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Does the Substance over Form approach implemented as a result of the BEPS package reconciles the Permanent Establishment definition with the existence of economic allegiances?

by

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Abbreviations

Action 1	OECD/G20 Base Erosion and Profit Shifting Project - Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Reports
Action 6	Base Erosion and Profit Shifting Project - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - Action 6: 2015 Final Reports
Action 7	OECD/G20 Base Erosion and Profit Shifting Project - Preventing the Artificial Avoidance of Permanent Establishment Status - Action 7: 2015 Final Reports
BEPS	Base Erosion and Profit Shifting
CRE	Close Related Entity
DTT	Double Taxation Treaty
Explanatory Statement	OECD/G20 Base Erosion and Profit Shifting Project – Explanatory Statement – 2015 Final Reports
IFA	International Fiscal Association
GAAR	General Anti-Avoidance Rule
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
MNE	Multinational Enterprise
MTC	Model Tax Convention on Income and on Capital
OECD	Organization for Economic Co-operation and Development
PE	Permanent Establishment
PoB	Place of Business
PPT	Principal Purpose Test
RCO	Non-resident entity
SCO	Entity located in the source state
SOF	Substance Over form
UK	United Kingdom
US	United States of America
2017 Commentaries	The commentaries to the 2017 OECD Model Tax Convention on Income and Capital

Summary

The Permanent Establishment (PE) concept plays a key role in the distribution of taxing rights between States by determining when the profits derived by an entity are taxable in a State other than the State of its residency. This concept, originally, evidenced the existence of sufficient economic allegiances between a non-resident entity and a State to justify taxation therein. However, the evolution of business models caused situations where a non-resident entity is substantially involved in the economy of a State without triggering a PE. Hence, a divergence between the existence of economic allegiances and the PE definition was created.

In order to tackle the circumvention of the PE definition, the Base Erosion and Profit Shifting (BEPS) package of the Organization of Economic Co-operation and Development (OECD) introduced several changes to the PE rules established in their 2014 Model Tax Convention on Income and on Capital (MTC). These changes mainly follow a Substance Over Form (SOF) approach which overlooks the legal qualifications a business model to focus in its economic activities and the value created. In principle, this could reconcile the PE definition with the existence of significant economic allegiances.

Closely analysing each change to the PE definition, they do reconciliate these concepts in some scenarios but fail to do so in several others. Particularly these changes mostly fail to reconcile them in the case of digital business models. Moreover, some changes presume the existence of a PE when the non-resident entity may not be substantially involved in the State, thus broadening the divergence.

Based on the above, these changes fail to fully reconcile the existence of significant economic allegiances with the PE definition, which translates in a failure to properly distribute taxing rights between States. Furthermore, the SOF approach introduced by the BEPS package brings legal uncertainty for foreign investments which means it loses one of the reasons for its historical success.

1 Introduction

1.1 Topic

(…) *one of the most important issues concerning tax sovereignty is the issue of the permanent establishment*[1]

This investigation focuses on the current divergence between the PE definition, and the existence of economic allegiances between a State and a non-resident entity. Also, this investigation assesses whether the changes to the PE rules, resulting from a SOF approach included in the BEPS package of reports of the OECD, solve this issue.

1.2 Background

Since the 19th century,[2] the concept of PE has played an essential role in the distribution of taxing rights between states by determining situations where the source state possesses the right to tax the business profits of a non-resident entity.[3] As stated by Vogel, the PE rules were designed to ensure taxation for the source state when the foreign entity possessed strong economic bonds therein.[4] In other words, as expressed by Skaar, a PE presupposed that the activities of a foreign entity extended in the source state to such a degree that *the benefits from this country's expenditure networks justify taxation in that country*.[5] The PE concept thus operated as benchmark for allocating taxing rights between the residence and source states, being mostly successful at fulfilling this goal in times of non-globalization.[6] However, globalization and electronic commerce opened the door to business models that challenge the applicability of the PE definition by allowing foreign entities to have a substantial economic involvement in the source country without triggering a PE under its traditional formulation.[7] Consequently, the PE definition is no longer a synonym of significant

[1] Dos Santos António C. and Mota Lopes Cidália, *Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment*, EC Tax Review, Volume 25, Issue 5/6, 6 June 2016, Pg. 301.
[2] John F. Avery Jones, et. al., *The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States*, Bulletin – Tax Treaty Monitor, Volume 60, Issue 6, June 2006, Pg. 233.
[3] Ekkehart Reimer, "Article 5- Permanent Establishment" In: Becker Johannes; et. al., *Klaus Vogel on Double Taxation Conventions*, 4th Edition, Kluwer Law International, Pg. 297.
[4] Vogel Klaus, *Klaus Vogel on Double Taxation Conventions*, 3th Edition, Kluwer Law International, Pg. 280.
[5] Skaar Arvid A., *Permanent Establishment: Erosion of a Tax Treaty Principle*, 1991 Edition, Boston Kluwer Law and Taxation Publishers, Pg. 559.
[6] Dhuldhoya Vishesh, *The Future of the Permanent Establishment Concept*, Bulletin for International Taxation, Volume 72, Issue No. 4a/Special issue, 26 March 2018, Pg. 10.
[7] Pinto Dale, *The need to reconceptualize the permanent establishment threshold, Bulletin for International Taxation*, Volume 60: Issue 7, IBFD, 2006, Pg. 266.

economic allegiances, thus failing to work as a benchmark for allocating taxing rights.

In response to the existence of business models that circumvent the PE definition, the OECD issued the BEPS package of reports consisting of 15 Actions with the goal of securing taxation *where economic activities take place and value is created*.[8] Particularly Action 7 deals with business models – detected by the OECD – that avoid the PE definition through *artificial* arrangements commonly used by Multi National Enterprises (MNEs). As a result of Action 7, the OECD made changes to the PE rules established in their MTC as well as its commentaries. Furthermore, these changes were included in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), a legal instrument designed to adjust existing double tax treaties (DTTs) to prevent BEPS.[9] Currently it has been signed by 88 jurisdictions[10].

The BEPS package (particularly Actions 6 and 7) seeks to readapt the meaning of the PE definition through a SOF approach that prioritizes the economic substance of MNEs' businesses instead of their legal qualifications.[11] In summary, the changes to the PE rules brought by the BEPS package are the following:

- Changes to the PE exceptions established in Article 5.4 of the 2014 OECD MTC
- Changes to the agency PE definition and the independent agent exception established in Articles 5.5 and 5.6 of the 2014 OECD MTC (with the main purpose of preventing the use of a commissionaire to circumvent the PE definition)
- Changes to the construction PE rule established in Article 5.3 of the 2014 OECD MTC

Several authors have concluded that the new rules – to some extent – solve the problems created by the strategies detected by the OECD.[12] However, do they reconcile the PE definition with the existence of significant economic

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[8] OECD, *OECD/G20 Base Erosion and Profit Shifting Project – Explanatory Statement – 2015 Final Reports*, OECD Publishing, Paris, http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf (the "Explanatory Statement"), Pg. 4.

[9] See: Silberztein Caroline, et. al., *OECD Multilateral Convention to Prevent BEPS: Implementation Guide and Initial Thoughts*, International Transfer Pricing Journal, Volume 24, Issue No. 5, 2 August 2017, Pgs. 324–325.

[10] OECD, *Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion And Profit Shifting*, Status as of 29 May 2019, https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

[11] Dhuldhoya Vishesh, Op. cit., Pg. 17.

[12] Wanyana Oguttu Annet, *Should Developing Countries Sign the OECD Multilateral Instrument to Address Treaty- Related Base Erosion and Profit Shifting Measures?*, Washington DC: Center for Global Development, 2018. See also: Wettersten Maria, *How can the proposed changes to the OECD tax model convention in action 1 and action 7 counter the issue of an artificial avoidance of a PE status?*, Lunds Universitet, 2016, Pg. 28.

allegiances of the foreign entity in the source state? The original idea of the PE definition is that it evidences economic allegiances in the source state,[13] which in turn justifies its taxation rights. In this regard, if the changes to the PE rules fail to address the divergence between the existence of economic allegiances and the PE definition, then such rules simply fail to fulfil their main purpose.

Moreover, the new changes appear to be less predictable.[14] This loss of foreseeability appears to derive from the SOF approach of the rules themselves, given the existence of subjective elements (e.g., determining whether an agent has a principal role in the negotiation of contracts with clients) as well as the challenges of controlling substance, consequently requiring a case-by-case analysis.[15] In this sense, Zimmer convincingly defends rules that use a SOF approach[16] such as the General Anti Avoidance Rule (GAAR) established in Action 6 of the BEPS package – highly criticized for lack of foreseeability – by indicating they are necessary to tackle situations where a tax benefit is *at odds with the object and purpose of the tax rules in question*.[17] This argument could be used to defend the new PE rules provided they focus on the underlying economic allegiances of the foreign entity (i.e., their economic substance) to determine the existence of a PE. However, failure to do so means the changes lose foreseeability in exchange for nothing.

Based on the above, these issues impact potential fiscal policy decisions for countries that (i) have not signed the MLI, (ii) are negotiating new DTTs, or (iii) consider revising their existing DTTs.

1.3 Aim

This investigation determines whether the SOF approach, implemented through the changes to the PE rules established in the 2014 OECD MTC, reconcile the requirements in the PE definition with the existence of significant economic allegiances of a non-resident entity in a State.

From a theoretical perspective, the investigation analyses how a SOF approach may solve the issue. On the other hand, from a practical perspective, the investigation determines whether the changes to the PE rules implemented as a result of the BEPS package solve this issue.

[13] Skaar Arvid A., Op. cit., Pg. 559.
[14] Dhuldhoya Vishesh, Op. cit., Pg. 13. See also: Barbier Casper, *The Permanent Establishment in a post BEPS world*, Tilburg University, 2 June 2016, Pg. 61.
[15] Ibid., Pg. 13. See also: Barbier Casper, Op. cit., Pg. 61.
[16] Zimmer Frederik, *In Defence of General Anti-Avoidance Rules*, Bulletin for International Taxation, Volume 73 04: No. 4, 11 March 2019, Pg. 9.
[17] Zimmer Frederik, Op. cit., Pg. 6-7.

1.4 Method

This investigation follows a legal-dogmatic research method, which consist of an analysis of existing rules, principles, doctrine, and case-law to extract a conclusion regarding the coherence and understanding of the international legal system. [18] In this sense, the legal-dogmatic method entails an analysis of the PE rules, the SOF principle, and the changes introduced by the BEPS package. This method therefore allows to assess these elements altogether to determine whether the current PE definition is still incongruous with the existence of economic allegiances between a State and a non-resident entity.

Following the legal-dogmatic method, this investigation analyses the PE definition as an expression of economic allegiances of a non-resident entity by examining its historical development in MTCs. The results of such assessment allow to understand why these two concepts started diverting from each other. Additionally, the legal-dogmatic method is applied for understanding how the SOF approach included primarily in Actions 6 and 7 of the BEPS package addresses the divergence between the existence of economic allegiances and the PE definition. This is achieved by examining the OECD's purpose of securing taxation at the place of value creation together with a general definition of the SOF doctrine.

Afterwards, the analysis focuses on the specific changes introduced by the BEPS package, examining how they accommodate with the unchanged PE rules,[19] and determining whether the new PE rules reconcile the PE characterization with the existence of significant economic allegiances. A general conclusion is extracted from the analysis performed on each particular change to the PE rules.

For this purpose, given these changes are mainly based on Action 7[20] and 6[21] of the BEPS package, these documents are considered for the interpretation of the new PE rules. Furthermore, the analysis takes into consideration the existence of the GAAR – particularly the Principal Purpose Test (PPT) – included in article 29.9 of the 2017 OECD MTC and Article 7 of the MLI. The reason lies on the fact that the GAAR may operate as a safety net to assess a particular tax-avoidance scheme, and may be used instead of the "Splitting-up of Contracts" rule introduced in Article 14 of the MLI as well as the commentaries to the 2017 OECD MTC.

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[18] Douma Sjoerd, *Legal Research in International and EU Tax Law*, 2014 Edition, Wolters Kluwer Business, Pgs. 17-18.

[19] This approach is described by Douma as "Fitting new developments into the system". Douma Sjoerd, Op. cit., Pgs. 26-27.

[20] OECD, *OECD/G20 Base Erosion and Profit Shifting Project - Preventing the Artificial Avoidance of Permanent Establishment Status - Action 7: 2015 Final Reports*, OECD Publishing, Paris ("Action 7").

[21] OECD, *OECD/G20 Base Erosion and Profit Shifting Project - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - Action 6: 2015 Final Reports*, OECD Publishing, Paris ("Action 6").

1.5 Delimitation

The focus of this investigation is to determine whether the new PE rules solve the divergence between the existence of economic allegiances and the PE definition. In this regard, several critiques regarding the application of the new PE rules are considered (e.g., the lack of foreseeability or the failure to address digital business models). However, such critiques are considered to examine whether they have an impact on the issue which is the contribution of this research.

Moreover, notwithstanding the fact that the analysis considers the existence of the GAAR introduced in the 2017 OECD MTC and the MLI, this investigation does not address its applicability in-depth. Consequently, it limits to determine how the GAAR could apply in situations where a PE is not deemed to exist despite the existence of a substantial economic involvement of the foreign entity in the source state.

Additionally, this investigation does not intend to be exhaustive with regards to the cases where the PE rules coincide or not with the existence of significant economic allegiances in the source state. Also, the attribution of profits to the PE is not discussed.

For practical purposes, references are mostly made to the 2017 MTC given the changes included therein are substantially the same to the MLI. Also, considering the commentaries to the 2017 OECD MTC (the "2017 Commentaries") derive from the BEPS package (being substantially the same to the commentaries) which in turn should also be applicable for the interpretation of the MLI provisions, reference are mostly made to the Actions included in the BEPS package (particularly Action 7).

1.6 Outline

Based on the above, the investigation is divided in two chapters. The first chapter analyses the PE definition as evidence of economic allegiance, and later demonstrates that it no longer fulfils its intended purpose. Afterwards, the analysis focuses on the OECD's response, consisting of changes to the PE rules based on a SOF approach to secure taxation where activities are carried out and value is created. The analysis in the second chapter shifts to each particular change to the PE rules, and determines whether they solve the divergence between the existence of economic allegiances and the PE definition.

2 A Substance Over Form approach as response to the divergence between Economic Allegiances and the PE definition

2.1 Divergence of between the existence of Economic Allegiances and the PE definition

The PE is an economic projection or continuation of an enterprise in a different territory[22]

It is important to note that a PE is more than a fixed place of business or an agent acting on behalf of a foreign entity. A PE represents a substantial economic involvement of an entity in a country where it is not a resident for tax purposes, which in turn serves a justification for the source country to tax its profits.[23] In other words, when a business is essentially present in the source state, the source state should possess the taxing rights to the corresponding profits. However, there are situations where this is not the case, which are analysed below.

The following sections examine how the concept of PE is a manifestation of economic allegiance. These sections also point-out business models where the former PE definition (established in the 2014 OECD MTC) did not necessarily apply despite a substantial economic involvement of a foreign entity in the source state. Thus, proving there is a mismatch between these concepts.

2.1.1 Economic allegiance as criterion to distribute taxing rights

As indicated by Skaar, a PE is not the reason for source taxation but rather the evidence that the income derived from it should be taxed.[24] Therefore, it is necessary to determine what a PE stands for prior to understanding the elements that constitute its existence.

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[22] Gómez Requena José A. and Moreno González Satumina, *Adapting the Concept of Permanent Establishment to the Context of Digital Commerce: From Fixity to Significant Digital Economic Presence*, Intertax, Volume 45: Issue 11, Kluwer Law International, 2017; referencing the findings of Calvo Vérgez, *La atribución de beneficios a establecimientos Permanentes en el ámbito del comercio electrónico*, Revista Española de Derecho Financiero, Issue 146, 2010, Pg. 458.

[23] Skaar Arvid A., Op. cit., Pg. 559.

[24] See Skaar Arvid A., Op. cit., Pg. 72. See also: Otegui Pita Federico, "The Concept of Permanent Establishment" in: Ecker Thomas and Ressler Gernot, *History of Tax Treaties – The relevance of the OECD Documents for the Interpretation of Tax Treaties*, Series on International Tax Law, Volume 69, Linde, 2011, Pgs. 559-560; and Pinto Dale, Op. cit., Pg. 267.

As covered by several authors, the term PE was first introduced as a tax concept in the eastern part of Prussia during the 19th century to prevent double taxation between its municipalities.[25] Prussian legislation established that a municipality possessed taxing rights over a business despite that its owner was living in an area governed by another municipality.[26] Similarly, this early PE reference was later used as a tool to allocate taxing rights in several DTTs.[27]

Later, a group of economists was appointed by the League of Nations to set the theoretical foundations for the allocation of taxes between States.[28] They considered that taxes should be levied where the taxpayer and the corresponding income possessed stronger economic allegiances, indicating that the two main allegiances were: (i) the place of residence, and (ii) the place of origin. In this regard, they settled on the former as the default taxing state giving the limited collection possibilities for the source state.[29] As appointed by Melzerova, the conclusions of these economists did not result in a concrete PE definition, but provided the cornerstones of international taxation regarding the allocation of taxing rights.[30]

Based on their conclusions, a group of technical experts appointed by the League of Nations to make a MTC draft, settled that the residence state should tax the business profits of an enterprise. They also noted that several tax conventions accepted source taxation of commercial/industrial profits (i.e., business profits) whenever a physical presence such as a branch, agency or permanent representative was located in such state – i.e., a PE.[31] Taking this into consideration, the experts settled that profits – and consequently the corresponding taxation rights – should be split between the head office and its *satellites*[32]. This lead to the inclusion of an early definition of PE in the 1927 League of Nations 's MTC. [33] In the criteria of Reimer, assigning taxing rights to the source state – in the presence of strong economic allegiances – is a requirement of international justice considering its efforts to *create, maintain and safeguard good economic conditions for foreign investors*. [34] At the same time noting that loose economic allegiances should not justify taxation of the source state given

[25] Ibid., Pg. 237. See also: Avery Jones John F, et al., Op. cit., Pg. 233.
[26] Ibid., Pg. 237. See also: Avery Jones John F, Ibid., Pg. 233.
[27] Skaar Arvid A. Op. cit., Pg. 74–77 and 81.
[28] Ibid., Pgs. 79-80.
[29] Ibid., Pgs. 79-80.
[30] Melzerova Eva, "Dependent Agent Permanent Establishment" in: Ecker Thomas and Ressler Gernot, Op. cit., Pg. 261. See also, Skaar Arvid A., Ibid., Pg. 79.
[31] Skaar Arvid A., Ibid., Pgs. 81-82.
[32] Melzerova Eva, Op. cit., Pg. 26.
[33] Ibid., Pg. 265.
[34] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention" In: Reimer Ekkehart; et. al., *Permanent Establishments – A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*, Sixth Edition, Kluwer Law International, Pgs. 11–13.

that the compliance and administration costs it would entail could diminish international trade.[35] Therefore, the existence of a PE serves as evidence of economic allegiances with the source state that are sufficiently strong to justify its taxation rights. Such reasoning was brought by the League of Nations 's group of economist and technical experts by establishing that taxing rights should be allocated to the residence state, and to the source state to the extent of the income arising from its territory.[36] Moreover, with the exception of Mexico's 1943 and the Andean Pact's 1971 MTCs that discarded the default use of residence taxation all together,[37] the use of the PE as evidence of significant economic allegiances has subsisted in following MTCs including the present OECD's 2017 MTC. This is supported by the fact that the BEPS package expressly stated that it does not aim to change the international standards for allocation of taxing rights.[38] Furthermore, the consideration of the PE as evidence of economic allegiance still stands in accordance to authors like Reimer,[39] Vogel,[40] and Dauer.[41] However, how can a strong economic allegiance be determined?

2.1.2 Elements that deem the existence of a PE

Based on the criteria established above, a business merely carried on a foreign country should not be taxed by the source state. Consequently, certain specific connections with the source state should reflect a strong economic allegiance – i.e., a *home abroad.*[42] During its inception, apart from international transportation which possessed a special treatment in MTCs, an international business was only significant if the foreign entity possessed a stationary physical presence (e.g., a factory or office)[43] – i.e., a fixed place of business. The reports of the League of Nations also clarify that auxiliary or preparatory activities should not be regarded as a PE given that several countries considered that such activities did not constitute the *carrying of a business*.[44] This supports the fact that the end-goal of using a fixed place of business in the PE definition was to assess the existence of economic allegiance.

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[35] Ibid., Pgs. 11–13.
[36] League of Nations, *Double Taxation and Tax Evasion – Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Publications of the League of Nations – Economic and Financial, C.216 M.85, April 1927.
[37] Melzerova Eva, Op. cit., Pg. 266. See also: Skaar Arvid A., Op. cit., Pg. 88.
[38] Action 7, Op. Cit., Pg. 14.
[39] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 11.
[40] Vogel Klaus, Op. cit., Pg. 280.
[41] Dauer Veronika, *Tax Treaties and Developing Countries,* Series on International Taxation, Volume 44, Kluwer Law International, 2014, Pg. 69.
[42] Skaar Arvid A., *Erosion of the Concept of Permanent Establishment: Electronic Commerce*, Intertax, Volume 28: Issue 5, Kluwer Law International, 2000, Pg. 189.
[43] Skaar Arvid A., *Permanent Establishment: Erosion of a Tax Treaty Principle*, Op. cit., Pg. 559. See also, Melzerova Eva, Op. cit., Pg. 264.
[44] Avery Jones John F., et al., Op. cit., Pgs. 235–236.

In the case of agents that could be regarded as PEs, in the beginning it was not clear whether such agents had to be connected to a fixed place of business .[45] Nonetheless, an agent was included in the list of PEs contained in the MTC drafted by the technical experts clearly establishing that *an agent was considered to be a permanent representative of its foreign head*.[46] Logically this entails a significant presence of such foreign head in the source state. Such reasoning was later clarified in the First Report Organization for European Economic Cooperation (later superseded by the OECD) regarding DTTs, which removed the agency PE from the list of PE examples of a fixed place of business. The removal implied that a fixed place of business was not essential for the existence of an agency PE.[47] Therefore, the existence of a dependent agent – carrying out the business of its principal in the source state to certain degree – could be deemed as evidence of a strong economic involvement of the principal in such state.[48] This is also supported by the fact that the League of Nations' MTC acknowledges that agents acting in an independent manner (e.g. a broker) would not be considered as PEs of the foreign entity.[49]

Lastly, the existence of a construction site as evidence of economic allegiance first appeared in the Swedish-German DTT (1928) provided the corresponding project lasted more than 12 months.[50] Regarding MTCs, the reference to a *building site or construction or assembly project* can also be found in the positive list of PE examples provided in Article 5.2. of the 1963 OECD MTC.[51] Nonetheless, discussion arose among scholars and governments because these businesses, by their nature, may not be fixed and are temporal, thus failing the permanence test.[52] This discussion lead to the removal of this type of PE from Article 5.2 to a new Article 5.3 in the 1977 OECD MTC that established a particular treatment for them. The new Article 5.3 addressed the special nature of these businesses by establishing that, in addition to the requirements set in Article 5.1, they had to meet a time threshold of 12 months.[53] In its core, the evolution of this concept may be interpreted as a pursue of economic allegiances given that a small-scale construction project that lasts two or three months may not be regarded as substantially involved in the economy of the source state. On the other hand, a project that lasts 12 months or more, and shows the level of permanence

[45] Melzerova Eva, Op. cit., Pg. 265.
[46] Ibid., Pg. 265.
[47] Ibid., Pgs. 268-269.
[48] Cf. Ekkehart Reimer, "Article 5 - Permanent Establishment", Op. cit., Pg. 307.
[49] Melzerova Eva, Op. cit., Pgs. 247-275.
[50] Avery Jones John F. et al., Op. cit., Pg. 235.
[51] Otegui Pita Federico, Op. cit., Pg. 246.
[52] See: Avery Jones John F. et al., Op. cit., Pg. 235.
[53] Otegui Pita Federico, Op. cit., Pgs. 254-255.

required under Article 5.1 and its commentaries[54] may be regarded as substantially involved in such state.

Based on the above, the elements that constituted the PE definition coincided with those that denoted a strong economic bond in the source state; based on the recurring business models of their time. These elements were not subject to substantial modifications prior to the 2017 OECD MTC.[55] Expectedly, the evolution of business models impacts the application of the PE definition and its discrepancy with the existence of substantial economic allegiances.

2.1.3 Divergence between Economic Allegiances and the PE definition as a result of new business models

The analysis in the previous section revealed that the existence of a fixed place of business, an agent, or a construction site/project in the source state is merely evidence of economic allegiances. In other words, it is the form through which a foreign entity engages in substantial activities within the source state. However, the existence of a fixed place of business was not equal to the existence of significant economic allegiances. The evolution of the PE concept itself supports this reasoning given the slow but steady separation of the agent as an autonomous form of PE without the need of a fixed place of business. This is also the case of the existence of exceptions to the PE definition such as a warehouse solely used for storage of stock for a manufacturing company (provided it is an auxiliary activity) or the use of an independent agent. The separation of the agency and construction PE definitions from Article 5.1 of the OECD MTC with the purpose of adapting to these business models show that the existence of a substantial economic allegiance and the existence of PE may not always coincide.

When elements such as a fixed place of business or an agent were introduced in the MTCs, they appeared to mostly coincide with the economic reality of their time. Thus, falling into the PE definition most of the time was a synonym of strong economic allegiances. In turn, failure to do so meant the economic allegiance of the foreign business was not relevant enough to justify any taxing rights to the source state. However, this is not the case anymore.

For instance, electronic commerce enables businesses to participate substantially in the economic life of the source state without the need of a physical presence (either a fixed place of business or an agent).[56]

[54] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD publishing, Pgs. 116-127.
[55] The changes introduced in the 2017 OECD MTC are analysed in detail in Chapter 3.
[56] Pinto Dale, Op. cit., Pg. 273.

Furthermore, the use of commissionaires enable foreign businesses to avoid the agency PE definition (under the 2014 OECD MTC) despite their sales taking place in the source state,[57] and the splitting of construction contracts permit foreign businesses to avoid fulfilling the 12-month time threshold of Article 5.3 of the OECD MTC. These cases denote a growing divergence between the PE definition and the existence of economic allegiances, as showed in Figure 1[58] below.

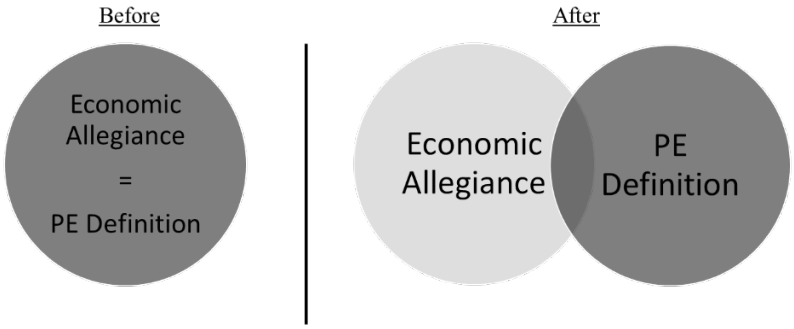

Figure 1

A disconnection between the existence of economic allegiances and the PE definition leads to situations where the source state should have the right to tax but – under the applicable PE definition – does not have it. In such cases, the PE definition fails to fulfil its historical purpose.[59] In response to the circumvention of the PE definition caused by some business models, the BEPS package introduced several changes to the PE definition following a SOF approach. In this regard, it is necessary to previously examine the OECD's SOF approach in a general sense to provide context to each change to the PE rules as result of such approach.

2.2 Understanding the Substance Over Form approach introduced in the BEPS package as means to secure taxation upon the existence of significant economic allegiances

2.2.1 General Definition of Substance Over Form

[57] Action 7, Op. cit., Pgs. 9-10.
[58] Figure made by the author.
[59] Eisenbeiss Justus, *BEPS Action 7: Evaluation of the Agency Permanent Establishment*, Intertax, Volume 44: Issue 6 and 7, 2016, Pg. 481

Form and substance in tax law is a subject of a basic theoretical nature and at the same time a very practical one[60]

As indicated by Zimmer, the application of tax law involves an *assessment of facts and the interpretation of the law*.[61] During such assessment of facts, an interpreter may focus on: (i) their legal reality (also referred as legal substance), or (ii) their economic reality (also referred as economic substance).[62] The first focus on the legal qualification of an arrangement based on its rights and obligations (e.g., based on the rights/obligations derived from a contract, an independent contractor might actually operate as an employee in the legal reality). In turn, the second entails an analysis of the economic content of the arrangement (e.g., a financial leasing of a building might be characterized as future purchase where each lease-payment is actually a portion of the price of the asset).[63] It is important to note that the end-result of both qualifications usually coincide. However, an occasional tension might exist between the private law and the economical qualification of an arrangement.[64] In such situations, as indicated by De Broe, *taxation on the basis of economic reality or substance allows tax authorities to set aside transactions which the taxpayer has actually carried on*, consequently disregarding the legal characterization of the acts to focus on the economic result.[65] The SOF doctrine referred by De Broe thus requires a disregard of legal forms to apply tax laws based on the economic substance laying underneath.

Notwithstanding the above, despite being coherent in theory, this concept has been criticized due to the existence of concepts in the field of tax law which are not purely economic.[66] For example, based on domestic income tax law, the definition of "income" might not be the total revenue earned by a taxpayer during the year. Therefore, a conciliation between a taxpayer's accounting and the corresponding tax return is required. Income in this context is mainly a legal qualification for a portion of the taxpayer's revenue thus the "economic version" of income is non-existent. Furthermore, the

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[60] Zimmer Frederik, *Form and Substance in Tax Law – General Report*, Op. cit., Pg. 21.
[61] Ibid., Pg. 28.
[62] Ibid., Pg. 24. See also: Jinyan Li, *"Economic Substance": Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance*, Canadian Tax Journal, Volume 54: Issue No. 1, 2006, Pgs. 43-44.
[63] Ibid., Pg. 24 and 25. See also, Rosenblatt Paulo, *General Anti-avoidance Rules for Major Developing Countries, Series on International Taxation*, Volume 49, Kluwer Law International, 2015, Pg. 138.
[64] Ibid., Pg. 24.
[65] De Broe Luc, *International tax planning and prevention of abuse: a study under domestic tax law, tax treaties and EC law in relation to conduit and base companies*, 2008 Edition, IBFD Publications, Pg. 168.
[66] Rosenblatt Paulo and Tron Manuel E., *Anti-avoidance measures of general nature and scope - GAAR and other rules*, IFA Cahiers, Volume 103A, International Fiscal Association, Pg. 14.

application of the SOF doctrine varies depending on the country where it is applied.[67] De Broe's explanation of economic reality is therefore understandable in abstract terms, but difficult to apply in practice. In other words, it is complicated to apply the SOF doctrine when it is not clear what is and what is not the economic reality or substance in a particular situation.

As pointed out in the 2018 International Fiscal Association (IFA) General Report regarding GAARs, whilst tests related to SOF doctrine are the origin of current anti-avoidance doctrine,[68] their evolution has not been consistent or precise.[69] This explains a lack of consensus on the meaning economic substance. By itself this fact gives insight on the different understanding and evolution of the concept considering that such doctrines have developed in different contexts. For instance, a SOF principle might have a broader scope in countries that do not possess a standard GAAR considering the courts and tax authorities must work with the tools they have to tackle tax avoidance.[70] Nonetheless the 2018 IFA General Report reveals that the SOF doctrine is mainly relevant for two purposes: (i) as an interpretation tool that disregards forms to apply tax laws based on the underlying economic substance, and (ii) to determine whether a transaction can be characterized as avoidance or abuse with the consequence that any tax benefit derived therefrom is denied.[71]

In this context, the US and UK SOF doctrines pose as insightful examples of each purpose. As an anti-avoidance tool, the US SOF doctrine originated in *Gregory v. Helvering*,[72] and was later developed in *Newman v. Commissioner*,[73] leading to its codification in 2010. These US SOF rules state that, whenever the SOF analysis is applicable, an arrangement possesses economic substance provided that (i) the taxpayer's economical position changes in a meaningful way, and (ii) there is a substantial non-tax purpose for entering the arrangement.[74] On the other hand, as an

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[67] Zimmer Frederik, *Form and Substance in Tax Law – General Report*, Op. cit., Pg. 61. See also: Rosenblatt Paulo and Tron Manuel E., Ibid., Pg. 14.
[68] Rosenblatt Paulo, Op. cit., Pg. 134.
[69] Ibid., Pgs. 134–149.
[70] See: Rosenblatt Paulo and Tron Manuel E., Op. cit., Pg. 14.
[71] Ibid., Pg. 12 and 13. See also: Jinyan Li, Op. cit., Pg. 53.
[72] In this case the Supreme Court determined that a corporate reorganization was ultimately used to transfer an asset; thus, the Supreme Court ruled that the substance (i.e., the transfer) should take precedence over the form (i.e., the reorganization) for the purposes of applying the corresponding tax laws. Supreme Court of the United States of America, *Gregory v. Helvering*, 293 U.S., 465, 1935. See: Rosenblatt Paulo, Op. cit., Pg. 134.
[73] In this case, the Second Circuit clarified that other elements of the transaction should be taken into consideration before disregarding the legal form chosen by the taxpayer, including the existence of a *legitimate non-tax business reason*. See: United States Court of Appeals – Second Circuit, *Newman v. Commissioner*, 894 F.2d 560, 1990, Paras. 21-22. See also, Lee Hoon and Turner Candice M., *Anti-avoidance measures of general nature and scope - GAAR and other rules: United States Branch Report*, IFA Cahiers, Volume 103A, International Fiscal Association, Pg. 16.
[74] Lee Hoon and Turner Candice M., Ibid., Pg. 7.

interpretation tool, the UK SOF doctrine was introduced in *WT Ramsay Ltd vs CIR* where the house of lords ruled that a series of transactions should be viewed as a single composite one given that the underlying commercial transaction was the transfer of an immovable asset.[75] As explained by Rosenblatt, further developments in UK's case law reveal that its version of the SOF doctrine aims to tackle artificial arrangements by using it as a principle of purposive statutory construction, where the tax law should focus on the true nature of a transaction *to which it was intended to apply*.[76] A comparison of the US and UK SOF doctrines reveals that both involve a preliminary assessment of the arrangement of the taxpayer – past the legal forms implemented – as well as the economical results therein.

Based on the above, regardless of the way it is used, the SOF doctrine requires an assessment of the results or economic changes derived from an arrangement. This reasoning coincides with Rosenblatt who analysed the case law from several other countries, concluding that the SOF doctrine in these cases invites to compare the pre- and post-tax profits with the real economic advantages.[77] Therefore, a common meaning of economic reality or substance in the context of SOF doctrines (or even the application of GAARS) shows to be the results or economic changes derived from an arrangement.

2.2.2 Substance Over Form approach in the context of BEPS

As stipulated in the Explanatory statement of the BEPS package, there is an urgent need to restore confidence in the international tax framework and ensure that *profits are taxed where economic activities take place and value is created*.[78] Consequently, in the context of BEPS, Stewart indicates that economic substance should equal such value creation because it can be applied to digital services, anti-avoidance rules, and transfer pricing matters.[79] Her reasoning is certainly consistent with the purpose of the BEPS package to bring taxation to the place of value creation – i.e., the substance – by tackling the erosion of the taxable base through abusive or

[75] House of Lords, *WT Ramsay Ltd vs CIR*, STC 174, 1987. See also: Burchner Anna; Cape Jeremy; and Hodkin Matthew, *Anti-avoidance measures of general nature and scope - GAAR and other rules: United Kingdom Branch Report*, IFA Cahiers, Volume 103A, International Fiscal Association, Pg. 20.
[76] Rosenblatt Paulo, Op. cit., Pg. 141.
[77] Cf. Rosenblatt Paulo, Op. cit., Pg. 148. See also: Rosenblatt Paulo and Tron Manuel E., Op. cit., Pg. 31.
[78] Explanatory Statement, Op. cit., Pg. 4.
[79] Stewart Miranda, *Abuse and Economic Substance in a Digital BEPS World*, Bulletin for International Taxation, Volume 69: Issue 6/7, 23 October 2013, Pg. 399.

artificial arrangements – i.e., the forms – as expressed in Action 6[80] and 7[81] respectively.

The use of a SOF doctrine in this context implies an objective assessment of the circumstances of an arrangement, focusing on the economic activities carried-out and the value created.[82] The OECD particularly shows to be taking this approach regarding PE rules considering its changes included in the 2017 OECD MTC and the MLI resulted on a PE definition more based on the economic substance of the foreign entity in comparison to the 2014 OECD MTC counterpart. The addition to the inclusion of a GAAR should also be taken into consideration because, based on economic substance, it is used to determine whether an arrangement is tax-driven, and deny DTT benefits in such case. The SOF doctrines consequently permit taxation based on value creation and economic activities.

Furthermore, the BEPS's SOF approach appears to coincide with the existence of economic allegiances considering the creation of significant value and the activities carried out by a foreign enterprise in a state should imply their existence. In this sense, Pinto conceptualizes the existence of significant economic allegiances as a *business presence* – i.e., when an entity is not merely carrying on activities abroad, but instead, is substantially involved in the economic life of the source state.[83] As Vogel stipulated, taxation is given to the source state provided there are strong economic bonds between that State and a foreign enterprise.[84] Conversely, the source state should possess taxing rights whenever significant value is created therein. Hence, in principle, rules that deem the existence of a PE based on the creation of significant value and the economic activities carried out in the source state should be in-line with the existence economic allegiances.

Based on the above, the SOF approach in the context of BEPS implies a disregard of the forms implemented by entities to focus on the place where activities are carried out, and where value is created. Such approach applied to the PE rules should in principle reconcile its definition with the existence of significant economic allegiances in the source state. However, theory and practice do not necessarily coincide. Naturally, it is necessary to analyse each of the changes to the PE rules – introduced as a result of the BEPS package – to determine whether the approach implemented by the OECD solves the divergence between the PE definition and the existence of economic allegiances.

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[80] Explanatory Statement, Op. cit., Pg. 15.
[81] Ibid., Pg. 15.
[82] The economic activities and value created is referred by Stewart as the real facts of the arrangement. However, as indicated by Stewart, they are hard to pin-point. Stewart Miranda, Op. cit., Pg. 400.
[83] Pinto Dale, Op. cit., Pg. 273.
[84] Vogel Klaus, Op. cit., Pg. 280.

3 Assessment of the Changes to the Permanent Establishment Rules

(...) the disconnection between economic activity and taxation caused by the PE concept is a matter of growing controversy[85]

In this chapter, the changes to the PE rules introduced in the MLI and the 2017 OECD MTC are analysed to determine whether they solve the divergence between the existence of economic allegiances and the PE definition. The changes introduced both in the MLI and the 2017 OECD MTC are summarized and analysed as follows:

- Changes to the exceptions to the PE definition
- Changes to the agency PE rules
- Changes to the construction PE rule

3.1 Changes to the PE exceptions

3.1.1 Changes to Article 5.4 of the OECD Model Tax Convention

First, the 2017 OECD MTC proposes a change to Article 5.4 of the 2014 OECD MTC by expressly stating that the exceptions included in Subparagraphs a) to f) are only applicable if those activities or combinations thereof have a preparatory or auxiliary nature.[86] In the case of the MLI, such change is included in Option A of Article 13 whereas Option B does not change the previous wording.[87] In short, the change settles the debate on whether the exemptions established in Paragraphs a) to d) had to be activities of preparatory or auxiliary nature considering the preparatory/auxiliary characterizations only appeared in the exemptions established in Paragraphs e) and f).[88] In this regard, Action 7 provides guidance with regards to the meaning of the concepts preparatory and auxiliary. Particularly, Action 7 stresses the need to assess such activities in conjunction with the foreign entity's business. This way an internet trading company that only possesses a warehouse in the source state for the purpose of storage and delivery of products purchased online by its client could be

[85] Eisenbeiss Justus, Op. cit., Pg. 481.
[86] Action 7, Op. cit., Pgs. 28 and 29. See also, Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg 96.
[87] OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, OECD Publishing, 2016, Article 13.
[88] Dhuldhoya Vishesh, Op. cit., Pg. 5.

regarded as a PE considering that warehouse constitutes an integral part of the foreign entity's business[89] (see Figure 2[90] below).

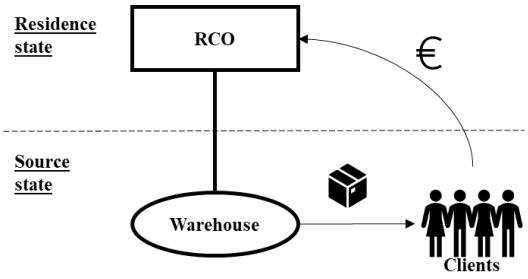

Figure 2

Following a SOF approach, preparatory or auxiliary activities should not constitute a sufficiently strong economic allegiance to justify the taxation rights of the source state. In this sense, clarifying that the exceptions contained in Subparagraphs a) to d) of Article 5.4 must be of preparatory or auxiliary nature rather than applying these exceptions automatically is a positive change. Otherwise, companies could use one of the exceptions set out in these subparagraphs (e.g., see Figure 2) to avoid triggering a PE despite having an essential part of the value chain of their business – i.e., having strong economic allegiances – in the source state.[91] Even though the 2014 OECD MTC Commentaries could be interpreted in a way to prevent such automatic application of these exceptions, and the fact that Commentary 30.1. of Action 7 offers leeway for the States to deviate from such change,[92] the focus on the economical allegiances of modern businesses[93] instead of their formal aspects addresses this specific source of divergence.

Additionally, Vishesh convincingly indicates with regards to the use of this clauses that they hook digital business models that still use some physical elements.[94] The new rules anchor these digital businesses through their physical presence; treating the ones with strong economic allegiances in the source state as PEs. Nevertheless, such rules do not deal with businesses that go full-digital given Action 7 and the OECD MTC Commentaries (both the 2014 and 2017 versions) state that the exceptions of Article 5.4 are only relevant when a PE is deemed to exist under Article 5.1 – i.e., when

[89] Action 7, Op. cit., Pg. 31.
[90] Figure made by the author.
[91] See Dos Santos António C. and Mota Lopes Cidália, Op. cit., Pg. 308.
[92] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 92.
[93] Dos Santos António C. and Mota Lopes Cidália, Op. cit., Pg. 308.
[94] Dhuldhoya Vishesh, Op. cit., Pg. 11. See also: Dutriez Jean- François, *Attribution of Profits to a Permanent Establishment of a Company Engaged in Online Sales of Goods through a Local Warehouse,* International Transfer Pricing Journal, Volume 25: Issue 3, IBFD, 9 April 2018, Pg. 188.

businesses are carried out through a fixed place of business.[95] Taking this into consideration, the change falls short on fully reconciling the divergence between economic allegiances and the PE definition when it is caused by the incursion of digital business models.

3.1.2 New anti-fragmentation rule

This new rule is included both in the 2017 OECD MTC (Article 5.4.1) as well as the MLI (Article 13 Option B). In short, it consists of an aggregation rule for the purpose of applying the exceptions established in Article 5.4. Specifically, this rule takes in consideration the activities of the foreign entity and its PEs along with the activities carried out by its Close Related Entities (CRE) and their corresponding PEs provided they are located in the same source state.

As expressed in Action 7, the anti-fragmentation rule is the logical consequence to the restriction of the exceptions established in Article 5.4 to a preparatory or auxiliary nature.[96] The anti-fragmentation rule may be considered as the other side of the coin of the exceptions established in Article 5.4 Subparagraph f). On one side, a combination of activities that – considered together – is of preparatory or auxiliary nature should not be regarded as a PE. On the other side, a combination of activities of both the foreign entity and its CREs that – considered together – constitute a relevant part of the foreign entity's business should logically be deemed as one.

As expressed by Reimer, Articles 5.4 and 5.4.1 apply in the cases shown in Figure 3:[97]

		Places of business (PoB)	
		1	**2**
Enterprises	**1**	One PoB used by one enterprise	Two PoB used by the same enterprise
	2	One PoB is used by an enterprise and a CRE	The enterprise and the CRE each use a different PoB

Figure 3

While the first case (i.e., one fixed place of business used by one enterprise) should be covered by Article 5.4, the other scenarios should be covered by Article 5.4.1, and all of them should be on equal footing regarding the assessment of whether the exception of Article 5.4 should apply.[98] In all

[95] Action 7, Op. cit., Pg. 29.
[96] Action 7, Op. cit., Pg. 39.
[97] Figure made by the author based on the constellations indicated by Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 101.
[98] Ibid., Pg. 101.

these scenarios, the exception of Article 5.4 should not apply whenever a PE already exists. Also, Article 5.4 should not apply when the combinations of the activities carried out in the PoBs or enterprises is not of auxiliary/preparatory nature, provided that all the activities carried out are complementary functions of a cohesive business operation.[99]

From a SOF perspective, clearly a mere fragmentation of activities should not alter the economic allegiance of the foreign entity in the source state because such activities – fragmented or not – are being carried out in the source state. Figure 4[100] exemplifies a case where a Non-resident Company (RCO), dedicated to provide loans to clients in other jurisdictions, uses – in Scenario A – a PE to carry-out the necessary risk-assessment and afterwards the provision of the loan. In Scenario B, the RCO uses an office to provide the risk assessment functions while the PE provides the loan once such risk is approved. In both cases the economic involvement of the RCO should be the same. Nevertheless, the PE definition (pursuant to the 2014 OECD MTC) may be circumvented in Scenario B provided the risk assessment functions are considered as an auxiliary activity for the RCO. The anti-fragmentation rule prevents this circumvention by deeming that the risk-assessment functions constitutes a PE of the RCO because it is a complementary function of a cohesive financial operation of RCO in the source state. As a result, the application of Article 5.4 is prevented.

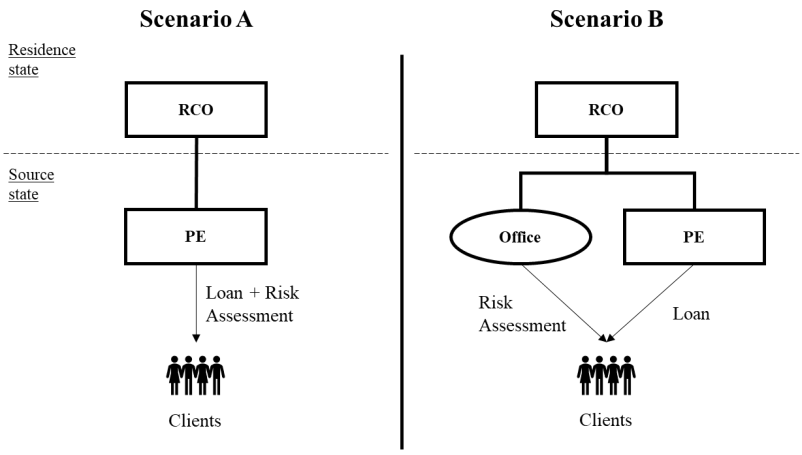

Figure 4

In these types of scenarios, the anti-fragmentation rule requires an evaluation of the existing economical allegiances of the foreign entity in the source country, which was not mandatory under the previous versions of

[99] See: Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pgs. 101-102.
[100] Figure made by the author. However, Scenario B corresponds to Example A contained in Action 7. See: Action 7, Op. cit., Pgs. 40-41.

Article 5.4,[101] especially regarding the cases where the fragmentation involves a CRE.

Notwithstanding the above, even though the anti-fragmentation rule should apply regardless of the residency of the CRE,[102] it is still necessary that its activities are carried out in the source state. In this sense, Article 5.4 should not apply to the extent that the complementary functions are carried abroad. An example of the abovementioned reasoning is detailed in Figure 5.[103]

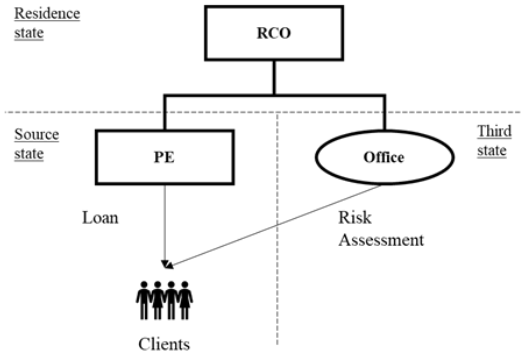

Figure 5

This case is similar to the Scenario B of Figure 4 with the difference that the risk assessment functions are carried out remotely by the office from a third state. The office receives all the information it requires either from the PE or directly approaching the Clients (e.g., via email or phone call). Substantially the business arrangement has not changed, which means the economic allegiances to the source state should have maintained. However, the activities of the office should not be taken into consideration because it is located in a third state, despite carrying out a complementary function to a cohesive business operation. Moreover, assuming a tax treaty exists between the residence state and the third state that follows the 2017 OECD MTC, the office should not be considered as a PE in the third state either provided it qualifies as an auxiliary activity under Article 5.4 Subparagraph d). Depending on the circumstances, the PPT rule established in Article 29.9 of the 2017 OECD MTC could be applicable to the extent such arrangement was implemented with the main purpose, or one of the main purposes, of circumventing the PE provision. However, assuming this would be the case every time goes beyond a bold statement. In short, this case exemplifies the ever-growing pressure that PE rules suffer due to the changes of business

[101] Note that the commentaries to subparagraph f) of Article 5.4 in the 2014 OECD MTC established that the foreign entity might not separate a cohesive business operation into several small ones. However, this only applied to Subparagraph f) and its application could be limited in practice given its status as mere commentary rather than being inserted in the wording of Article 5. See OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD publishing, Pg. 106.
[102] See Articles 5.4.1 and 5.8 of the 2017 OECD MTC.
[103] Figure made by the author.

models as a result of technological advancements and globalization, which allow an interaction with a market without a physical presence therein.[104]

Another issue the anti-fragmentation rule might have is the lack of clarity regarding the definitions of complementary functions and cohesive business operation given that Action 7, the MLI, or the 2017 OECD MTC do not provide guidelines for their meaning. As considered by Reimer, the context suggests that the former term could be regarded as two different functions that form part of a chain of economic value.[105] In turn, the latter should consist of a combination of functions that are directly connected.[106] Nevertheless, a PE might be deemed to exist where the economic allegiances of the foreign entity are not secured. This problem can be particularly complex when CREs are involved. An example of this situation is shown in Figure 6 below. [107]

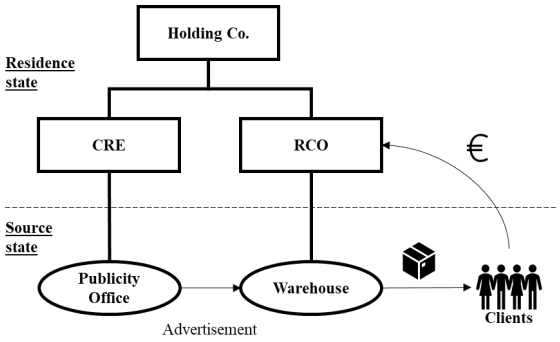

Figure 6

Figure 6 reveals a scenario where the RCO, through its website, sells products that are located and delivered from its warehouse in the source state. Additionally, a CRE (considered as such in accordance to Article 5.8 because both the CRE and RCO are owned by the same entity) possesses a publicity office in that same state which advertises the products of the CRE and the RCO. To what extent could this activity be considered a cohesive business operation with the warehouse?

Following a strict interpretation of Article 5.4, the publicity office indeed carries out a complementary activity that is directly connected to the RCO's business, thus making it cohesive. Nevertheless, the exclusiveness of such services is an element that should be taken into consideration because it questions whether the economic allegiance in the source state corresponds to

[104] See Escribano López Eva, *An Opportunistic, and yet Appropriate, Revision of the Source Threshold for the Twenty-First Century Tax Treaties*, Intertax, Volume 43: Issue 1, 2015, Pgs. 9-10.
[105] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 102.
[106] Ibid., Pg. 102.
[107] Figure made by the author.

the CRE or RCO (provided that the publicity office could be regarded as an auxiliary activity for the CRE). This was not a problem in the 2014 OECD MTC considering the activities of the CRE were not taken into consideration for the application of its version of Article 5.4. In this regard, the cohesiveness test takes paramount importance given it essentially answers how much is a foreign business involved in the source state. However, cases like this leave the interpreter with potential interpretations that may not necessarily coincide with the existence of economic allegiances between the source state and the foreign entity. Cases like the ones detailed in Figures 5 and 6 demonstrate that the anti-fragmentation rule might fail at solving the issue it was intended to tackle.

3.2 Changes to the agency PE rules

For the purpose of analysis, the changes to the PE rules are summarized as follows:

- Changes to the agency PE definition included in Article 5.5 of the 2017 OECD MTC and Article 12.1 of the MLI[108]
- Changes to the independent agent exception included in Articles 5.6 and 5.8 of the 2017 OECD MTC, and Articles 12.2 and 15 of the MLI[109]

3.2.1 Changes to the agency PE definition

The modifications included in Article 5.5 of the 2017 OECD MTC lowers the PE threshold by establishing that the person acting on behalf of the foreign entity can be deemed as a PE, not only by concluding contracts on behalf of such entity (which is the requirement set in Article 5.5. of the 2014 OECD MTC), but also by habitually playing a principal role in their conclusion. Furthermore, these modifications specify that such contracts may be:[110]

- In the name of the foreign entity
- For the transfer of ownership of the foreign entity's property of the right to use it
- For the provision of services

In line with a SOF approach, these changes give priority to activities carried out in the source state with the purpose of concluding contracts for the

[108] Both articles are substantially the same. For practical purposes the analysis just mentions Article 5.5.
[109] Both articles are substantially the same. For practical purposes the analysis just mentions Article 5.6 and 5.8.
[110] See Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 116.

foreign enterprise instead of the authority of the person carrying out such activities for the foreign entity.[111]

In general, both changes intend to tackle the use of commissionaire arrangements to circumvent the previous PE definition.[112] A commissionaire structure consists of a person (i.e., the commissionaire) who acts on its own behalf but for the risk and account of the foreign entity.[113] The commissionaire thus concludes contracts which: (i) are not legally enforceable against the foreign entity (in civil-law countries),[114] and (ii) are backed-up by contracts between the commissionaire and the foreign entity in a way that such commissionaire is never the owner of the goods traded.[115]

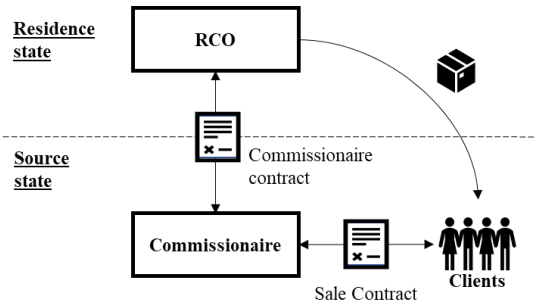

Figure 7

Figure 7[116] above provides insight on how a commissionaire structure could operate. The commissionaire habitually sells goods owned by RCO but on its own behalf. Later the RCO – in accordance to a commissionaire contract – ships its goods to the Clients in the source state. RCO receives the remuneration while the commissionaire just receives a fee for its services given it was never the owner of the goods sold.[117] This way the PE characterization was circumvented considering such a person does not carry out contracts in the name of the enterprise. Consequently, the profits of its sales in the source state should not be taxed therein (they should be taxable in the residence state according to Article 7 of the 2014 OECD MTC). This arrangement allowed a substantial economic participation of a foreign entity in the source state without triggering a PE.

[111] Dhuldhoya Vishesh, Op. cit., Pg. 12.
[112] Action 7, Op. cit., Pgs. 15 -16. See also: Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 116.
[113] De Wilde Maarten F., *Lowering the Permanent Establishment Threshold via the Anti-BEPS Convention: Much Ado About Nothing?*, Intertax, Volume 45: Issue 8 and 9, 2017, Pg. 559.
[114] Ibid., Pg. 559.
[115] Ibid., Pg. 559.
[116] Figure made by the author.
[117] Action 7, Op. cit., Pg. 15. See also, Einar Gustav, *Dependent Agents after BEPS: Especially with regard to commissionaire arrangements*, Uppsala Universitet, 2017, Pg. 23.

According to the changes established in Article 5.5 of the 2017 OECD MTC, a commissionaire should be considered as a PE given that such a person is habitually playing a principal role in the conclusion of contracts for the transfer of ownership of goods of the of a foreign entity. Note that such contracts are not substantially altered by the foreign entity. In this sense, this change allows to disregard the formalistic understanding of the concept of *acting in the name of* (which is believed to originate from an interpretation discrepancy between civil law and common law countries)[118] to focus on the economic allegiances of the foreign entity. In other words, these new PE rules focus more on the activities carried out than the entitlement of who is carrying them out. The changes to the comments of the 2017 OECD MTC introduced by Action 7 support this reasoning given that the *principal role* is characterized by the task of convincing clients to enter into agreements with the foreign entity,[119] or the creation of obligations ultimately performed by such foreign entity.[120]

Notwithstanding the above, this change carries drawbacks. For instance, Pleijsier convincingly points out that this change penalizes agents whose contracts do not require material modification due to their great skills rather than being truly a dependent agent of the foreign entity.[121] Although agents in such situations might skip the PE characterization if they qualify as independent agents under Article 5.6,[122] such rule could indeed trigger a PE when the foreign entity is not substantially involved in the source state.

Additionally, the changes expressly state that the agent must be acting *in a Contracting State*[123] meaning the agent might not create a PE to the extent its activities are carried out from a third country. Although Action 7 establishes that a person *is acting in a Contracting State on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the State concerned*,[124] this commentary refers particularly to the involvement in business activities rather than the place of location of the potential agent. It is also important to note that Action 7 does not suggests a deviation from the traditional criterion that the dependent

[118] The core issue appears to lie in a difference of understanding of the concept of commissionaire between civil law and common law countries; whereas the agreements concluded by commissionaire under common law always bind the foreign entity (thus being considered to act in its name), this is not always the case in civil law countries. See Dhuldhoya Vishesh, Op. cit., Pg. 3 and John F. Avery Jones, et. al., Op. cit., Pg. 236.
[119] Action 7, Op. cit., Pg. 19.
[120] Ibid., Pgs. 20-21.
[121] Pleijsier Arthur, *The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report*, International Transfer Pricing Journal, Volume 23: Issue 6, 21 November 2016, Pg. 443.
[122] See Section 3.2.2 infra.
[123] Action 7, Op. cit., Pg. 16.
[124] Ibid., Pg. 18

agent should be physically present in the source state.[125] A potential scenario involving an agent located in a third state is shown in Figure 8[126] below.

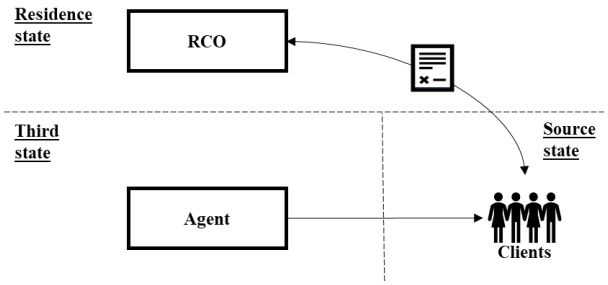

Figure 8

Assuming an unrelated agent habitually reaches and convinces clients from a third state (e.g., using telephone calls, emails or internet meetings) to enter into agreements with the RCO for the provision of services, the solution to such case is not clear under current rules.[127] As indicated above, an extensive interpretation of the 2017 Commentaries suggests that a PE should be triggered whenever the agent habitually exercises a principal role which leads to the conclusion of contracts in the source state. Nevertheless, the context of Article 5 or its respective commentaries does not suggest this approach. The other possibility would be to deem the existence of a PE in the third state but that is an illogical conclusion considering the third state would earn income derived from another state (provided the third state could somehow tax such income from a practical perspective). Furthermore, the 2017 Commentaries specify that the PE should be triggered in the country where the business activities are carried out which certainly is not the third state. In this case, even if the PPT is somehow applicable (considering the arrangement was purposefully implemented for tax purposes), its application is not certain at all (e.g., just identifying a benefit to be denied poses a problem in itself). Again, the new rules fail to reconcile the PE definition with the existence of economic allegiances when the activities of the foreign entity are carried out without a physical presence in the source state.

In summary the focus on the activities carried-out by the agent and the foreign entity reconcile the PE definition and economic allegiances to a certain extent, but again it fall short when there is no physical presence in the source state. Moreover, a PE may be triggered in situations where the foreign entity is not substantially involved in the source state.

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[125] Skaar Arvid A, *Erosion of the Concept of Permanent Establishment: Electronic Commerce*, Op. cit., Pg. 193.
[126] Figure made by the author.
[127] Dos Santos António C. and Mota Lopes Cidália, Op. cit., Pg. 303.

3.2.2 Changes to the independent agent exception

Under the 2014 OECD MTC, independent agents acting in their ordinary course of business for a foreign entity should not be regarded as PEs thereof.[128] This exception remains in the 2017 OECD MTC although the wording of Article 5.6 (which establishes this exception) has been modified completely.[129]

First, the reference to brokers and general commission agents is eliminated, which prevents potential interpretation discrepancies between States given they were defined under domestic law (according to Article 3.2 of the OECD MTC).[130] Such simplification certainly allows a focus on the underlying economic allegiances of the foreign entity in comparison to the 2014 OECD MTC. That previous version gives importance to the legal qualification of a broker or general commission agent, potentially preventing a PE from being triggered despite a substantive economic involvement of the foreign entity. Moreover, the 2017 Commentaries emphasize a case-by-case analysis[131] taking into consideration, among other things, whether:

- The agent bears an *entrepreneurial risk*[132]
- The agent is subject to detailed instructions regarding how its work is carried out[133]
- The activities exercised by the agent are part of its ordinary trade of business
- The agent works exclusively or almost exclusively for the foreign entity[134]

A case-by-case analysis permits an assessment of the economic allegiances of the foreign entity. Thus, the analysis allows a reconciliation between such allegiances and the PE definition. Nonetheless, it is important to note the last point applies differently when CREs are involved.

As indicated above, Article 5.6 of the 2017 OECD MTC is applicable to the extent the agent is qualified as being independent. Nonetheless, the second part of this article expressly establishes that agents acting exclusively or almost exclusively for CREs cannot be regarded as independent.[135] The first issue with this presumption lies in the fact that an agent acting almost exclusively for a few CREs might as well be acting independently in reality,

[128] Reimer Ekkehart, "Article 5 - Permanent Establishment", Op. cit., Pg. 307-308.
[129] Cf. Action 7, Op. cit., Pgs. 16-17.
[130] Pleijsier Arthur, Op. cit., Pg. 444.
[131] See: Garbarino Carlo, *Permanent Establishments and BEPS Action 7: Perspectives in Evolution*, Intertax, Volume 47: Issue 4, 2019, Pg. 381.
[132] Action 7, Op. cit., Pg. 24.
[133] Ibid., Pg. 24.
[134] Ibid., Pgs. 24-25.
[135] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. cit., Pg. 118.

as convincingly pointed out by Monsenego.[136] Therefore, a PE might be deemed to exist when the foreign entity is not substantially involved in the source state. Also, the issue gets more complex when determining whether the agent works exclusively or almost exclusively for more than one CRE.[137]

Action 7 establishes that an agent is working exclusively or almost exclusively when its activities with non-CREs is not a significant part of its business. [138] For instance, an agent whose sales to non-CREs correspond only to 10% of its total sales.[139] Whilst the use of sales as parameter is reasonable,[140] and the use of the 10% threshold is backed-up by international practice as well as case-law,[141] the computation of such a test raises questions. Figure 9[142] exemplifies one of these potential issues.

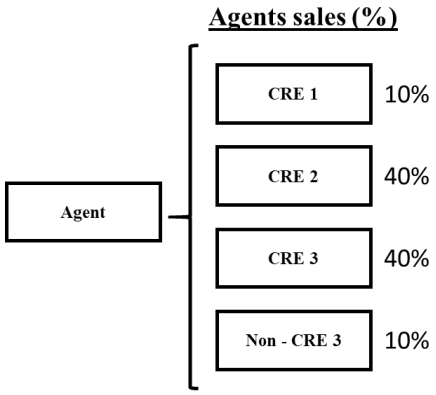

Figure 9

Assume the Agent, located in the source state, is fully owned by a holding company along with CRE 1, 2 and 3 (thus qualifying as CREs under Article 5.8), but the latter entities are in the residence state. From a sales perspective, CRE 1 does not appear to be a relevant account that could force dependency on the agent, but the wording of Article 5.6 and corresponding commentaries establish that it should be viewed as dependent. Assuming the group is forcing dependency on the agent is possible but then the application of the independence exception could be denied based on a case-by-case analysis (i.e., the first part of Article 5.6) or, if such an arrangement was set up mainly for circumventing the PE characterization, under the PPT rule. Furthermore, other practical issues like the time period that should be

[136] Monsenego Jérôme, *The Independent Agent Exception and Group Membership*, Intertax, Volume 46: Issue 12, Kluwer Law International, 2018, Pgs. 951-952.
[137] Ibid., Pgs. 951-952.
[138] Action 7, Op. cit., Pg. 26.
[139] Ibid., Pg. 26.
[140] Monsenego Jérôme, Op. cit., Pg. 953.
[141] Ibid., Pg. 952. See also: Pleijsier Arthur, *The Agency Permanent Establishment in BEPS Action 7: Treaty Abuse or Business Abuse?*, Intertax, Volume 43: Issue 2, Kluwer Law International, 2015, Pg. 151.
[142] Figure made by the author.

analyzed, or the potential use of other parameters (e.g., costs spent with each client)[143] further fuel the fact that the agent might as well be acting independently with respect to one or more CREs. Hence this sub-exception might actually create a divergence between the PE definition and the existence of economical allegiances.

Finally, it is important to note that Action 7 leaves out Limited Risk Distributors – i.e., entities that purchase the goods from the foreign entity to resale them in the source state – from being considered as PEs given it is the entrepreneur of its own business (i.e., distribution of goods).[144] Such consideration should be in-line with the existing economic allegiances of the foreign entity provided the Limited Risk Distributors is the entity substantially involved in the source state, not the foreign entity.

Based on the above, the changes to the agency PE rule have the virtue of being unaffected by the legal qualifications of the agent. Also, the case-by-case analysis allows the interpreter to deem the existence of a PE in the presence of substantial economic allegiances of the foreign entity. However, such virtues can be undermined by presumptions (e.g., when an agent works mostly for CREs) that disregard such economic allegiances to the extent of potentially broadening their divergence with the PE definition.

3.3 Changes to the construction PE rules

In the cases of construction, installation or assembly projects or sites, given their special nature and characteristics, Article 5.3 of the 2014 OECD MTC establishes an extension to the regular PE rule (Article 5.1).[145] In general, such projects should be deemed as PEs whenever they last more than 12 months. The last change to the PE rules is contained in the 2017 Commentaries as an optional provision, and in Article 14 of the MLI, with the intent of tackling the splitting of contracts for projects or sites to prevent the fulfillment of the 12-month threshold. However, both indicate that such practice could be addressed via the PPT rule established in Article 29.9 of the 2017 OECD MTC, and Article 7 of the MLI, which derives from Action 6 of the BEPS package.[146] For practical purposes each option is analyzed separately.

3.3.1 Optional provision to the construction PE rule

The optional provision specifies that whenever a construction, assembly or installation project or site does not last more than 12 months, connected

[143] Monsenego Jérôme, Op. cit., Pgs. 951–953.
[144] Action 7, Op. cit., Pgs. 21-24.
[145] See Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. Cit., Pgs. 76–78.
[146] For this reason, Article 5.3 of the 2014 OECD MTC was not changed in the 2017 version.

activities – that last more than 30 days – that are carried out in the same project or site, either by the same entity or a CRE, shall be added to the time spent in the main project for the purposes of applying Article 5.3.[147] To this end, Action 7 provides several elements that, among others, should be taken into consideration.[148] In general, they refer to the pertinence of separating contracts from a non-tax perspective.[149] Figure 10[150] below shows a case included in both Action 6[151] and 7.[152]

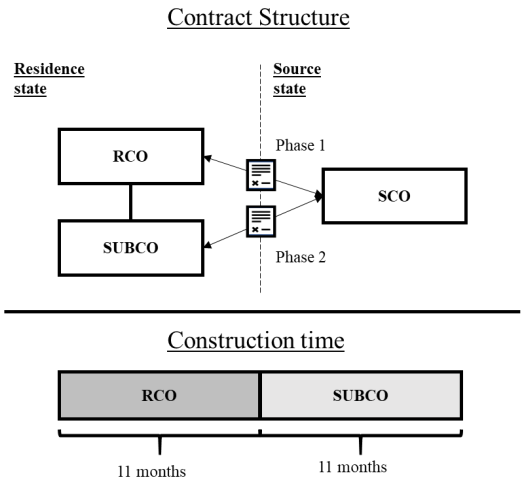

Figure 10

A construction project of 22 months is separated in two contracts with the same client: the first contract is executed by the RCO, and the second one is executed by SUBCO which is the RCO's subsidiary (i.e., a CRE under Article 5.8). The RCO is jointly and severally liable for the execution of SUBCO. Despite that each separate contract should not be deemed as a PE under Article 5.3, the optional provision establishes that the time of SUBCO's contract should be added to RCO's (or vice-versa depending on the circumstances). Therefore, two PEs (one for RCO and one for SUBCO) should be deemed to exist, allowing source taxation. In principle, the economic involvement of RCO in the source state should be the same if its

[147] Action 7, Op. cit., Pg. 43-44.
[148] The elements are the following:
- "*whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;*
- *whether the activities would have been covered by a single contract absent tax planning considerations;*
- *whether the nature of the work involved under the different contracts is the same or similar;*
- *whether the same employees are performing the activities under the different contracts*."

See Action 7, Op. cit., Pgs. 43-44.
[149] Ibid., Pgs. 43–44.
[150] Figure made by the author.
[151] Action 6, Op. cit., Pg. 64.
[152] Action 7, Op. cit., Pg. 42.

construction project lasted the full 22 months in comparison to the case showed in Figure 10. Furthermore, the provisional rule and Action 7[153] reinforce an already existing SOF approach[154] for the interpretation of this provision that enables the interpreter to overlook the forms implemented by the foreign entity to focus on the geographical and commercial coherence of each project/site.[155] Consequently, the SOF approach implemented through this optional provision appears to reconcile the divergence between the existence of economic allegiances and the PE definition, when it is caused by the split of contracts for these types of projects or sites.

3.3.2 Use of the PPT to address construction PE situations

Pursuant to Article 29.9 of the 2017 OECD MTC or Article 7 of the MLI, the PPT specifies that – based on all relevant circumstances – the benefits of a tax treaty shall not be granted to arrangements entered mainly for tax purposes unless such grant is *in accordance with the object and purpose of the relevant provision*[156] (in this case Article 5.3 of the MTC). In this sense, Action 6 establishes that the time threshold included in Article 5.3 of the OECD MTC shall be regarded as the benefit for the purpose of the application of the PPT rule.[157]

Essentially, both the PPT and the provisional rule analyzed previously require a case-by-case analysis,[158] which allows to focus on the economic allegiances of the foreign entity[159] in the source state resulting from its project or site. However, as indicated by Kuźniacki, Action 6, the MLI and the 2017 OECD MTC remain silent regarding the consequences of applying the PPT rule.[160] For instance, applying the PPT rule to the case shown in Figure 10 would result in a denial of the application of Article 5.3. From this point onwards, Action 6 does not stipulate what to do. Noting that adding the time of each contract is not an option under the PPT, the possibilities should be the following:

- Assess whether a PE exist under Article 5.1 of the OECD MTC
- Apply Article 5.3 without the 12-month threshold

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[153] See Action 7, Op. cit., Pgs. 43-44.
[154] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. Cit., Pgs. 83.
[155] See OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD publishing, Pg. 129.
[156] Article 29.9 of the 2017 OECD MTC.
[157] Action 6, Op. cit., Pg. 64.
[158] In the case of the PPT, see: Action 6, Op. cit., Pgs. 57-58.
[159] Kuźniacki Błażej, *The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application*, World Tax Journal, Volume 10: Issue 2, 12 March 2018, Pg. 275.
[160] Ibid., Pgs. 272-273.

- Deny the application of the applicable tax treaty provisions and consequently apply domestic legislation[161]

The first possibility could be applied provided the PPT rule denied the protection of the 12-month threshold. Nonetheless, Article 5.3 is an extension of Article 5.1 rather than a "lex specialis", given its purpose is to address situations where Article 5.1 or Article 5.4 might not apply.[162] Denying the application of Article 5.3 in such cases translates to a scenario where no PE is deemed to exist (thus the taxpayer circumvents the PE definition despite the application of the PPT) leaving the source country with no taxation rights despite the economic involvement of the foreign entity therein. This outcome certainly leads to a divergence between economic allegiances and the PE definition.

The second possibility coincides with the result achieved through the application of the optional provision – i.e., two PEs should be deemed to exist. However, such interpretation contradicts the rest of the wording of Article 5.3 which establishes that a PE would be deemed to exist only if the project/site lasts more than 12-months.[163] Applying only a part of Article 5.3 is troublesome given it tends to devoid such provision of any meaning.

Lastly, the use of domestic legislation presents as the harshest measure (denying the application of applicable DTT provisions); exposing foreign the entity to juridical double taxation assuming its revenues are taxed in both the residence and source state. Such interpretation should not be valid considering that Article 31 of the Vienna Convention on the Law of Treaties and Article 3 of the OECD MTC (both 2014 and 2017 versions) establish that the interpretation of treaty provisions should be made according to its context. In this regard, the context of the OECD MTC includes its preamble which states the purpose to prevent double taxation. Therefore, if the application of domestic legislation leads to double taxation, this should not be an option for the interpreter.[164]

Based on the above, the PPT rule operates similarly to the optional provision regarding the assessment of the situation, but its outcome is not

[161] This scenario could be possible provided the benefit referred in Article 29 of the 2017 OECD MTC is interpreted as the use of the DTT itself. See Kuźniacki Błażej, Op. cit., Pg. 252.
[162] Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. Cit., Pgs. 76–78.
[163] This excluding effect of the 12-month threshold is supported by Reimer who argues that a construction, installation or assembly project or site that complies with all the requirements set-out in Article 5.1 to be deemed as a PE, should not be qualified as such if the 12-month period has not been fulfilled. See Reimer Ekkehart, "Permanent Establishment in the OECD Model Tax Convention", Op. Cit., Pg. 77.
[164] See: Kuźniacki Błażej, Op. cit., Pgs. 255-256.

certain,[165] and might lead to situations were a substantial involvement in the source state is not characterized as a PE. Therefore the PPT rule fails to solve the divergence between the existence of economic allegiances and the PE definition.

4 Conclusion

(...) it would be essential to look for new indicators of economic allegiance considering the new economic context[166]

The analysis made in the previous chapters reveals that the PE definition stood as evidence that a non-resident entity was economically involved in a state to a degree that justifies taxation therein. Consequently, the PE definition should secure an effective distribution of taxing rights between the residence and source states. Nonetheless, the evolution of business models (e.g., the use of commissionaire structures, the splitting of construction contracts, or the use of technologies to carry-out activities without a physical presence in the source state) enabled the existence of economic allegiances without triggering a PE in the source state.

In response to the circumvention of the PE definition, the changes to the PE rules introduced mainly by Action 6 and 7 of the BEPS package use a SOF approach with the intent to secure taxation at the place where activities are carried-out and value is created. In principle, a SOF approach could reconcile the PE definition with the existence of significant economic allegiances.

Analyzing these changes to the PE rules, some positive aspects are visible. For instance, settling the debate of the auxiliary/preparatory nature of the exceptions established in Article 5.4, and eliminating potential conflicts of qualification between civil and common law countries regarding the use of commissionaires, reconcile the PE definition with the existence of economic allegiances of the foreign entity, and at the same time reduce legal uncertainty.

Other changes however are more controversial. The anti-fragmentation rule is a hit or miss that can reconnect the PE definition with economic allegiances in some cases but may also lead to results where a PE is triggered without the foreign business being substantially involved in the source state. The use of the PPT to tackle the splitting of construction, assembly or installation contracts falls into this category as well considering

[165] The author agrees with Kuźniacki which proposes that a second part to the PPT should be added to clarify that once treaty benefits are denied the situation should be taxed in accordance to its economic reality. Kuźniacki Błażej, Op. cit., Pg. 274.
[166] Escribano López Eva, Op. cit., Pg. 13.

it does not provide guidance to the interpreter regarding the steps to take after the avoidance structure has been detected. These cases reveal that reconnecting the PE definition with the existence of economic allegiance requires more than a case-by-case assessment of the foreign entity's business. Particularly, it is essential to prevent that the formal elements of an arrangement meddle with the result of the assessment. For instance, as Pleijsier argued, the fact that the contracts negotiated by an agent are not substantially modified by the foreign entity may not necessarily entail the existence of a PE.[167] In other words, qualifying a foreign business as a PE when it is not substantially involved in the source state demonstrates a divergence between the PE definition and the underlying economic involvement of the foreign entity.

Lastly, some changes or the lack thereof are evident sources of divergence. The presumption that agents that work mostly for a MNE group cannot act in an independent manner may result in the existence of a PE which does not correspond to economic bonds of the MNE or the agent. If the aim of the BEPS package is to ensure taxation *where economic activities take place and value is created*[168] then rules that permit a case-by-case analysis of such activities/value appear to be the essential element, not a presumption that automatically allows source taxation.

Nevertheless, a deeper problem lies in the lack of changes that align the PE definition with businesses carried out remotely. Although some changes tend to tackle this issue (e.g., when a foreign retailer website uses a warehouse in the source state), this is merely a patch to a rule that is already obsolete in a digitalized and globalized economy.[169] Except for the construction PE rule – that by its own nature does not have to deal with this problem – the other changes fail to fulfill their purpose when digital services are involved.[170] Stretching the reach of the physical presence for certain digital or remote activities does not appear to be the solution for that issue. However, the use of the SOF principle as a lighthouse for future tax reforms certainly brought improvements for the PE definition.

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[167] Pleijsier Arthur, *The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report*, Op. cit., Pg. 443.
[168] Explanatory Statement, Op. cit., Pg. 4
[169] Escribano López Eva, Op. cit., Pg. 13.
[170] In this regard the author disagrees with Sapirie who states that the changes introduced to the PE rules will hold the international system for a while. The failure to properly address the issues brought, up to this moment, by the digital economy just reveals that the system is currently not working equally for all businesses, and the ever-evolving nature of the digital economy suggests the problem will only get worse. See Sapirie Marie, *Permanent Establishment and the Digital Economy, Bulletin for International Taxation*, Volume 72: No. 4a/Special issue, 26 March 2018, Pg. 1.

Furthermore, it is important to note that the use of economic allegiances as a reason to tax still appears to be applicable.[171] The problem lies in how to weigh the economic activity of an enterprise to see if source taxation is appropriate.[172] As an example, the use of a sales threshold (i.e., source taxation is allowed after a certain number of sales) presents as a practical solution.[173] A harsher approach is suggested by Escribano who proposes to abandon the default residence taxation in favor of a source taxation principle that weighs economic allegiances differently, potentially allowing the taxation of a significant presence through digital means.[174] However, this solution requires an agreement among countries which is certainly hard to achieve.[175] More than suggestions, these proposals demonstrate that trying to pin down the economic allegiances of the foreign entity in the residence state is the right choice. The problem is that the recent developments of the PE concept have not been sufficient to catch up with modern businesses, thus deepening the incongruity between the PE definition and the economic allegiances of the foreign entity.

In conclusion, the PE changes intend to focus on economic allegiances rather than the forms implemented by foreign entities to determine whether a PE exists, but they fail to do it in several situations. The consequences of such failure should not be taken lightly. As explained by Vogel, the PE concept is *the decisive condition for the taxation* of business profits in the source state, whenever the corresponding foreign entity possesses significant economic bonds therein.[176] Taking this into consideration, the divergence between the existence of economic allegiances and the PE definition proofs that the PE concept is simply failing its purpose.

Furthermore, a SOF approach requires a case-by-case analysis which gives freedom to the interpreter but – inevitably at some point – also brings legal uncertainty to taxpayers. The fact that such trade-off exists is not the problem, it is rather a matter of tax policy of the country trying to balance the provision of legal certainty to foreign investment versus securing taxation when substantial value is created in their country. Nonetheless, the current changes appear to have the downside (i.e., the loss of legal certainty) and only a portion of the upside (i.e., more or less secure taxation whenever the foreign business is economically involved in the source state). A trade-

[171] As indicated by Hägglund: *the PE concept ought to change in order to be in compliance with the principle of economic allegiance*. Hägglund Camilla Berkesten, *The Definition of a Permanent Establishment in the BEPS Era*, Uppsala Universitet, 2017, Pg., 39 referring to Avi-Yonah Reuven S., *International Taxation of Electronic Commerce*, Tax Law Review, Volume 52: Issue 3, NYU School of Law, 1997, Pg. 535.
[172] Sapirie Marie, Op. cit., Pg. 2. See also: Escribano López Eva, Op. cit., Pg. 13.
[173] Sapirie Marie, Op. cit., Pg. 2.
[174] Escribano López Eva, Op. cit., Pgs. 10–13.
[175] Ibid., Pgs. 10–13.
[176] Vogel Klaus, Op. cit., Pg. 280.

off in these terms does not seem attractive for countries who are negotiating (or renegotiating) DTTs (based on the 2017 OECD MTC),[177] or considering signing the MLI; especially for developing countries seeking to secure foreign investment.

The PE concept was successful because it provided legal certainty to foreign investors.[178] Using the PE rules to seek the economic substance of each business model in the form of a SOF approach has taken a toll on its effectiveness, resulting in the inability to provide legal certainty, or to secure taxation when a foreign entity possesses significant economic allegiances in the source state.

[177] Although some of the positive elements indicated may be used given that countries negotiating a tax treaty do not have to fully implement all these changes.
[178] Dhuldhoya Vishesh, Op. cit., Pg. 10.

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