisdiction.

For purposes of the examples set forth in the following discussion, it is assumed that a French MNC will manufacture products in the United States for sale outside the United States. The French tax rate is assumed to be 40 percent and the U.S. blended tax rate is assumed to be 40 percent.

### A. Traditional Manufacturing Business Models

#### 1. U.S. Manufacturing Subsidiary.

One traditional structure is for a foreign corporation (MNC) to set up a wholly owned U.S. subsidiary (“U.S. Manufacturing Sub”) to manufacture products. U.S. Manufacturing Sub would manufacture products in the United States and sell them to MNC for MNC to sell to its customers.

Under this alternative, all of the manufacturing profit would be earned by U.S. Manufacturing Sub and would be subject to U.S. federal income tax since U.S. Manufacturing Sub would be a U.S. taxpayer and would therefore be subject to tax on its worldwide income.<sup>74</sup>

**Example 1.** French MNC forms U.S. Manufacturing Sub to conduct manufacturing operations in the United States and to sell the products to MNC for resale. Assuming that U.S. Manufacturing Sub earned \$100 of income from its manufacturing operations, the income would be subject to \$40 of U.S. tax.

MNC would not be considered to have a PE in the United States as a result of purchasing products from U.S. Manufacturing Sub.

Purchasing activities are specifically included in the list of activities which are considered to be preparatory or auxiliary and do not result in the creation of a PE. This would be true even if MNC had an office in the United States through which it conducted its purchasing activities, or had a dependent agent in the United States with the authority to sign purchase orders on its behalf.<sup>75</sup>

#### 2. U.S. Manufacturing Branch.

Alternatively, MNC may conduct the manufacturing operations in the United States directly rather than through U.S. Manufacturing Sub. In that case, MNC would be considered to have a PE in the United States under the fixed place of business test (*i.e.*, it would have a factory or plant in the United States) and would be subject to U.S. tax on the income attributable to the manufacturing PE (*i.e.*, the manufacturing profit). Under the example set forth above, if MNC earned \$100 from its manufacturing operations in the United States, it would be subject to \$40 of U.S. tax on that income (*i.e.*, \$100 x 40%).<sup>76</sup> MNC should not be subject to U.S. tax on its sales income, however, because MNC’s sales profit would not be considered attributable to its U.S. PE (*i.e.*, assuming the manufacturing plant was not involved in the sales activities that gave rise to the sales income).<sup>77</sup>

### B. Manufacturing Business Models Used to Minimize Local Country Manufacturing Profits

It is generally beneficial for a MNC with manufacturing operations in a high-tax country to develop a structure that shifts the manufacturing income to a low-tax country. This can be done by forming a subsidiary company in a low tax country, such as Switzerland, to take on certain functions

and assume certain economic risks.<sup>78</sup> For purposes of the following examples, it is assumed that MNC has a wholly owned subsidiary in Switzerland (“Swiss Co”) that is subject to a 10-percent Swiss tax rate.

### 1. Contract Manufacturing

**a. General.** A MNC may use a contract manufacturing arrangement as a technique for increasing the tax savings in the country where the products are manufactured. This type of arrangement allows a group of related corporations to reduce income in a high-tax jurisdiction by reducing the amount of the manufacturer’s profit earned by a high taxed manufacturer and splitting off the sales profit (for both U.S. and non-U.S. sales) into a low taxed affiliate (*i.e.*, Swiss Co).

Under a contract manufacturing arrangement, one party hires another party to manufacture products on its behalf; *i.e.*, “the Principal.” The Principal generally controls and supervises the manufacturing process, provides the manufacturing intangibles with respect to the manufacture of the products, and retains all risks and benefits with respect to the manufacture and sale of the products. A second party typically owns (or leases) the manufacturing facilities and performs manufacturing in the facilities through its own employees as a service to the Principal, rather than producing products for entrepreneurial profits; *i.e.*, the “Manufacturing Services Provider.”<sup>79</sup>

The Principal may be formed in a low-tax jurisdiction (*e.g.*, Switzerland, Ireland, Hong Kong or a tax haven country), and earns most of the income derived from the production and sale of products produced by the Manufacturing Services Provider under a manu-

facturing services arrangement. The Manufacturing Services Provider, however, may be located in a high-tax jurisdiction as the best place to manufacture the product (*e.g.*, United States, Germany, Italy or Japan), and earn only a service fee (*e.g.*, cost plus five percent).<sup>80</sup>

**Example 2.** Assume the same facts as in Example 1 except that MNC owns 100 percent of Swiss Co and Swiss Co<sup>81</sup> enters into a contract manufacturing arrangement with U.S. Manufacturing Sub pursuant to which U.S. Manufacturing Sub agrees to manufacture products in the United States for Swiss Co in exchange for a service fee (*i.e.*, a small markup over costs). U.S. Manufacturing Sub purchases all of the raw materials and components and Swiss Co acquires title to the finished products. Swiss Co sells the products to French MNC. A portion of the income from the manufacturing activities is shifted from U.S. Manufacturing Sub to Swiss Co because U.S. Manufacturing Sub functions only as a service provider (rather than as an entrepreneur). For example, of the \$100 of profits from manufacturing products, U.S. Manufacturing Sub may earn \$20 and Swiss Co \$80, with U.S. taxes reduced to \$8 (*i.e.*, \$20 x 40%), and total taxes on the manufacturing profits are reduced from \$40 to \$16 (*i.e.*, \$8 of U.S. tax plus \$8 of Swiss tax – \$80 x 10%), or a tax savings of \$32.

**b. PE Analysis.** The contract manufacturing arrangement (which is structured as a buy-sell arrangement) between Swiss Co and U.S. Manufacturing Sub should not

cause Swiss Co to have a U.S. PE. Swiss Co does not have an office or employees in the United States and, therefore, does not have a fixed place of business PE in the United States. In addition, U.S. Manufacturing Sub is not authorized to enter into contracts on behalf of Swiss Co and, therefore, should not create an agency PE in the United States for Swiss Co.

In addition, there does not appear to be a basis under U.S. law (or under the OECD Model Treaty) for imputing the activities of a contract manufacturer to its Principal for purposes of creating a PE for Swiss Co.

The Tax Court addressed the treatment of contract manufacturing arrangements for Subpart F purposes in *Vetco, Inc.*<sup>82</sup> and *Ashland Oil, Inc.*<sup>83</sup> and held that the Manufacturing Services Provider did not constitute a “branch” of the Principal for purposes of applying the subpart F “branch” rules.<sup>84</sup> In reaching its decision in both cases, the court relied on the fact that the contract manufacturer was a separate corporation, and therefore its activities should not be attributed to the Principal for purposes of determining if the Principal had a foreign manufacturing branch. While not expressly on point, the Tax Court’s holdings in *Vetco* and *Ashland Oil* may be used to support the position that the activities of the Manufacturing Services Provider should not be attributed to the Principal for purposes of treating the Principal as having a PE in the country in which the manufacturer is located.

In addition, in an early case involving the U.K.-Australia Treaty, the Australian court rejected the argument that a U.K. corporation could be treated as having a “factory” in Australia as a result of a contractual arrangement to purchase goods

from a related Australian corporation that manufactured products on its behalf.<sup>85</sup> In that case, a U.K. corporation was a shareholder (along with four other companies) of an Australian corporation (“A”), which manufactured goods sold by its shareholders. The U.K. corporation (and the other shareholders of A) licensed technology to A to manufacture certain products for them, and the shareholders were each entitled to a quota share of A’s production. In finding that the U.K. corporation did not have a PE in Australia, the court rejected the argument that A was a “factory” of the taxpayer, stating that:

If it were to be held that the factory portion of the definition had been satisfied, then I am unable to see how, in principle, a similar application of the definition could be denied in any case where a United Kingdom establishment purchased from a local company which operated a factory locally situated. This, in my opinion, would be an absurd result and one right out of harmony with the obvious intention of the Double Tax Agreement.

## 2. Consignment Manufacturing

**a. General.** A “consignment” or “toll” manufacturing arrangement is similar to a contract manufacturing arrangement except that the Principal acquires the raw materials and components, and at all times owns the raw materials, components, work-in-process, and finished products. The Principal may provide the raw materials and components to the Manufacturing Services Provider or the manufacturer may purchase them on behalf of the Principal. In a traditional contract manufacturing arrangement, by contrast, the

Manufacturing Services Provider holds title to the raw materials, components and work-in-process (although the Principal generally assumes the inventory risks) and title to the products transfers to the Principal upon completion of the products. The economic result is essentially the same in both arrangements; that is, the service provider receives an arm’s-length fee based on a small markup on its costs (which includes inventory carrying costs in a consignment manufacturing arrangement). The PE analysis in a consignment manufacturing arrangement, however, is different than in the contract manufacturing arrangement (which is typically a pure buy/sell arrangement).

**b. PE Analysis.** The act of purchasing raw materials or components in the United States either directly by the Principal or by the Manufacturing Services Provider on behalf of the Principal should not by itself cause the Principal to have a PE in the United States since, as discussed above, purchasing activities are considered as preparatory or auxiliary activities. Many Treaties (including the U.S./Swiss Treaty) now provide that “the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another enterprise” is a preliminary or auxiliary activity that does not give rise to a PE.<sup>86</sup> Therefore, the fact that the Principal may own the raw materials and work in process during the manufacturing process should not by itself cause the Principal to have a U.S. PE.

The Principal may also warehouse its manufactured products in the United States. The use of a fixed place of business in the United States solely for the purpose of storage is a preliminary or auxiliary activity, which should

not, by itself, cause the Principal to have a PE in the United States.

When a number of preliminary or auxiliary activities are conducted through a fixed place of business or dependent agency arrangement, however, the activities must generally be considered as a whole to determine if together they constitute a PE.<sup>87</sup> If the Principal is purchasing raw materials in the United States, providing the raw materials to the Manufacturing Services Provider to have them processed on its behalf, and is warehousing the products in the United States, the combination of all of these activities may rise to the level of a PE.<sup>88</sup>

In GCM 35183,<sup>89</sup> the IRS ruled that a foreign copper company that had its unrefined copper refined in the United States and converted to electrolytic copper through a consignment manufacturing arrangement with a U.S. company had a PE in the United States. Although the reasoning articulated in the GCM is not entirely clear, the IRS appears to have drawn a distinction between a contract manufacturing arrangement where the Manufacturing Services Provider owns all of the raw materials and components during the processing and sells the finished products to the Principal (which would not create a PE), and a consignment manufacturing arrangement where the Principal has title to the raw materials during the processing.

There is some uncertainty, therefore, as to whether a U.S. consignment manufacturer may constitute a PE of a foreign principal, both because of the IRS’s holding in the GCM and because of the language in the OECD Model PE provisions which requires that all of the preliminary and auxiliary activities engaged in by the Principal in the United States

must be considered as a whole to determine if together they constitute a PE. In order to avoid this uncertainty, it is best to structure the arrangement with the U.S. Manufacturing Services Provider as a contract manufacturing arrangement rather than as a consignment manufacturing arrangement.

### 3. Manufacturing Related Services

**a. General.** Under the structures described above, various functions and risks are shifted away from the local manufacturing affiliate. As a result, the MNC (or an affiliate) must perform such functions, and monitor the activities of the Manufacturing Services Provider to manage its risks. The services provided may be tangential to the core manufacturing function. For example, in both the contract and consignment manufacturing structures, MNC would typically be involved in quality control activities in the United States. In addition, MNC might also have warehousing activities in the United States and certain post-sale activities such as installation, training, and warranty services.

In order to limit its local PE exposure, MNC may hire local service providers, related or unrelated, to provide these services to it in the United States in exchange for an arm's-length fee based on their costs plus a percentage of their costs as a return.

**b. PE Analysis.** As discussed above, a MNC generally will be considered to have a PE in the United States if it has either a fixed place of business in the United States or a dependent agent in the United States with the authority to conclude contracts on its behalf. Even if MNC has a fixed place of business in the United States by reason of its activities in the United States, however, it will not be considered to have a PE if the activities engaged in at

the fixed place of business are preliminary or auxiliary activities (*e.g.*, purchasing activities or storage activities). Similarly, if the MNC has a dependent agent in the United States, the dependent agent will not create a PE in the United States if its contract signing authority is limited to activities which are preliminary or auxiliary.

As described above, if a foreign taxpayer maintains a fixed place of business in the United States solely for any combination of preliminary or auxiliary activities, it will not have a PE provided that the overall activity of the fixed place of business (*i.e.*, looking at all of the preliminary or auxiliary activities together) resulting from this combination is of a preparatory or auxiliary character.<sup>90</sup>

In addition, MNC may have other limited contacts with the United States that should not even rise to the level of creating a fixed place of business in the United States for MNC (and, therefore, should not need to rely on the exempt activities provision to avoid PE status). For example, MNC will purchase finished products in the United States from the U.S. contract manufacturers. In addition, some of MNC's employees may travel to the United States periodically to provide quality control (or similar services) to the U.S. contract manufacturers. These activities should not be given much weight for purposes of determining if a PE exists.<sup>91</sup>

### C. Summary

In summary, under the traditional manufacturing business models, MNC is subject to U.S. tax on all of its manufacturing profit—either at the U.S. subsidiary level or directly if the manufacturing function is conducted through a U.S. branch. Therefore, assuming

\$100 of manufacturing profit, \$40 of U.S. tax is imposed on the manufacturing profit under the traditional business models.

In the new manufacturing business models, however, since the U.S. contract/consignment manufacturer earns a cost plus fee for its services rather than earning all of the manufacturing profit, only a small portion of the manufacturing profit is subject to U.S. tax. In the example above, assuming \$100 of manufacturing profit, only \$20 was paid to the U.S. Manufacturing Services Provider, resulting in a U.S. tax of only \$8 (rather than \$40). In addition, since the remaining manufacturing profit was earned by a Principal located in a low tax jurisdiction such as Switzerland, the remaining \$80 of manufacturing profit was subject to Swiss tax of only \$8 (*i.e.*, \$80 x 10%).

As discussed above, the contract manufacturing structure should not give rise to a U.S. PE so long as the foreign Principal does not carry on significant other activities in the United States through its own employees related to the manufacturing activities conducted by the Principal. In the case of the consignment manufacturing model, there is some question as to whether that arrangement may create a PE for the foreign Principal, although if structured properly (*i.e.*, by limiting the number of contacts that the Principal has with the United States other than the consignment manufacturing arrangement), it should not have that result.

Thus, by structuring its manufacturing operations using the contract/consignment manufacturing arrangements rather than the traditional manufacturing arrangements, the MNC is able to significantly reduce its U.S. tax liability (and reduce its overall taxes

on its manufacturing profit), without materially changing the level of activities conducted in the United States (*i.e.*, it still has a U.S. manufacturing subsidiary in the United States).

## V. Comparing Traditional Sales Business Models to New Business Models That Shift Sales Income out of the Source Country

This section describes the traditional cross-border sales models that were contemplated at the time the PE definition was drafted, focusing on a foreign multinational corporation selling products to U.S. customers. This section then analyzes the U.S. tax consequences of these traditional sales business models and compares the traditional models to new sales business models which result in shifting income out of the United States under the PE rules.

For purposes of the examples set forth in the following discussion, it is assumed that a French multinational corporation (“French MNC”) purchases inventory that is manufactured outside the United States and sells the inventory to U.S. customers. The French tax rate is assumed to be 40 percent and the U.S. blended tax rate is assumed to be 40 percent.

### A. Traditional Sales Structures

#### 1. Direct Sales

**a. General.** A MNC may sell products directly to U.S. customers from outside the United States. This type of arrangement should not cause MNC to have a PE in

the United States so long as MNC has little or no activities in the United States.

**Example 4.** Assume French MNC purchases products and sells the products to unrelated customers in the United States. French MNC has minimal activities in the United States. Assume French MNC earns \$150. Under these circumstances, all of French MNC’s sales income is taxable in France. French MNC would pay \$60 of taxes to France, and no income taxes to the United States.

**b. PE Analysis.** As long as MNC sells products to U.S. customers from outside the United States and has little if any U.S. contacts, MNC should not have a U.S. PE.

MNC may, through its own employees, perform certain sales related activities in the United States (*e.g.*, marketing and solicitation). This should not result in a U.S. PE so long as its employees are not in the United States on a regular basis. A better alternative may be for MNC to hire a separate U.S. company to provide certain solicitation, marketing and other related services to it in the United States in exchange for a fee. The activities of the services company should not cause MNC to have a PE in the United States so long as the U.S. company does not have the authority to negotiate any of the terms of the sales contracts entered into by MNC or to conclude the sales contracts.

#### 2. U.S. Commission Agent

**a. General.** Alternatively, MNC may sell products to customers in the United States through a local commission agent. The commission agent generally acts in the name, and on behalf, of the prin-

cipal (*i.e.*, as a disclosed agent). Title to the products passes from MNC directly to the U.S. customer. This kind of an arrangement would cause MNC to have a PE in the United States.

**Example 5.** Assume French MNC owns 100 percent of a U.S. corporation (U.S. Sales Agent Sub) which acts as a commission agent for MNC. U.S. Sales Agent Sub solicits sales and concludes the contract with U.S. customers on behalf of French MNC, and title to the products passes directly from the French MNC to the U.S. customers. French MNC earns the sales income and pays a service fee to U.S. Sales Agent Sub. Assume French MNC earns \$150 of sales income. Of this amount, \$50 is attributable to its purchasing activities and \$100 is attributable to its sales activities. Assume French MNC pays a \$20 commission to U.S. Sales Agent Sub. As discussed below, French MNC would be considered to have a PE in the United States and its purchase and sales income (subject to the deduction for the amount paid to U.S. Sales Agent Sub) would all be subject to U.S. federal income tax. As a result, the entire \$150 of sales income derived by French MNC and its U.S. Sales Agent Sub would be subject to U.S. tax of \$60.

**b. PE Analysis.** As discussed above, a taxpayer will be considered to have a PE in a local treaty country if a person (other than an agent of independent status) is acting on its behalf and has and habitually exercises an authority to conclude contracts on its behalf in the local country.<sup>92</sup> For this

purpose, a person will be considered to exercise an authority to conclude contracts on behalf of a foreign taxpayer if the person is authorized to negotiate all elements and details of a contract in a way binding on the enterprise even if the contract is signed by another person.<sup>93</sup>

The IRS and U.S. courts have expressly held that where a foreign taxpayer has a sales agent in the United States, the sales agent creates a PE for the foreign taxpayer. In *F. Handfield*,<sup>94</sup> for example, the Tax Court held that where the relationship between a foreign taxpayer and his contact in the United States was one of principal/agent, the activities of the agent created a PE for the foreign taxpayer under the U.S.-Canada Treaty. In *Handfield*, a Canadian person manufactured postcards in Canada and entered into an agreement with a U.S. company to have the U.S. company be the exclusive distributor of these postcards in the United States. In the absence of other facts to show that a buy-sell arrangement existed between the parties, the court relied exclusively on the terms of the agreement to find that the arrangement between the parties was an agency arrangement and held that the Canadian person had a PE in the United States as result of this arrangement.<sup>95</sup>

Similarly, in LTR 6510289940A,<sup>96</sup> the IRS ruled that where a foreign corporation sold its merchandise in the United States under an arrangement with its U.S. subsidiary whereby title passed directly from the foreign corporation to the customer, the foreign corporation was treated as having an agent in the United States which resulted in it having a PE in the United States. The IRS distinguished this arrange-

ment from the consignment arrangement analyzed in Rev. Rul. 63-113 (*see* discussion below), in which title passes to the U.S. seller and thereby causes the arrangement between the parties to be treated as a buy-sell arrangement rather than an agency arrangement.

A U.S. PE may generally be avoided so long as U.S. Sales Agent Sub does not have any authority to negotiate and/or sign the sales contracts and the sales contracts are negotiated and signed by MNC outside the United States.<sup>97</sup> If U.S. Sales Agent Sub negotiates all of the terms of sale, however, and MNC simply authorizes such sales, U.S. Sales Agent Sub will be considered to have concluded sales on behalf of MNC, and therefore create a U.S. PE.<sup>98</sup>

**c. Determining Amount of Sales Income Attributable to a U.S. PE.** As discussed briefly above, if a foreign corporation has a PE in the United States, it will be subject to U.S. federal income tax only on its income that is “attributable to” such U.S. PE.<sup>99</sup> The IRS has ruled that the concept of taxing profits attributable to a U.S. PE is analogous to the concept of taxing profits effectively connected to a U.S. trade or business and, therefore, the U.S. tax rules should apply for purposes of determining the amount of income attributable to a U.S. PE with certain limitations, discussed below.<sup>100</sup>

In general, whether income is “effectively connected” depends in part on its source.<sup>101</sup> Under the “effectively connected” rules of the Code, all U.S. source noninvestment income, such as sales income,<sup>102</sup> is considered to be effectively connected income for U.S. tax purposes.<sup>103</sup> This rule is often referred to as the “limited force of attraction” rule. In the case of foreign source sales income,

however, such income will be considered effectively connected income (and 100 percent subject to U.S. tax) only if the foreign corporation has an office or fixed place of business in the United States *and* the U.S. office or other fixed place of business (which is defined to include a dependent agent with the authority to conclude contracts) was a material factor<sup>104</sup> in the realization of the sales income.<sup>105</sup>

A foreign corporation resident of a Treaty country will be subject to U.S. tax on 100 percent of its sales income (whether U.S. or foreign source) to the extent it has a PE in the United States and the U.S. PE is a material factor in such sales (*i.e.*, the limited force of attraction rule does not apply under the Treaty).<sup>106</sup> Note that if the U.S. PE is a material factor in realizing income from the inventory sales, then for U.S. tax purposes, *all* of the sales income is considered attributable to the U.S. PE.<sup>107</sup> This is true even though the foreign corporation may carry on significant purchasing or other activities outside the United States to which some of the sales income could be attributed.<sup>108</sup>

As an exception to this general rule, which subjects to U.S. tax all sales income that is considered attributable to a U.S. PE, if the property sold in the United States was manufactured by the seller outside the United States, then 50 percent of the profits is treated as manufacturing income (not subject to U.S. tax<sup>109</sup>) and only 50 percent of the profits is treated as sales income subject to U.S. tax.<sup>110</sup>

Under the above Example 5, \$150 of income in aggregate is derived from the sales to U.S. customers. Of this amount, the \$20 derived by U.S. Sales Agent Sub would be subject to U.S. tax, because it is a U.S. corporation. In addition, French MNC’s re-

maintaining \$130 is considered as attributable to its U.S. PE, even though \$50 is economically derived from its purchasing activities that occur in France.

### 3. U.S. Distributor

**a. General.** Instead of selling directly into the United States or through a U.S. sales agent, MNC may sell products to a local U.S. distributor (related or unrelated) for resale to customers in the United States. In that case, the distributor takes title to the products and acts in its own name and on its own behalf when it on-sells the products to U.S. customers. If the U.S. distributor acts as an entrepreneur, all income associated with the sale of products to U.S. customers would be fully taxed at the U.S. distributor level.

**Example 6.** Assume the facts above, except French MNC forms U.S. Distributor Sub in the United States. U.S. Distributor Sub buys products from French MNC and sells the products to unrelated customers for use in the United States. Assume U.S. Distributor Sub earns \$100 of sales profit, and French MNC earns \$50 for its purchasing activities. U.S. Distributor Sub would pay \$40 of U.S. tax on the sales income. French MNC's \$50 derived from its purchasing activities would not be subject to tax in the United States (but would be taxable in France).

**b. PE Analysis.** French MNC would not have a U.S. PE as a result of selling its products to U.S. Distributor Sub since French MNC would not have a fixed place of business in the United States and U.S. Distributor Sub would sell products on its own behalf rather than on behalf of French

MNC and, therefore, would not create a dependent agent PE for French MNC. U.S. Distributor Sub would be subject to U.S. taxes on its own sales profits.

The amount subject to tax in the United States, however, differs from the results in Example 5. This is because when French MNC itself sells through a PE, its purchasing profits are attributed to the U.S. PE, and become subject to U.S. taxation. When a buy-sell U.S. distributor structure is used, however, only the sales portion of the profits is subject to U.S. taxation.

### B. Structures Used to Minimize Local Country Sales Profits

This section provides a description of structures increasingly used by multinationals to reduce the amount of overall tax imposed on their sales income, focusing specifically on the MNC's ability to reduce its U.S. tax on its sales income and the PE consequences of these structures.

#### 1. Consignment Sales Arrangement

**a. General.** In a *consignment sales arrangement* (also referred to sometimes as a *limited risk buy-sell arrangement*), the local distributor holds title to the inventory momentarily (e.g., on a consignment basis) and accepts limited risks, while the foreign sales company retains inventory, credit, warranty and currency risks. This structure can be used to reduce the amount of U.S. tax imposed on profits from sales to U.S. customers.

For example, a multinational company may organize a company in a low-tax jurisdiction, such as Switzerland, to purchase products from related and unrelated persons and serve as a master distributor. Related limited risk distributors may be formed in high-tax countries such as the United States to sell the products

to local customers. This structure allows for a reduction of overall tax on sales income by shifting sales income from the high tax countries where the products are sold to the low tax country of the master distributor.

**Example 7.** For example, assume the same facts as in Example 6 except that MNC has a wholly owned subsidiary in Switzerland ("Swiss Co") that is subject to tax in Switzerland at a 10-percent rate. Swiss Co purchases products from unrelated suppliers, and sells them to U.S. Distributor Sub at an arm's-length price and title transfers from Swiss Co to U.S. Distributor Sub immediately prior to the sale by U.S. Distributor Sub to its U.S. customers. U.S. Distributor Sub sells the products to customers on its own behalf, in its own name and at prices that it (not Swiss Co) determines. U.S. Distributor Sub, for products in its possession, bears the cost of warehousing the products and pays for the insurance on these products (with the proceeds to go to Swiss Co) until they are sold to customers. U.S. Distributor Sub is under no obligation to purchase the products and Swiss Co has the right to recall any consigned products prior to sale. U.S. Distributor Sub provides Swiss Co with an inventory of products held on consignment, but is not required to account to Swiss Co for the proceeds of its sales. U.S. Distributor Sub does not have the authority to contract for sales on behalf of Swiss Co. U.S. Distributor Sub holds title to the products on a "flash title" basis and bears very little entrepreneurial risk with respect to the inventory. Assume that U.S. Sub earns \$20 of income on the sales to U.S. cus-

tomers and that Swiss Co earns \$130 of income on the sales to U.S. Distributor Sub. U.S. Distributor Sub would pay U.S. tax of \$8 on its sales income and Swiss Co would pay Swiss taxes of \$13 on its sales income, resulting in a total tax of \$21 on the sales income (assuming Swiss Co does not have a U.S. PE).

**b. PE Analysis.** As discussed above, Swiss Co. will be considered to have a PE in the United States if it has a fixed place of business in the United States or if there is a person in the United States (other than an independent agent) that has the authority to conclude contracts on its behalf and regularly does so. As a result of the consignment sales arrangement, Swiss Co. will sell products to U.S. Distributor Sub and U.S. Distributor Sub will onsell the products in its own name to customers in the United States. U.S. Distributor Sub will not sell the products to U.S. customers for or on behalf of Swiss Co.

Swiss Co should not be considered to have a PE in the United States as a result of selling products to a U.S. affiliate (U.S. Distributor Sub) on a consignment sales basis so long as the arrangement is structured to comply with the guidelines set forth in the IRS rulings discussed below. By contrast, if Swiss Co had an agency arrangement with U.S. Distributor Sub (discussed above), which is economically similar to a consignment sales arrangement, Swiss Co would have a PE in the United States and would be subject to U.S. tax on all of its income from sales to U.S. customers.

In Rev. Rul. 63-113, Rev. Rul. 76-322 and several private letter rulings<sup>111</sup> the IRS has ruled that a foreign person who enters into a consignment arrangement with a

U.S. person is not considered to have a U.S. PE because the arrangement is characterized as a buy-sell arrangement, rather than an agency arrangement. These cases all involved similar facts—a foreign corporation (“Foreign Seller”) sold products to a related or unrelated U.S. corporation (“U.S. Buyer”) at arm’s-length prices and the U.S. Buyer sold the products to U.S. customers on its own behalf and in its own name. The U.S. Buyer on consignment held the products; that is, the title to and ownership of such products was in the Foreign Seller until purchased by the U.S. Buyer immediately before the sale of such products by the U.S. Buyer. The U.S. Buyer set the prices at which it sold the products to U.S. customers.

In these rulings the parties entered into a consignment agreement which generally provided as follows: (1) U.S. Buyer bears the expense and risk of loss on the products sold to U.S. customers; (2) U.S. Buyer may from time to time and without notice to or consent of Foreign Seller move its products to such locations as it desires; (3) U.S. Buyer is responsible to Foreign Seller for damage, destruction, theft or loss of goods prior to the purchase by U.S. Buyer; (4) U.S. Buyer bears the cost of insurance of the consigned goods with the amount to cover any loss payable to Foreign Seller; (5) upon request, U.S. Buyer must furnish Foreign Seller with an inventory of all products held on consignment but it is not liable to account to Foreign Seller for the proceeds of sale made by it; (6) U.S. Buyer is under no obligation to purchase the consigned products; and (7) Foreign Seller has the right to recall any consigned products prior to the time of their purchase by U.S. Buyer.

The IRS ruled in each of these cases that Foreign Seller did not have a PE in the United States as

a result of the consignment sales arrangement with U.S. Buyer. In reaching this conclusion, the IRS distinguished the consignment sales arrangement from an agency arrangement and stated that “[u]nder the agreement in the instant case, neither a limited agency nor a general agency is established. The relationship between P and S is that of seller and purchaser, since the power that S has in determining when title to the consigned goods passes from P is exercisable only as purchaser.”<sup>112</sup>

Based on the authorities discussed above, Swiss Co should not be considered to have a PE in the United States for U.S. federal income tax purposes as a result of its consignment sales arrangement with U.S. Sub. Therefore, only the \$20 derived by the U.S. Distributor Sub is subject to U.S. tax, and the \$130 derived by Swiss Co is not subject to U.S. tax.

### 2. *Commissionaire Sales Arrangements*

**a. General.** A commissionaire structure is another arrangement that may be used to shift sales income from a high tax source country, and sometimes results in an even greater tax saving than the limited-risk distributor arrangement. In these arrangements, the foreign corporation selling products to unrelated customers earns commission income for arranging the sales of goods for an affiliate (“the principal”). The commissionaire acts in its own name but on behalf of and at the risk of the principal (*i.e.*, as an undisclosed agent). The commissionaire does not bind the principal, so generally the principal will not have a local permanent establishment. A commissionaire does not take legal title to goods, so title passes directly from the principal to the customer. The commissionaire arrangement is a concept of civil law countries, such

as Belgium, France and Germany, which have taken the position that such arrangements generally do not give rise to a local country PE.

**Example 8.** Assume the facts in the above Example 7, except Swiss Co sells products to German customers using a German service provider (“German Co”) pursuant to a commissionaire arrangement. Swiss Co holds title to the property at all times prior to sale. German Co provides sales services and invoices the customers in its own name. German Co is compensated by Swiss Co on a cost plus basis. For example, Swiss Co may earn \$130 and German Co earn \$20. If the entire \$150 were taxable in Germany, the tax cost would be \$60 (assume a German tax rate of 40 percent). On the other hand, under the commissionaire structure, only \$20 is subject to German tax. Total foreign taxes would be reduced to \$21  $[(\$130 \times 10\%) + (\$20 \times 40\%)]$ , or a tax savings of \$39.

**b. PE Analysis.** Under the law of civil law countries, the principal in a commissionaire generally is not considered to have a taxable presence or PE in the country where the products are sold.<sup>113</sup> In common law countries (e.g., Australia, Canada, United States, etc.), however, the commissionaire generally is treated as an undisclosed agent and because it is deemed to bind the principal, is normally considered to create a local agency PE for the principal.

**3. Summary.** In the traditional local country sales business models—either the sales agent arrangement or the full risk distribution arrangement—all of the sales income earned

from sales to U.S. customers is fully subject to U.S. tax. In the income shifting sales business models, however, only a portion of the sales income earned from sales to U.S. customers is subject to U.S. tax and the rest is shifted to a low tax jurisdiction, thereby reducing the MNC’s overall tax on its sales profit.

In the consignment sales arrangement, structured as a buy-sell arrangement between the foreign seller and the U.S. distributor with flash title passing to the U.S. distributor, no PE is considered to exist so long as the U.S. distributor sells the products in the United States in its own name and on its own behalf. Because of the limited risk borne by the U.S. distributor, however, only a small amount of profit (i.e., a cost plus type of return) is required to be left in the United States. Similarly, in the commissionaire sales structure, civil law countries consider that the commissionaire does not create a PE for its principal.

Therefore, in the examples discussed above, instead of paying \$60 of U.S. tax on \$150 of income in the U.S. commission agent sales business models, the MNC paid \$8 of tax on \$20 of income attributed to the United States in the new business models and paid \$13 of Swiss tax on the remaining \$130 of profit, thereby reducing its overall tax by \$39 (\$60 – \$21).

### C. Shifting Both Manufacturing and Sales Income out of United States Through the Use of New Business Models

**1. General.** A company that manufactures and sells products in a local country (e.g., the United States) may combine the structures described above in order to shift both manufacturing and sales profit out of that country and to a low-taxed foreign affiliate.

**Example 9.** Assume that MNC owns Swiss Co and also owns two separate U.S. subsidiaries, one that conducts manufacturing activities in the United States (U.S. Manufacturing Sub) and one that conducts sales activities in the United States (U.S. Distributor Sub). Assume that U.S. Manufacturing Sub manufactures products for Swiss Co in the United States pursuant to a contract manufacturing arrangement and receives a fee in exchange for its services. Assume further that U.S. Distributor Sub purchases products from Swiss Co for resale in the United States pursuant to a consignment sales arrangement and earns a profit commensurate with a cost plus return. As discussed above, the use of a contract manufacturing arrangement allows for the reduction of U.S. Manufacturing Sub’s manufacturing profit, shifting much of the profit to Swiss Co. For example, assuming Swiss Co earns \$100 of manufacturing profit and pays a \$20 manufacturing fee to Manufacturing Sub, only \$8 of U.S. tax will be paid on the manufacturing profit. The use of the consignment sales arrangement allows for an additional shifting of sales income to Swiss Co from the United States. For example, assuming that Swiss Co earns \$100 of sales income from sales to U.S. customers and through the intercompany pricing arrangement, U.S. Sales Sub retains only \$20 of that income (i.e., the remaining \$80 is earned by Swiss Co since U.S. Sales Sub bears very little entrepreneurial risk on the sales), only \$8 of U.S.

tax is imposed on the sales income. By shifting most of the manufacturing profit and sales profit out of the United States to a low-tax country, MNC saves \$64 of U.S. tax. (*i.e.*, US\$80 – US\$16).<sup>114</sup>

This structure may serve as a paradigm for organizing local country operations in a tax beneficial way by shifting income from the country of manufacture and the country of sale, which are high-tax countries, to a low-tax jurisdiction.

**2. PE Analysis.** The PE analysis generally would be the same as set forth above. That is, each activity conducted in the U.S. would first be analyzed separately to determine if it gives rise to a U.S. PE. Next, to the extent that MNC conducted several activities in the United States which are considered preliminary or auxiliary activities under the terms of the PE and individually would not give rise to a PE, these activities must generally be considered together to determine whether if in the aggregate they may give rise to a PE.

In the context of a contract manufacturing arrangement (as opposed to a consignment manufacturing arrangement), the Principal would simply purchase the finished products from the Manufacturing Services Provider which should not cause the Principal to have a PE in the United States. In addition, the limited risk distribution arrangement should not cause the Principal to have a PE in the United States, so long as it is structured to qualify as a buy/sell arrangement in accordance with the authorities described above. In this case, it would not be necessary to look at the Principal's overall activities in the United States since neither its manufacturing arrangement nor its sales arrangement would be considered preliminary or auxiliary

activities which must be looked at together. It would still be necessary to look at any manufacturing or sales related services in which MNC may engage in the United States.

In the context of a consignment manufacturing arrangement, however, as discussed above, the activities of the Principal in the United States may cause the Principal to have a fixed place of business in the United States, but the activities conducted through this fixed place of business should all be considered to be preparatory or auxiliary. The issue, therefore, is whether considered together the level of preparatory or auxiliary activities (*i.e.*, purchasing, processing by another and warehousing) may give rise to a PE. The fact that the Principal is selling its products in the United States through a limited risk distributor arrangement should not increase the likelihood that the Principal may be considered to have a PE as a result of its consignment manufacturing arrangement, except to the extent that the Principal conducts material sales related services in the United States which may be added to the consignment manufacturing activities performed in the United States and cause the balance to tip towards the creation of a PE.

## VI. Adapting the PE Concept to E-Commerce

### A. PE Definition Difficult to Apply to E-Commerce Business Model

E-commerce is another type of sales business model that allows MNCs to avoid tax on income from sales into a source country under the current PE definition. The current PE definition, as discussed above, is

based on the existence of a physical presence such as a building, equipment or persons. The distinguishing characteristic of e-commerce, however, is that it is essentially nonphysical in that it occurs electronically. It is difficult, therefore, to find a taxable presence within a country since there are often no business offices in existence anywhere, the individuals responsible for a Web page are often located in various parts of the world, the server can be located in any country in the world (regardless of where the information it contains is derived from), and the Web page is accessible to people all over the world.<sup>115</sup>

For example, in a common e-commerce transaction, a foreign corporation may sell products to U.S. customers through a Web site that uses software that can accept an order, process a sale with a credit card, notify the foreign seller and send a confirmation to the U.S. buyer. The Web site may be hosted on a server owned by the foreign corporation, which may be in the United States or outside the United States, or the Web site may be hosted by a server owned by an Internet Service Provider (ISP), which receives a service fee from the foreign corporation for the right to use its server. The foreign corporation may not have any business facilities or personnel located in the United States. The traditional definition of a PE is difficult to apply in such situations to determine whether the seller has a PE in the United States.

### B. OECD Proposal

On December 22, 2000, the OECD issued a proposed final draft of amendments to the OECD Commentary on Article 5 (PE) of the OECD Model Treaty to address the application of the PE definition currently contained

in Article 5 to e-commerce business activities.<sup>116</sup> The draft provides guidance as to when the activities of a server and/or a Web site may constitute a PE under the current PE definition contained in the OECD Model Treaty.<sup>117</sup> A separate committee has been charged with the task of analyzing whether any changes should be made to the PE definition to address e-commerce business activities.<sup>118</sup>

The proposed OECD Commentary draws a fundamental distinction between the software and data that comprise a Web site, which, according to the Commentary, can never constitute a PE, and the computer equipment (server) on which the software and data is used or stored, which can constitute a PE under certain circumstances.<sup>119</sup> A Web site by itself cannot constitute a PE because it is only “a combination of software and electrical data that does not, in itself, involve any tangible property,” and, therefore, cannot create a fixed place of business that could constitute a PE.<sup>120</sup>

A server, however, on which the Web site is stored and through which it is accessible is a piece of equipment having a physical location and may thus constitute a fixed place of business of the enterprise that operates (*i.e.*, owns or leases) the server, if the other requirements of a PE are satisfied.<sup>121</sup> In order for a server to constitute a PE, it must first be located at a certain place for a sufficient period of time so as to become “fixed.”<sup>122</sup> In addition, if an enterprise operates a server at a particular location (*i.e.*, it is “fixed”), a PE may exist “even though no personnel is required at that location for the operation of the equipment.”<sup>123</sup> A server will not constitute a PE, however, “where the electronic commerce operations carried on through computer equipment at a given location in a

country are restricted to the preparatory or auxiliary activities.”<sup>124</sup>

Therefore, in the example set forth above, under the proposed OECD commentary the foreign corporation would not have a PE in the United States if its Web site was hosted by an ISP or if the foreign corporation owned or leased its own server located outside the United States. However, if the foreign corporation owned or leased a server located in the United States, it would be considered to have a PE in the United States.

### C. Responses by Countries to OECD Proposal

Several countries have already indicated that they will apply the PE provision to e-commerce activities in their countries differently from the proposed OECD Commentary. The United Kingdom, for example, has indicated that a server (as well as a Web site) located in the United Kingdom will not be considered to create a U.K. PE for the foreign enterprise that owns the server.<sup>125</sup> This is presumably driven by the United Kingdom’s desire to attract e-commerce businesses to the United Kingdom.<sup>126</sup>

Spain and Portugal, by contrast, have dissented from the OECD consensus and have indicated that a Web site alone may give rise to a PE, depending on the nature of the Web site.<sup>127</sup> Both countries have indicated that they are looking forward to subsequent OECD guidance as to the need to change the PE definition to deal with e-commerce activities.

As a result of the amendments to the Commentary on Article 5, enterprises that operate in countries that follow the OECD Model Treaty (and follow the OECD’s Commentary regarding the application of the PE provision to e-commerce) have relatively clear guidelines as to how to structure

their e-commerce operations in order to avoid creating a PE in a high-tax jurisdiction. The new guidance also offers opportunities for shifting income from e-commerce operations to a low-tax (or no-tax) jurisdiction by either hosting a Web site on an ISP, or owning or leasing a server located in a low- (or no-) tax jurisdiction. For example, a foreign sales company that wants to expand its market to the United States may lease a server in a low- or no-tax jurisdiction (*e.g.*, Bermuda) that has the software to advertise the products to U.S. customers through a Web site, take an order and process payment and shipping. The foreign sales company will not be considered to have a PE in the United States under the proposed OECD Commentary as a result of its e-commerce sales and will, therefore, not be subject to U.S. tax on any of its sales income.

## VII. Expansive Local Country Interpretation of Current PE Definition

As discussed above, in the case of the traditional manufacturing and sales structures, all entrepreneurial profits associated with manufacturing or sales is subject to tax in the United States (*i.e.*, the country where the manufacturing and sales activities takes place.) By contrast, the income-shifting structures described above appear to effectively remove income from the source country (*e.g.*, the United States). This occurs, even though there is minimal change in the physical activities occurring in the United States.

The proliferation of income shifting structures has prompted some

countries to re-examine the traditional approaches to applying the PE definition. Some countries are interpreting PE provisions expansively to cause the foreign principal to have a local PE and therefore pull some income back into the country's tax jurisdiction. Like e-commerce, such structures may necessitate reconsideration of how to apply the definition of a PE.

For example, in *Ministry of Finance (Tax Office) v. Philip Morris*,<sup>128</sup> the Italian Supreme Court broadly interpreted the PE provision in the Italian/German Treaty and reversed the lower court's holding that Philip Morris GmbH did not have a PE in Italy as a result of its contacts with Italy. The case has been remanded to the lower courts. In that case, Philip Morris GmbH sold its finished tobacco products to the Italian State Monopoly ("the Monopoly") (an unrelated distributor) which onsold the products to Italian customers. Philip Morris GmbH hired a related company located in Italy, "Intertaba," to provide certain services to it within Italy, including monitoring the unrelated distributor's storing and handling of Philip Morris products and collecting information on the Italian cigarette market.<sup>129</sup> In addition, it was alleged that Intertaba personnel were present at some negotiations between Philip Morris GmbH (and other Philip Morris group companies) and the Monopoly. Intertaba received a service fee from Philip Morris GmbH in exchange for its services that was subject to Italian income tax. The Italian tax authorities asserted that Philip Morris GmbH had a PE in Italy and that, as a result, all of Philip Morris GmbH's sales income was subject to Italian income tax.

The Supreme Court articulated several new treaty interpretation

principles that appear to be much broader than is warranted under the PE definition contained in Article 5 of the OECD Model. The court first found that Intertaba's activities should not be considered preliminary or auxiliary (although this determination is only relevant if a fixed place of business or dependent agent arrangement first exists) because it performed activities for many entities within the Philip Morris group not just the German entity (and its total activities for the group should be relevant to this determination). In addition, the court found that Intertaba's role of monitoring the performance of the distribution agreement with the Monopoly should not be considered preliminary. The court also indicated that the presence of Philip Morris officers at the contract negotiations between Philip Morris GmbH and Intertaba fell within the "authority to conclude contracts" (even though the facts indicate that Philip Morris GmbH had no opportunity to negotiate the contract with the Monopoly as it was a standard agreement used by the Monopoly with all foreign cigarette distributors). According to commentators, the Italian Supreme Court appears to have been influenced at least in part by Philip Morris documents that indicate that the Italian structure was intended to avoid taxation of sales income in Italy. The Italian Supreme Court, viewing that Philip Morris GmbH had structured its sales operations in Italy in such a way that it paid tax in Italy on only a small services fee paid to Intertaba rather than on the sales income from sales to Italian customers, expansively interpreted the PE provision in the German/Italy Treaty in order to tax sales income that they considered Italy's to tax.

As another illustration, under Australian law, a foreign corpora-

tion that sells products to Australian dealers may, under certain circumstances, be considered to have a PE in Australia even if it does not have a fixed place of business in Australia or an authorized sales agent situated in Australia. For example, a foreign corporation may enter into an agreement with an Australian dealer to sell products to such dealer through an electronic contractual arrangement where the offer is made by the foreign corporation, and accepted by the Australian dealer and the Australian dealer confirms its acceptance to the foreign corporation. Under Australian law, if the acceptance of the offer is communicated to somebody in Australia (e.g., an Australian corporation) that acts as a service provider to the foreign corporation, the Australian service provider will be considered to be concluding contracts on behalf of the foreign corporation and will create a PE in Australia for the foreign corporation. Australia may resolve the PE issue, however, through its advance pricing agreement procedure—that is, if the service fee paid to the service company in Australia captures an appropriate amount of profit, the Australian tax authorities would not tax the foreign sales corporation on any of its sales income. Like Australia, certain Mexican PE issues may also be resolved through transfer pricing. The U.S./Mexico Income Tax Treaty expressly provides that a Mexican *maquiladora* (i.e., a Mexican entity that manufactures products for its foreign owners in exchange for a fee and does not own the production assets or inventory) will constitute a PE.<sup>130</sup> In 1999, the United States and Mexico entered into a mutual agreement that essentially provides that a *maquiladora* will not constitute a PE for a U.S. enterprise so long as the *maquiladora* obtains an advance pricing agree-

ment from the Mexican tax authorities or reports income of an appropriate amount (a safe harbor is provided).<sup>131</sup> Mexico recently issued regulations that codify this agreement and make it applicable to other Treaty countries.<sup>132</sup>

Under the Japanese approach, a foreign corporation may be considered to have a PE in Japan if it acts through an independent agent. In particular, assume a foreign e-commerce retailer has a Web site in Japan through which it advertises its products. The foreign retailer hires a third-party service provider in Japan ("Japanese Service Co.") to receive telephone orders for merchandise from Japanese customers in exchange for a service fee. Japanese Service Co. is in the business of providing phone bank related services and provides these services to many unrelated companies. Pursuant to the terms of the

arrangement with the Japanese Service Co., the independent agent does not have the authority to accept orders over the phone; it simply takes the information from the customer and the order must be accepted by the foreign retailer (*i.e.*, the foreign retailer can reject the customer's order if the credit card given by the customer is denied). According to Japanese legal counsel, Japanese Service Co.'s activities would create a PE for the foreign retailer and, further, all of the sales income relating to orders placed with Japanese Service Co. would be subject to Japanese income tax. The basis for this conclusion is that the Japanese Service Co. essentially has the authority to conclude contracts in Japan on behalf of the foreign retailer (since it is unlikely that the foreign retailer will reject any orders except those where the customer's credit card is not ap-

proved) and may be considered as a dependent agent (rather than an independent agent) on the basis of the legal independence test.

## VIII. Conclusion

The current PE definition permits sales and/or manufacturing income to be shifted from the source country under the new business models described above. Countries are concerned about these income shifting structures and are aggressively interpreting the PE provision to allow them to tax more income. Rather than countries attacking income shifting structures on an *ad hoc* basis, it may be preferable to revise the PE definition in the OECD Model in order to provide a more uniform, consistent rule for OECD participants.

### ENDNOTES

<sup>1</sup> Michael J. Graetz and Michael M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 DUKE L. J. 1021, 1033 (1997).

<sup>2</sup> Michael P. Boyle et al., *The Emerging International Tax Environment for Electronic Commerce*, 28 TAX MGMT. INT'L J. 357, 369 (1999).

<sup>3</sup> ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE, §7.3, at 75 (1991).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*, at §6.1, at 66.

<sup>7</sup> *Id.*, at §6.1, at 67.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*, at §7.4.4, at 86.

<sup>10</sup> *Id.*, at §7.6.5, at 91.

<sup>11</sup> *Id.*, at §7.6.5, at 92.

<sup>12</sup> *Id.*, at §7.7.1, at 96-97. Note that while the OECD Model Treaty is followed by many countries, treaties nevertheless continue to be entered into on a bilateral basis, rather than on a multilateral basis. The OECD Model Treaty has been regularly revised since 1963. The latest revision was published by the OECD in April 2000. References to the OECD Model Treaty in this article are to the latest revised version.

<sup>13</sup> The Treasury adopted the PE definition and commentary contained in the OECD Model Treaty for the U.S. Model

Income Tax Treaty, adopted September 20, 1996, which is used as a basis for negotiating U.S. bilateral tax treaties. See U.S. Dept. of Treas. United States Model Income Tax Convention of 20 September 1996: Convention between the United States of America and for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

<sup>14</sup> The OECD Model Commentary has been regularly amended since 1963. The most recent published commentary was issued in the report entitled *2000 Update to the Model Tax Convention*, adopted by the OECD Committee on Fiscal Affairs on April 29, 2000. References to the OECD Model Commentary in this article are to the latest published version. A draft of the *2002 Update to the Model Tax Convention* was issued by the OECD on October 2, 2001, but has not yet been adopted. Any references to the 2002 draft commentary are specifically referenced as the "2002 Draft Commentary." Note that courts often refer to the OECD Commentary for purposes of interpreting a provision of a particular bilateral treaty. See *Taisei Fire and Marine Insurance Co., Ltd.*, 104 TC 535, Dec. 50,620, acq., 1995-2 CB 1.

<sup>15</sup> OECD Model Treaty, Art. 5, ¶11.

<sup>16</sup> *Id.*, at Art. 5, ¶15.

<sup>17</sup> *Id.*, at Art. 5, ¶14.

<sup>18</sup> OECD Model Commentary to Art. 7, ¶11, note 5.

<sup>19</sup> See *id.*, Art. 7, ¶12, comment 11. Many U.S. tax treaties also contain a provision in Article 7 (not contained in the OECD Model Treaty) stating that the business profits attributable to a PE are only those derived from the "assets or activities" of the PE. According to the Treasury, this provision is included to make clear that the limited "force of attraction rule" in Code Sec. 864(c)(3) (discussed further below) is not incorporated into Article 7. See, e.g., Department of the Treasury Technical Explanation of the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income Signed at Washington on October 2, 1996, and the Protocol Signed at Washington on October 2, 1996.

<sup>20</sup> OECD Model Treaty, Art. 7.3. Note that if a foreign corporation incurs interest that is considered attributable to a U.S. PE (or a U.S. trade or business in a non-Treaty context), a U.S. withholding tax may be imposed on such interest when paid. See Code Sec. 884(f).

<sup>21</sup> See OECD Model Treaty, Art. 7, ¶13.

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<sup>22</sup> Code Sec. 894(a) provides that the U.S. Internal Revenue Code provisions will be applied to a taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer. Code Sec. 7852(d)(1) provides that neither a treaty nor U.S. tax law will have preferential status. Therefore, the IRS and courts will generally interpret a treaty provision consistently with U.S. law. See Rev. Rul. 80-233, 1980-2 CB 69. If a conflict arises between a treaty and the Code, however, the provision that was enacted later in time will govern, unless the statute or its legislative history expressly provides otherwise. See e.g., *Reid v. Covert*, SCt, 354 US 1, 18, 77 SCt 1222 (1956). See also Committee Report on PL. 100-647 (Technical and Miscellaneous Revenue Act of 1988) commenting on modification to Code Sec. 7852(d).

<sup>23</sup> See Code Secs. 871(a)(1) and 881(a)(1).

<sup>24</sup> Note that this is a no ruling area for the IRS. See Rev. Proc. 2001-7, 2001-1 CB 236.

<sup>25</sup> *E. Higgins*, SCt, 41-1 USTC ¶9233, 312 US 212, 61 SCt 475.

<sup>26</sup> See *J.C. Lewenhaupt*, 20 TC 151, 162, Dec. 19,606 (1953), *aff'd*, CA-9, 55-1 USTC ¶9339, 221 F2d 227; *Spermacet Whaling & Shipping Co.*, CA-6, 60-2 USTC ¶9645, 281 F2d 646; Rev. Rul. 73-522, 1973-2 CB 226.

<sup>27</sup> For example, in *I. De Amodio*, 34 TC 894, Dec. 24,315 (1960), *aff'd*, CA-3, 62-1 USTC ¶9283, 299 F2d 623, the Tax Court held that the activities of an independent agent (which would not create a PE under a treaty) caused the principal to have a trade or business in the United States. In addition, although U.S. case law provides that a foreign corporation that purchases products in the United States (without maintaining a U.S. office) does not have a fixed place of business resulting in a PE, the implication is that if the foreign corporation had a U.S. office that was actively engaged in purchasing activities, the foreign corporation would have a U.S. trade or business. See *Amalgamated Dental Co.*, 6 TC 1009, Dec. 15,139 (1946) (purchase of supplies from a U.S. corporation did not create a PE in the absence of an agency relationship).

<sup>28</sup> See Code Sec. 864(c)(2); Reg. §1.864-4(c).

<sup>29</sup> See Code Sec. 864(c)(3); Reg. §1.864-4(b).

<sup>30</sup> Code Sec. 864(c)(4); Reg. §1.864-5.

<sup>31</sup> For example, as discussed further below, the U.S. limited force of attraction

rule does not apply for purposes of the attributable to concept in the Treaty. *Supra* note 21.

<sup>32</sup> OECD Model Treaty, Art. 5, ¶1.

<sup>33</sup> OECD Model Commentary to Art. 5, ¶1, comment 2.

<sup>34</sup> OECD Model Treaty, Art. 5, ¶2.

<sup>35</sup> OECD Model Commentary to Art. 5, ¶1, comment 3.

<sup>36</sup> *Id.*, at comment 4.

<sup>37</sup> *Id.*, at comment 10.

<sup>38</sup> *Id.*, at comments 5 and 6.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*, at comment 7.

<sup>41</sup> *Id.*, at comment 10.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> OECD Model Treaty, Art. 5, ¶4(a)-(f). The U.S. Model Income Tax Treaty contains a PE definition that is in most respects the same as the PE definition contained in the OECD Model Treaty. The U.S. Model Treaty, however, does not require that the preliminary and auxiliary activities be considered together to determine if they constitute a PE in combination. The Commentary to the U.S. Model Income Tax Treaty expressly provides that any combination of "exempt activities" will not give rise to a PE. Most recent U.S. tax treaties follow the language of the OECD Model (see, e.g., U.S./Germany, U.S./France, U.S./Swiss and proposed U.S./U.K. Treaties).

<sup>45</sup> OECD Model Commentary to Art. 5, ¶4, comment 27.

<sup>46</sup> *Supra* note 44; *infra* note 88.

<sup>47</sup> *Supra* note 45, at comment 43.

<sup>48</sup> *Id.*, at comment 24.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*, at comment 25.

<sup>52</sup> OECD Model Treaty, Art. 5, ¶5.

<sup>53</sup> OECD Model Commentary to Art. 5, ¶5, comment 35.

<sup>54</sup> *Supra* note 52.

<sup>55</sup> See *J.C. Bollinger, Jr.*, SCt, 88-1 USTC ¶9233, 485 US 340, 108 SCt 1173; *National Carbide Corp.*, SCt, 49-1 USTC ¶9223, 336 US 422, 69 SCt 726.

<sup>56</sup> See Chang Hee Lee, *Instability of the Dependent Agency Permanent Establishment*, 27 TAX NOTES INT'L 1325 (2002).

<sup>57</sup> *Supra* note 53, at comment 32.

<sup>58</sup> *Id.*

<sup>59</sup> 2002 Draft Commentary to Art. 5, ¶5, comment 32.1.

<sup>60</sup> *Supra* note 53, at comment 32.

<sup>61</sup> *Supra* note 53, at comment 33.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> OECD Model Commentary to Art. 5, ¶6, comment 37. For U.S. authorities

addressing whether or not a person was an independent agent, see *Taisei Fire and Marine Insurance Co., Ltd.*, 104 TC 535, Dec. 50,620, acq., 1995-2 CB 1 (1995); *De Amodio*, *supra* note 27.

<sup>65</sup> OECD Model Commentary to Art. 5, ¶5, comment 38.

<sup>66</sup> 2002 Draft Commentary to Art. 5, ¶5, comment 38.6.

<sup>67</sup> *Supra* note 65.

<sup>68</sup> *Supra* note 66, at comment 38.7.

<sup>69</sup> *Id.*

<sup>70</sup> OECD Model Treaty, Art. 5, ¶7.

<sup>71</sup> OECD Model Commentary to Art. 5, ¶7, comment 40.

<sup>72</sup> *Id.*

<sup>73</sup> *Supra* note 70; *supra* note 71, at comment 4. See also Reg. §1.864-7(d)(1) and (d)(3).

<sup>74</sup> See Code Sec. 11 and Reg. §1.11-1(a).

<sup>75</sup> See OECD Model (and, specifically, U.S./France) Treaty Art. 5, ¶4(d) which provides, in relevant part, that the maintenance of a fixed place solely for the purpose of purchasing goods for the enterprise does not give rise to a PE. See also Art. 5, ¶5 which provides that the same rule applies when these purchasing activities are performed by a person with the authority to sign purchase orders on behalf of the enterprise.

<sup>76</sup> See Code Sec. 882(a)(1) and Reg. §1.881-2(b)(2), which provide that a foreign corporation is subject to U.S. federal income tax at ordinary graduated rates on its income that is effectively connected to its U.S. trade or business. See also Code Sec. 864, which defines "effectively connected income" and Reg. §1.863-3(c), which determines the source of production (*i.e.*, manufacturing) income.

<sup>77</sup> See Rev. Rul. 81-78, 1981-1 CB 604. Note, however, that if MNC earns any U.S. source sales income (e.g., sales of inventory where title passes in the United States), MNC may need to file a Form 8833 (Treaty Based Return Position) to claim the benefits of the treaty PE provision because under the U.S. effectively connected income rules, the "limited force of attraction" rule would cause the U.S. source sales income to be subject to U.S. tax regardless of such income's factual connection to MNC's manufacturing PE. Code Sec. 864(c)(3) and (c)(4)(B); See also Code Sec. 6114.

<sup>78</sup> For a U.S.-based multinational, the potential application of subpart F to such structures must be considered. For a discussion of structures that avoid subpart F, see Lowell D. Yoder, *Planning*

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*Techniques Described in the Treasury's Subpart F Study*, 30 TAX MGMT. INT'L J. 221 (2001); Lowell D. Yoder, *IRS Rocks Contract Manufacturing Boat*, 9 J. INT'L TAX'N 6 (1998).

<sup>79</sup> The use of the term "Principal" may be somewhat misleading, because a manufacturing services arrangement does not normally involve a principal/agency relationship. Generally, the Manufacturing Services Provider acts as an independent contractor. The designation "Principal" is used in the sense of the company being the predominate party in the relationship (or in the leading position), who acts with some level of control over the Manufacturing Services Provider (but not enough control to make it a dependent contractor).

<sup>80</sup> Since the Principal provides manufacturing intangibles to the Manufacturing Services Provider pursuant to the manufacturing services agreement, it should not have any deemed royalty income.

<sup>81</sup> This structure assumes that Swiss Co owns or has licensed the manufacturing intangibles that it is letting U.S. Manufacturing Sub use in performing manufacturing services for it.

<sup>82</sup> *Vetco, Inc.*, 95 TC 579, Dec. 47,001 (1990).

<sup>83</sup> *Ashland Oil, Inc.*, 95 TC 348, Dec. 46,899 (1990).

Code Sec. 954(d)(2).

<sup>85</sup> See Case F85 (Board of Review No. 1; 6 TBRD 483), Oct. 28, 1955.

<sup>86</sup> See OECD Model (and, specifically, U.S./France) Treaty, Art. 5, ¶4(c).

<sup>87</sup> This is true in the case of treaties that follow the OECD Model rather than the U.S. Model.

<sup>88</sup> *Supra* note 86, at ¶4(f), which provides that "the overall activity of the fixed place of business" resulting from the combination of preliminary and auxiliary activities must itself be preliminary and auxiliary. GCM 35183 (Jan. 2, 1973).

<sup>90</sup> Note that in the case of treaties that follow the U.S. Model rather than the OECD Model, the combination of activities is not relevant.

<sup>91</sup> See e.g., LTR 7739023 (June 29, 1977).

<sup>92</sup> See OECD Model (and, specifically, U.S./France) Treaty, Art. 5, ¶5.

<sup>93</sup> See OECD Model Commentary to Art. 5, ¶5, comment 33.

<sup>94</sup> *F. Handfield*, 23 TC 633, Dec. 20,810 (1955).

<sup>95</sup> The contract in that case gave the U.S. company the exclusive right to distribute the postcards in the United States, specified the price at which the cards were to be sold by the U.S. company, provided that shipping costs would be paid by the

Canadian company and provided that the unsold merchandise could be returned to the Canadian person.

<sup>96</sup> LTR 6510289940A (Oct. 28, 1965).

<sup>97</sup> See e.g., Rev. Rul. 62-31, 1962-1 CB 367 (discussed below) in which the IRS revoked Rev. Rul. 54-588, 1954-2 CB 657. In Rev. Rul. 54-588, the IRS addressed the question of whether M, a U.K. corporation that maintained a showroom with salesmen in the United States to provide solicitation services to N, also a U.K. corporation, had a PE in the United States and was therefore subject to U.S. tax on the services income it received from N. The IRS ruled that M did not have a PE in the United States because its salesmen in the United States did not have the authority to conclude contracts but were merely involved in sales solicitation activities. In Rev. Rul. 62-31, the IRS revoked Rev. Rul. 54-588 and concluded that M did have a PE in the United States under the fixed-place-of-business test since it had a showroom in the United States and employees in the United States and that the dependent agency test was not relevant. The IRS further commented, however, that if the issue had been whether N (the U.K. sales company that hired M to provide solicitation services for it in the United States) had a PE in the United States, it would have been relevant to consider whether the U.S. salesmen had the authority to conclude contracts on behalf of N and the ruling in Rev. Rul. 54-588 (that no PE existed) would have been correct.

<sup>98</sup> See Rev. Rul. 62-31, *supra* note 97; see also Rev. Rul. 65-263, 1965-2 CB 561 (involving the U.S./Canada Treaty).

<sup>99</sup> See OECD Model Treaty, Art. 7.

<sup>100</sup> See Rev. Rul. 81-78, 1981-1 CB 604 in which the IRS ruled that a Polish corporation that earned sales income from selling a line of products through a U.S. independent agent (that did not create a U.S. PE) was not attributable to a separate PE that the Polish corporation had in the United States as a result of manufacturing and selling a different line of products in the United States. The IRS ruled that although the concept of taxing profits attributable to a U.S. PE is analogous to the concept of taxing income effectively connected to a U.S. trade or business, the limited force of attraction rule in the U.S. Code is not applicable for Treaty purposes.

<sup>101</sup> For this purpose, income from the sale of inventory generally is sourced according to where title to the inventory passes. See Code Sec. 861(a)(6) and

Reg. §1.861-7(c). Therefore, if a foreign corporation sells inventory in the United States and passes title in the United States, the income from the sale will be U.S. source. If title to the inventory passes outside the United States, however, the income from the sale will be foreign source, unless a U.S. office materially participated in the sale. Code Sec. 865(e)(1). As an exception to this rule, however, if the inventory is sold to non-U.S. customers, the income will be treated as foreign source (and will not be considered attributable to a U.S. PE), regardless of title passage, if a foreign office materially participated in the sales. Code Sec. 865(e)(2)(B).

<sup>102</sup> In addition, U.S. source investment income will be considered effectively connected income but only if the income was either derived from assets used or held for use in the U.S. trade or business or if the activities of the U.S. trade or business were a material factor in the realization of the income. Code Sec. 864(c)(2). Certain types of foreign source investment income may be considered effectively connected income as well. Code Sec. 864(c)(4).

<sup>103</sup> Under this rule, if a corporation has a U.S. trade or business and has U.S. source inventory sales income, such income will be considered effectively connected to its U.S. trade or business and will be subject to U.S. tax regardless of whether the U.S. trade or business was involved in generating the sales income.

<sup>104</sup> A U.S. office or fixed place of business will be considered a material factor in a sale if it actively participates in soliciting the order, negotiating the contract of sale or performing other significant services necessary for the consummation of the sale. Reg. §1.864-6(b)(2)(iii).

<sup>105</sup> If the inventory is sold for use, consumption or disposition outside the United States and a foreign office of the taxpayer materially participated in the sales of such inventory, the income from such sales will not be considered U.S. source income and will not be effectively connected. Code Sec. 865(e)(2)(B). This exception does not apply to inventory sold for use, consumption or disposition in the United States. *Id.*

<sup>106</sup> The Treasury Technical Explanation to most U.S. treaties expressly provides that this limited force of attraction rule does not apply for purposes of determining the amount of business profits attributable to a foreign corporation's U.S. PE. See also Rev. Rul. 81-78, *supra* note 100.

<sup>107</sup> Code Sec. 864(c)(1)(A) and (c)(3). Note that this rule is not the same as the limited force of attraction rule dis-

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cussed above which provides that U.S. source sales income is considered effectively connected to a U.S. trade or business of a foreign taxpayer even if there is absolutely no factual connection between the trade or business and the sales income. Under the PE “attributable to” concept, there must be a factual connection between the activities of the PE and the sales income. However, once that factual connection is found, the IRS takes the position that all of the sales income should be considered attributable to the U.S. PE.

<sup>108</sup> See Chang Hee Lee, *Instability of the Dependent Agency Permanent Establishment Concept*, 27 TNI 1325 (Sept. 9, 2002) in which the author states that “taxing the entire amount of sales profit is not consistent with the arm’s length principle, which would mandate that the host country taxable income be commensurate with the amount of local activities rendered by the permanent establishment.” The author notes, however, that the IRS has traditionally taken “the position that the IRC rules already incorporate the arm’s length principal adopted by tax treaties.” See Rev. Rul. 78-423, 1978-2 CB 194; Rev. Rul. 65-263, 1965-2 CB 561; Rev. Rul. 84-119, 1984-2 CB 193.

<sup>109</sup> Income attributable to manufacturing activities is sourced according to the location of the production assets. See Reg. §1.863-(c)(1). Therefore, if the products are manufactured outside the United States, the manufacturing income will be foreign source. Under the regulations, a person is not considered as manufacturing a product that is produced for it under a contract manufacturing arrangement. See Reg. §1.863-3(c)(1).

<sup>110</sup> Note that the same rule exists where property sold outside the United States is manufactured in the United States—i.e., the profits are split 50/50 between manufacturing and sales and are sourced accordingly. See Code Sec. 863(3) and Reg. §1.863-3.

<sup>111</sup> See e.g., LTR 8318010 (Jan. 25, 1983), in which the IRS ruled that a

U.K. corporation that sold goods in the United States through a consignment arrangement with a related U.S. corporation did not have a PE in the United States under the terms of the U.S.-U.K. Treaty. See also LTR 7816031 (Jan. 18, 1978), in which a Canadian corporation sold products to its U.S. subsidiary on consignment and the U.S. subsidiary sold the products to U.S. customers. The products were stored in public warehousing facilities at the expense of the U.S. subsidiary, and the facts explicitly state that the U.S. subsidiary “will set its own prices for the products it sells and will sell to U.S. customers it has or will have developed.” The IRS held that the Canadian company did not have a PE in the United States.

<sup>112</sup> See Rev. Rul. 76-322, 1976-2 CB 487.

<sup>113</sup> See Martin R. McClintock and Stephen A. Ward, *International Tax and Business Planning Opportunities Through Commissionaire Arrangements*, 22 INT’L TAX J. 55 (1996); Swanick, Mudrick and Bouman, *Tax and Practical Issues in Commissionaire Structures*, 14 TAX NOTES INT’L 137 (1997).

<sup>114</sup> Alternatively, MNC may be substituted for Swiss Co. MNC’s income may be reduced by leverage and royalties paid to a low-tax affiliate. This structure helps limit the amount of exposure if a PE is found to exist in the United States.

<sup>115</sup> Klitgaard, *OECD Finalizes E-Commerce Commentary on Permanent Establishment Article of Model Tax Convention*, CALIFORNIA TAX LAWYER, Spring 2001, at 16.

<sup>116</sup> OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, Dec. 22, 2000 (hereinafter “OECD E-Commerce PE Proposal”). These proposed changes to Article 5 of the OECD Model Commentary are included in the 2002 OECD Draft Model Commentary.

<sup>117</sup> In October 1998, the OECD agreed with an earlier pronouncement by the Treasury that traditional international

tax principles should be sufficient to deal with the taxation of commerce conducted over the Internet.

<sup>118</sup> The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce has been given the general mandate “to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules.”

<sup>119</sup> 2002 Draft Commentary to Art. 5, ¶42.2.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> For this purpose, “what is relevant is not the possibility of the server being moved, but whether it is in fact moved.” *Id.*, at ¶42.4.

<sup>123</sup> *Supra* note 119, at ¶42.6.

<sup>124</sup> Preparatory or auxiliary activities performed by a server are defined to include providing a communications link between suppliers and customers, advertising goods and services, relaying information through a mirror server for security or efficiency, gathering market data or supplying information, so long as these services do not form an essential and significant part of the enterprise’s business activity. An activity is not preparatory or auxiliary if it represents a core function of the business. *Supra* note 119, at ¶¶42.8 and 42.9.

<sup>125</sup> OECD E-Commerce PE Proposal, ¶14.

<sup>126</sup> See Buchanan, *The New Millennium E-Commerce Tax Dilemma*, 27 TAX NOTES INT’L 1097 (Aug. 26, 2002).

<sup>127</sup> OECD E-Commerce PE Proposal, ¶16.

<sup>128</sup> Decision 7682/02, Corte Suprema di Cassazione, Rome, released May 25, 2002.

<sup>129</sup> Intertaba also provided similar services to other Philip Morris subsidiaries that sold products to the Italian State Monopoly.

<sup>130</sup> U.S./Mexico Treaty, Art. 5, ¶15(b).

<sup>131</sup> See IR-INT-1999-13.

<sup>132</sup> See 2003 WTD 11-4, *News Analysis: Mexico’s New Tax Reforms for 2003* (Jan. 14, 2003).

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