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In international tax law, the concept of triangular cases normally refers to situations whereby a taxpayer is resident in one country and maintains a permanent establishment in another country that derives income from a third country. Needless to say, such situations may be complex, because income may be subject to tax in all three countries.

Triangular cases may also be used to represent the relationship between articles 5, 7, and 9 of the OECD model tax convention. At first glance, there is no direct link between those articles, because articles 5 and 7 deal with tax nexus and income allocation between the head office and PE of an enterprise, that is, a single taxpayer, whereas article 9 deals with income allocation between associated enterprises, that is, two taxpayers. However, the articles are linked because they govern the taxation of enterprises and business profits,[1] and because a subsidiary may qualify as a PE of its parent company (subsidiary PE). This was recently confirmed in *Roche Vitamins Europe Ltd.*, in which the Supreme Court of Spain decided that a contract manufacturer constituted a PE of its Swiss principal. (See Section II.B.3 of this article.) The principal's profits were thus subject to tax in Spain, hardly the result the group anticipated.

International law has addressed whether a subsidiary may qualify as a PE of its parent company since 1928. In 2002 the *Philip Morris* decision caused the topic to regain attention when the Italian Supreme Court held that multiple companies in the Philip Morris group could establish a PE through an Italian subsidiary (multiple PE).[2] The OECD disapproved of the decision in commentaries issued in 2005.[3] The issue was also addressed at the OECD's conference in 2008[4] and at International Fiscal Association congresses in 2010 and 2011.[5]

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[1] J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International, 2010), p. 177 et seq.

[2] Corte de Cassazione, Mar. 7, May 25, and July 25, 2002, case nos. 3367, 3368, 7682, and 10925.

[3] Paras. 41, 41.1, and 42 of the commentary on article 5 of the OECD model tax convention.

[4] OECD, Special Conference, 50th Anniversary of the OECD Model Tax Convention, Sept. 8-9, 2008.

[5] Seminar A, ''The subsidiary as a permanent establishment,'' IFA congress, 2010, Rome; and Young IFA Network Seminar, ''Commissionaire Arrangements and Permanent Establishment Exposure,'' IFA congress, 2011, Paris. *See* L.E. Schoueri and O-C. Günther, ''The Subsidiary as a Permanent Establishment,'' 65 *Bulletin for International Taxation* 2 (2011), p. 69.

In 2011 the OECD published a discussion draft that addresses various PE issues.[6] The discussion draft originates from the OECD's business restructurings project launched in 2005. Tax administrations often claim that they lose tax revenues because of business restructurings that cause intangibles and risks — and the associated profit potential — to be centralized with a nonresident principal. The administrative response may be to tax the lost tax base in the hands of the resident subsidiary in the form of a transfer pricing adjustment, and/or to tax the lost tax base in the hands of the nonresident principal in the form of PE taxation. In 2010 the transfer pricing prong of the project resulted in a new Chapter IX of the OECD transfer pricing guidelines. The PE prong is expected to result in the publication of new commentaries in 2014 based on the discussion draft and comments received thereon.

This article addresses the concept of a subsidiary PE and the relationship between articles 5, 7, and 9 of the OECD model tax convention. It will show how incorrect transfer prices under article 9 may trigger a subsidiary PE under article 5, how correct transfer prices may lead to the same result, and how article 7 may cause subsidiary PE taxation to vanish into the blue. The separate entity approach — under which associated enterprises must be treated as separate taxpayers in international tax law — is touched on (Section I). The conditions for obtaining a subsidiary PE are then addressed in relation to the main PE rule (Section II) and the agency PE rule (Section III). Finally, there is a discussion of the taxation of a subsidiary PE under article 7 (Section IV).

I. Separate Entity Approach

Under the separate entity approach, a parent company and its subsidiaries are treated as separate entities for tax purposes.[7] This is the case even if the companies function as an economic unit and economically are carrying on a single business. The separate entity approach means that a subsidiary cannot per se be treated as a PE of its parent company. This traditional view has its roots in the League of Nations' model tax convention from 1928, in which the term ''affiliated companies'' was deleted from the list of examples of PEs.[8] In 1933, a draft convention went on to state: ''The term 'permanent establishment' . . . does not include a subsidiary company.''[9] In 1943, the separate entity approach was incorporated into the model tax convention:

> The fact that a parent company, the fiscal domicile of which is one of the contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State, regardless of the fiscal obligations of the subsidiary toward the State in which it is situated.[10]

Finally, in 1963 the OECD included a slightly amended version of the separate entity approach in article 5(6) of its model tax convention, which opened the door to the possibility that a subsidiary may constitute a PE of its parent company in appropriate situations (''not of itself''):

> The fact that a company . . . controls or is controlled by a company which is a resident of the other Contracting State . . . shall not of itself constitute either company a permanent establishment of the other.

The wording of article 5(6) (now article 5(7)) has not changed since 1963. The OECD model tax convention thus sanctions the notion that group companies may constitute PEs for each other. Whether a subsidiary PE exists must be analyzed under the general PE rules. Hence, a subsidiary PE may arise under both the main rule in article 5(1)[11] and the agency rule in article 5(5).[12]

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[6]OECD, ''Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention,'' 2011. *See* Oliver R. Hoor, ''Comments on the OECD Discussion Draft on the Meaning of ''Permanent Establishment,''* Tax Notes Int'l*, Jan. 16, 2012, p. 207, *Doc 2011-26838*, or *2012 WTD 10-18*.

[7]The OECD transfer pricing guidelines ascribe the separate entity approach the additional meaning that a parent company and its subsidiaries must be treated as independent enterprises: ''Because the separate entity approach treats the members of [a multinational enterprise] group as if they were independent enterprises,'' cf. para. 1.6 of the OECD transfer pricing guidelines. However, there is nothing that hinders the application of the separate entity approach in conjunction with formulary apportionment. For example, the common consolidated corporate tax base proposed by the European Commission is based on formulary apportionment and treats associated enterprises as separate entities for tax purposes, *cf.* COM(2011) 121 final. The OECD is thus attempting to consolidate the separate entity approach and the method of separate accounting. This is evident from paragraph 3 of the 2010 commentary on article 7, which states that article 7(2) is based on the separate entity approach and the arm's-length principle. The OECD has not previously referred to the separate entity approach in relation to article 7(2).

(Footnote continued in next column.)

[8]''Double Taxation and Evasion — Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion'' (Geneva: League of Nations Document, C.562.M.178.1928.11, Oct. 1928).

[9]Fiscal Committee, ''Report to the Council on the Work of the Fourth Session of the Committee'' (Geneva: League of Nations Document, C.399.M.204.1933.II.A, June 1933), para. 2(c) of the protocol.

[10]Fiscal Committee, ''London and Mexico Model Tax Conventions'' (Geneva: League of Nations Document, C.88.M.88.1946.II.A, Nov. 1946).

[11]Para. 41 of the commentary on article 5 of the OECD model tax convention.

[12]Paras. 41 and 42 of the commentary on article 5 of the OECD model tax convention.

II. Subsidiary PE Under the Main Rule

The main rule defines a PE as a place of business that is fixed and where the business of the enterprise is carried on.[13] A subsidiary PE under the main rule may arise when:

- a parent company itself is carrying on business through the premises of its subsidiary;
- a parent company's business is carried on by its subsidiary; or
- a parent company and its subsidiary are carrying on a common business.

A. Scenario 1

If a parent company disposes of a fixed place of business belonging to its subsidiary, and is using it to carry on its business, a PE may arise under the main rule.[14] This may be relevant when:

- the parent company provides services to the subsidiary or third parties through the premises of the subsidiary;
- an employee of the parent company disposes of an office at the premises of the subsidiary; or
- the parent company seconds an employee to the subsidiary.

The first and second situations are straightforward, as the parent company is directly using the premises of its subsidiary to carry on its own business. The third situation is more complex, because activities at the premises of the subsidiary are carried on by a person that has ties with both the parent company and the subsidiary. In this situation, it may be unclear whether the business carried on by the secondee at the premises of the subsidiary must be attributed to the parent company or the subsidiary.

When a parent company seconds an employee to a subsidiary, the employee will often work in the interest of the subsidiary, under the instruction and control of the subsidiary, and for the account and risk of the subsidiary. However, there may be valid reasons not to discontinue the employment contract with the parent company. In such a situation, the question is whether a PE analysis should be based on the formal, legal employer (parent company), or the real, economic employer (subsidiary). The concept of an employer in article 15 of the OECD's model tax convention must be interpreted on the basis of domestic law; this also holds true in other contexts of the model tax convention, see article 3(2).[15] If the emphasis is on the legal employer, a secondee may cause the parent company to establish a PE at the premises of the subsidiary. In *Morgan Stanley*, the Indian Supreme Court relied on the legal employer, which caused a U.S. parent company to establish a PE in India even though the secondees were working under the direction and in the interest of the Indian subsidiary.[16] By contrast, in *Hotel Manager* the German Federal Fiscal Court emphasized the economic employer.[17] The domestic laws of the United States[18] and Denmark[19] also rely on the economic employer concept.

The OECD expresses a preference for the economic employer in relation to articles 5 and 15. Hence, in the context of service PEs, the employer is normally selected based on a test of which enterprise supervises, directs, and controls the employee.[20] This position is maintained in the 2011 discussion draft, which proposes that the employer be identified based on the guidelines laid down in paragraphs 8.13-8.15 of the commentary on article 15.[21] This is explained as follows:

> It was suggested that the practical situation in which this issue was most likely to occur was the case where an employee of a company that belonged to a multinational group was temporarily seconded to work for another company of the group. In many cases, the secondment would be done without a formal contract between the two enterprises but, to avoid transfer pricing issues, a cost-plus charge might be paid to the first company. This could have the unfortunate consequence that the services rendered by the employee might be considered to be provided by the first company to the second company, which would create the risk that the first company would be found to have a PE in the premises of the second company where the employee would work. The Group concluded that the analysis in

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[13] Para. 2 of the commentary on article 5 of the OECD model tax convention.

[14] Paras. 4.1 and 41 of the commentary on article 5 of the OECD model tax convention.

[15] Paras. 8.4 and 8.7 of the commentary on article 15 of the OECD model tax convention.

[16] *DIT (International Taxation) v. Morgan Stanley and Co. Inc.* (2007), 292 ITR 416, Supreme Court. The decision has been criticized by H. Pijl, ''Morgan Stanley: Issues Regarding Permanent Establishments and Profit Attribution in Light of the OECD View,'' 62 *Bulletin for International Taxation* 5 (2008), pp. 174, 180. In *DDIT-IT v. Tekmark Global Solutions LLC*, Mumbai Income Tax Appellate Tribunal, ITA 671/Mum/2007, Feb. 23, 2010, the court placed more emphasis on the instruction and control over seconded personnel. On this basis, an Indian subsidiary qualified as the employer of secondees from a U.S. parent company.

[17] Federal Fiscal Court, Feb. 3, 1993 (BStBl 1993 II 462). *See also* the German administrative guidelines on secondment and transfer pricing, Nov. 9, 2001 (BStBl I 2001 796).

[18] Rev. Rul. 87-41, 1987-1 C.B. 296, and Rev. Rul. 74-330, 1974-2 C.B. 278. *See* Wittendorff, *supra* note 1, at 631 et seq.

[19] TfS 1996.248 and TfS 2006.789.

[20] Para. 42.43 of the commentary on article 5 of the OECD model tax convention.

[21] OECD, *supra* note 6, para. 38.

paragraph 8.13 to 8.15 of the Commentary on Article 15 would be relevant for the purpose of distinguishing these cases from other cases where employees of a foreign enterprise perform that enterprise's own business activities.[22]

The OECD is thus of the view that a secondment should normally not give rise to a PE for the parent company, provided the subsidiary is the economic employer. Hence, in this situation the parent company does not provide a service to the subsidiary. This is in line with the OECD's position in relation to the hiring out of labor, which is considered not to trigger PE taxation of the legal employer.[23]

The OECD does not address secondments vis-à-vis transfer pricing directly. The objective scope of article 9(1) is defined in terms of ''commercial or financial relations,'' a phrase that is not defined in article 9(1) or elsewhere in the OECD model tax convention. A contextual interpretation of article 9(1) should, in particular, take article 7(1) (and article 8) into account, because article 9(1) determines the amount of business profits from transactions between associated enterprises that is covered by the taxing rights of the two residence states according to article 7(1). Thus, there is an overlap between income covered by articles 7(1) and 9(1). The profits from ''commercial or financial relations'' governed by article 9(1) are therefore identical to the ''business profits'' governed by article 7(1).[24] The OECD's position in relation to articles 5 and 15 must thus also be applicable in relation to article 9(1), for which reason a secondment should normally not qualify as a commercial or financial relation. This understanding is in line with the discussion draft's position that a secondment will normally not constitute a service. Accordingly, a subsidiary may be charged on a cost-only basis for a secondment.

The concepts of business profits and commercial and financial relation must be interpreted on the basis of domestic law.[25] National courts may thus reach results that diverge from each other and from the position of the OECD. This possibility is illustrated by cases decided in India and Denmark.

The Indian case of *Morgan Stanley* concerned, among other things, stewardship activities carried on by employees of a U.S. parent company at the premises of an Indian subsidiary.[26] The subsidiary performed back-office services for the parent company. The U.S. employees instructed the employees of the subsidiary on the group's quality standards and monitored the overall operations of the subsidiary. The U.S. employees were not involved in day-to-day management, or in the performance of back-office services. In relation to the stewardship activities, the Supreme Court held that the parent company was not performing a service for the subsidiary, as it was merely protecting its investment and controlling whether the services were performed in accordance with its quality standards. This aspect of the decision is consistent with the OECD position.

The Danish case concerned a Danish parent company that had seconded employees to foreign subsidiaries engaged in contract manufacturing for the parent company.[27] The secondees performed production and quality control duties, including technical assistance. The purpose of the secondments was to ensure that quality standards were satisfied. The subsidiaries' entire output was purchased by the parent company. The tax authorities disallowed the parent company's deduction for the salaries paid to the secondees. The taxpayer argued that the use of a principal's own employees for production and quality control was usual in relation to subcontractors. At trial, the tax authorities changed position and argued that the secondments were covered by the domestic transfer pricing provision, because the parent company's employees carried out work in relation to functions performed by the subsidiaries. The National Tax Tribunal held in favor of the tax authorities, and the parent company was deemed to provide services to the subsidiaries. This result contrasts with the position adopted by the OECD in the discussion draft.

The results of the two cases are difficult to reconcile, and illustrate the point that the objective qualification under article 9(1) is the prerogative of domestic law.

The OECD position on secondments in relation to PE taxation and transfer pricing is summarized in the table.

OECD Position on Secondments

Economic Employer	PE for Parent Company Under Article 5?	Secondment Covered by the Scope of Article 9?	Transfer Pricing of Secondment
Parent company	Yes	Yes	Arm's-length price
Subsidiary	No	No	Cost-only price

[22]OECD, *supra* note 6, para. 44.

[23]Arvid A. Skaar, *Norsk skatteavtalerett* (Gyldendal Akademisk, 2006), p. 169.

[24]Wittendorff, *supra* note 1, at 223.

[25]Wittendorff, *supra* note 1, at 225.

[26]*Supra* note 16.

[27]TfS 2007.163.

B. Scenario 2

1. Introduction

Information technology allows efficient value chains to be created across companies and geographic boundaries, resulting in the close integration of associated enterprises. Business restructurings often result in the centralization of intangible assets and risks with a principal company whereby the risks of other group companies are reduced and their activity designed to serve the needs of the principal. If the principal owns the production plant used by a subsidiary and the goods in process, and has seconded employees to instruct, monitor, and control the employees of the subsidiary, the value proposition of the subsidiary may, in essence, have been reduced to the procurement of the necessary personnel. If the subsidiary is compensated on a cost-plus basis, the arrangement may very well be viewed as the subsidiary carrying on business for the account and risk of the principal. This may raise doubts whether the business of the subsidiary must be attributed to the principal under article 5 of the OECD model tax convention.[28] If this happens, the principal may obtain a PE through the subsidiary.

Paragraph 42 of the OECD commentary on article 5 conveys the traditional position that a parent company normally does not establish a PE solely because it purchases goods or services from a subsidiary under a contract manufacturing arrangement:

> It is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

The mere fact that a subsidiary's activity *serves* the needs of its parent company is thus not sufficient to create a PE. Paragraph 42 has been relied on in cases decided in Mexico,[29] Poland,[30] and Denmark[31] to justify the conclusion that contract manufacturers did not trigger a subsidiary PE for a nonresident principal.

However, the assumptions underlying paragraph 42 are not met if:

- the parent company has a right of disposal over the subsidiary's premises; and
- the activity of the subsidiary may be attributed to the parent company.[32]

This understanding is confirmed by the 2011 discussion draft:

> Business restructurings may lead to assets being held, risks being managed or activities being performed by a converted local entity for the account of a foreign enterprise. The issue was raised of whether, and if so in which circumstances, the premises of the converted local entity in which these activities take place may constitute a fixed place of business of the foreign enterprise. Two relevant questions are whether these premises are *at the disposal of* the foreign enterprise and whether it is the *business of the foreign enterprise* (and not only the business of the local entity) that is wholly or partly carried on in these premises.[33]

2. Right of Use

The wording of article 5 does not explicitly lay down a right of use test, but such a test has been recognized by the OECD commentary since 1977. The OECD commentary does not address whether a parent company may be deemed to have a right of use of the premises of a contract manufacturing subsidiary. In this respect, the 2011 discussion draft proposed the following commentary:

> 4.2. Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or a contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant

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[28]M. Milet, "Permanent Establishments Through Related Corporations Under the OECD Model Treaty," 55 *Canadian Tax J.* 2 (2007), pp. 289, 300.

[29]Superior Chamber of the Federal Tax Court, First Section, 87627/05-17-04-4/06-SI-05-02, 2007.

[30]Tax authority decision of Feb. 19, 2007, DD7/033-227-ML/06/446.

[31]TfS 2008.747.

[32]Arvid A. Skaar, "Is There a Permanent Establishment?" *Cahiers de Droit Fiscal International*, Vol. 94a (2009), pp. 17, 39; and *id., Permanent Establishment — Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991), p. 547.

[33]OECD, *supra* note 6, para. 17.

merely because all these goods will be used in the business of that enterprise.[34]

According to the proposed commentary, a parent company does not meet the right of use test solely because it purchases the subsidiary's entire output. This is the case even if the parent company has made intangible assets available to the subsidiary, owns the goods in process, and compensates the subsidiary on a cost-plus basis.[35] This is line with paragraph 42 of the commentary.

On the other hand, the proposed commentary means that a parent company may be deemed to have a right of disposal of the subsidiary's premises if it is entitled to access the premises or is actually using it. For example, the test may arguably be met if the parent company has seconded personnel to the subsidiary to instruct, monitor, and control the production process.

The proposed commentary is based on the assumption that the subsidiary owns the production plant. So what happens if the plant is owned by the parent company and is rented out to the subsidiary or simply made available to the subsidiary? An enterprise normally does not establish a PE at premises used by another enterprise solely because it owns the premises used by the other enterprise. Thus, the rental of business premises does not create a PE if the rental activity is not carried on through a fixed place of business in the source state.[36] However, if a parent company owns a production plant that is leased to its subsidiary, this may mean that the parent company has a right of disposal of the plant.[37]

The 2011 discussion draft does not consider whether a parent company satisfies the right of use test when its business is deemed to be carried on by the subsidiary according to paragraph 10 of the commentary on article 5. (See Section II.B.3 below.) It may be argued that it is a necessary — and sufficient — condition that the activity of the subsidiary be attributed to the parent company. Hence, the discussion draft concludes that an employee's home office may give rise to a PE for the employer, even though the employer is not entitled to access the office.[38] A consistent application of this position must mean that a parent company may obtain a PE through a subsidiary that is carrying on the business of the parent company under paragraph 10, even though the parent company is not entitled to access the premises of the subsidiary. The OECD thus should consider the right of use test in the context of paragraph 10 and its position on home offices.

3. Attribution to the Parent Company

The issue of whether business carried on by a subsidiary can be attributed to its parent company under article 5 is complex. The OECD model tax convention does not govern this issue, because the terms ''enterprise'' and ''business'' must be interpreted on the basis of domestic law according to article 3(2).[39] Likewise, the model convention does not govern whether the transfer of business from a parent company to its subsidiary must be recognized for tax purposes.[40] In principle, the question must thus be answered on the basis of domestic law.[41]

The OECD nevertheless addresses the issue in paragraph 10 of the commentary on article 5:

> 10. The business of an enterprise is carried out mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorized to conclude contracts if he works at the fixed place of business (see paragraph 35 below).[42]

According to paragraph 10, the business of an enterprise is carried on by the employees of the enterprise and by ''other persons'' receiving instructions from the

[34]OECD, *supra* note 6, para. 11.

[35]OECD, *supra* note 6, para. 18.

[36]Para. 8 of the commentary on article 5 of the OECD model tax convention. *See* Skaar, *supra* note 32, ''Is There a Permanent Establishment?'' pp. 17, 40; and *id.*, *Permanent Establishment — Erosion of a Tax Treaty Principle,* p. 191.

[37]This was confirmed in German decisions from 1992 and 1996 by the Fiscal Court of Baden-Württemberg, May 11, 1992, 3 K 309/91, EFG 1992, 53; and Nov. 7, 1996, 3 K 54/93, *Internationales Steuerrecht*, 1997, p. 240.

[38]OECD, *supra* note 6, para. 23.

[39]Paras. 4 and 10.2 of the commentary on article 3 of the OECD model tax convention. *See* Skaar, *supra* note 32, ''Is There a Permanent Establishment?'' pp. 17, 38.

[40]Paras. 9.2 and 22-22.1 of the commentary on article 1, and para. 21.1 of the commentary on article 11 of the OECD model tax convention.

[41]For an analysis of this issue in relation to domestic law in the U.K. and Canada, see M. Milet, *supra* note 28, p. 289; in relation to domestic law of the United States and Canada, see W.B. Taylor, V.L. Davies, and J. McCart, ''Policy Forum: A Subsidiary as a Permanent Establishment of its Parent,'' 55 *Canadian Tax J.* 2 (2007), p. 333; and in relation to domestic law of the U.K. and Australia, see Richard J. Vann, ''Tax Treaties: The Secret Agent's Secrets,'' 50 *British Tax Rev.* 3 (2006), p. 345.

[42]Paragraph 19 of the commentary on article 5 also governs this issue. However, paragraph 19 is applicable only in tripartite arrangements when a general contractor is responsible to a customer for the result of the work carried on by a subcontractor. The 2011 discussion draft includes a proposed paragraph 10.1 that clarifies that the scope of paragraph 19 is not confined to building and construction work under article 5(3). The wording of paragraph 10.1 is somewhat ambiguous, but it must be assumed that it will continue to be applicable only in tripartite arrangements.

enterprise, such as dependent agents.[43] The other person need not be an employee of the parent company. The term ''person'' must be given a broad interpretation, and includes individuals, companies, and any other body of persons, compare article 3(1)(a) of the OECD model tax convention.

Such a person may be an individual who is formally employed by a subsidiary but the parent company is deemed to be the economic employer. (See Section II.A above.)

However, such a person may apparently also be a subsidiary that receives instructions from the parent company, provided it is dependent on the parent company.[44] The term ''dependent'' is not defined in paragraph 10 and must be interpreted in light of the term ''independent agent'' in articles 5(5) and 5(6) of the OECD model tax convention, which is clarified in paragraph 37 of the commentary:

> 37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:
>
> a) He is independent of the enterprise both legally and economically, and
>
> b) . . . .

If a subsidiary is legally *or* economically dependent on its parent company (and receives instructions), the business carried on by the subsidiary may thus potentially be attributed to the parent company according to paragraph 10.

A subsidiary is legally dependent on its parent company when its commercial activities are subject to detailed instructions or to comprehensive control by the parent company.[45] On the other hand, a subsidiary is not dependent on its parent company solely because of the shareholder control exercised by the parent company.[46] A subsidiary may be economically dependent on its parent company if it has no other customers,[47] or if it receives ongoing subsidies from the parent company to survive.[48]

The independence test must take into account whether the taxpayer assumes entrepreneurial risk.[49] The 2011 discussion draft addresses whether it should be clarified that the transfer pricing method applied may indicate whether a taxpayer bears entrepreneurial risk. In line with the position taken in 2002, the OECD maintains that it is not necessary to clarify the concept of entrepreneurial risk.[50] However, the application of a cost-plus method is a factor that may indicate that a taxpayer is not exposed to entrepreneurial risk.

A contract manufacturer will often be legally independent of the principal under article 5(6), but it may be difficult to avoid being marked as economically dependent. This is especially the case if the contract manufacturer is compensated on a cost-plus basis and has few principals.[51]

In a number of cases, courts have ruled that the activities of low-risk subsidiaries gave rise to a subsidiary PE for a principal under the main rule of article 5(1).

In *Roche Vitamins Europe Ltd.,* Spain's Supreme Court held that a Swiss principal had a PE in Spain through an affiliated Spanish company under both the main rule and the agency rule.[52] The Spanish company was acting as a contract manufacturer and sales commission agent in Spain on behalf of the principal. In relation to the main rule, the decision was justified on the basis that the activity of the Spanish company was directed, organized, and managed in a detailed manner by the principal. The Spanish company was thus legally dependent on the principal. The Court also took into account that the Spanish company had only one principal and that the cost-plus method applied did not provide it with a reasonable profit under the arm's-length principle. The Spanish company was thus also economically dependent on the Swiss principal.

In *Salad Dressing*, a German court ruled that a Swiss principal had a PE at the premises of an unrelated German contract manufacturer because the employees of the German company received detailed instructions from the Swiss principal.[53] The German company was thus working under the instruction and control of the Swiss principal.

[43]*See also* paragraph 2 of the commentary on article 5 of the OECD model tax convention.

[44]Para. 32 of the commentary on article 5 of the OECD model tax convention.

[45]Paras. 38 and 38.3 of the commentary on article 5 of the OECD model tax convention. *See* J-P. le Gall, ''Can a Subsidiary Be a Permanent Establishment of Its Foreign Parent? Commentary on Article 5, Par. 7 of the OECD Model Tax Convention,'' 60 *Tax Law Rev.* (2007), pp. 179, 202.

[46]Para. 38.1 of the commentary on article 5 of the OECD model tax convention.

[47]Para. 38.6 of the commentary on article 5 of the OECD model tax convention.

[48]*See* Section III of this article on *Interhome*.

[49]Paras. 38 and 38.6 of the commentary on article 5 of the OECD model tax convention.

[50]OECD, *supra* note 6, para. 124.

[51]The independence test may consider whether multiple principals are acting in concert toward the subsidiary, *cf.* para. 38.6 of the commentary on article 5 of the OECD model tax convention.

[52]*Roche Vitamins Europe Ltd. v. Administración General del Estado,* Second Section of the Third Chamber of the Supreme Court, Case No. STS/202/2012, Jan. 12, 2012. *See* E. Martínez-Matosas and J. Manuel Calderón, ''Subsidiary Constituted PE, Supreme Court Rules,'' *Tax Notes Int'l,* Mar. 5, 2012, p. 743, *Doc 2012-3789*, or *2012 WTD 37-2*.

[53]Fiscal Court Baden-Württemberg, Nov. 7, 1996, 3 K 54/93, *Internationales Steuerrecht*, 1997, p. 240.

In *Milcap Media Limited,* a Swedish court held that a Cyprus principal had a PE through a Swedish subsidiary, because the subsidiary was considered to be carrying on the business of the principal.[54] The subsidiary was deemed to be dependent on the principal because it was subject to detailed instruction and control and did not assume any risk. The court referred to paragraphs 7 and 10 of the commentary on article 5.

In *eFunds,* the Indian tax authorities held, and an appellate tribunal confirmed, that a U.S. parent company had a service PE in India because the employees of its Indian subsidiary qualified as ''other persons'':

> The other main condition is that the services should be provided through ''employees OR other personnel.'' Clearly, employees and other personnel are not one and the same thing. Since two terms are used as conjoint, the ''other personnel'' are the persons upon whom the assessee has control, though they may not be on its pay roll. . . . In these appeals, eFunds India is 100% subsidiary of eFunds Corporation USA. The employees of the affiliate i.e. eFunds India are under control of eFunds Corporation and therefore fall under category of ''other personnel.'' eFunds Corporation USA is rendering services to its clients through employees/other personnel of eFunds India and therefore eFunds India acts as service PE for eFunds Corporation USA.[55]

In *Lucent Technologies*, another Indian case, the tribunal adopted a similar reasoning and reached a similar result.[56]

The 2011 discussion draft does not address the interpretation of paragraph 10, even though it is at the very center of the issue of subsidiary PEs. In the preceding discussion, it has been assumed that a subsidiary may be deemed to carry on the business of its parent company under article 5. However, it may be argued that the scope of paragraph 10 hereby is pushed too far. First, the use of the term ''paid employment'' suggests that paragraph 10 is intended to be applicable solely to individuals. This is confirmed by the commentary on service PEs.[57] Second, the concept of an agent is generally used in a legal sense in article 5.[58] A parent company should thus not be able to obtain a PE under the main rule solely because a contract manufacturer subsidiary is acting on its behalf economically. When a subsidiary does not qualify as an agent for its parent company in a legal sense, it is irrelevant under article 5 whether the subsidiary is dependent on the parent company. Third, the domestic law of many countries will hardly recognize that a contract manufacturer is not carrying on its own business.

For these reasons, the OECD should adopt a narrow interpretation of the scope of paragraph 10 to include only individuals. This would have the effect that a subsidiary would give rise to a PE under the main rule only if the parent company qualifies as the economic employer of the subsidiary's employees. Economic dependence would not be a factor that could trigger a subsidiary PE under the main rule.

C. Scenario 3

If a parent company and its subsidiary are cooperating on the delivery of services to a third party, the contractual arrangement may be structured in such a manner that the two companies are carrying on business separately. For example, the companies may carry on a building project for a customer, or the parent company may have subcontracted the performance of customer services to its subsidiary. If it is accepted that the companies are carrying on separate businesses, the parent company will normally not establish a subsidiary PE. On the other hand, if the companies are deemed to carry on a common business vis-à-vis the third party, the activities of the subsidiary may trigger a PE for the parent company, irrespective of whether the parent company is present in the source state.[59]

The OECD commentary does not govern whether companies must be treated as carrying on business separately or in common. Since the terms ''enterprise'' and ''business'' must be given a domestic interpretation, the issue must be resolved under domestic law. This understanding is confirmed in the 2011 discussion draft:

> 10.3. It follows from the definition of ''enterprise of a Contracting State'' in Article 3 that this term, as used in Article 5, refers to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form. Different enterprises may collaborate on the same project and the question of whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State. Clearly, if two enterprises carried on by different persons decide to form a company in which these persons are

[54] Court of Appeal, Stockholm, May 31, 2005, case nos. 7453-54-02, 7456-57-02.

[55] *eFunds Corporation v. ADIT*, ITA 3668-3675 and 3714-3722, Income Tax Appellate Tribunal, Delhi, Sept. 30, 2010.

[56] *Lucent Technologies International Inc. v. DCIT*, ITA 2224/Del/2001, Income Tax Appellate Tribunal, Delhi, Dec. 19, 2008.

[57] Paras. 42.32 and 42.43 of the commentary on article 5 of the OECD model tax convention refer solely to individuals in the context of paragraph 10 of the commentary.

[58] Vann, *supra* note 41, pp. 345, 359. This point is confirmed by the OECD, *supra* note 6, paras. 20 and 114-117.

[59] Para. 19.1 of the commentary on article 5 of the OECD model tax convention; and OECD, *supra* note 6, para. 54. *See* Skaar, *supra* note 32, *Permanent Establishment — Erosion of a Tax Treaty Principle*, p. 168.

shareholders, the company constitutes a legal person that will carry on what becomes a separate enterprise. It will often be the case, however, that different enterprises will simply agree to each carry on a separate part of the same project and that these enterprises will not jointly carry on business activities and share the profits thereof even though they may share the overall output from the project or the remuneration for the activities that will be carried on in the context of that project (e.g. what is considered to be a ''joint venture'' according to the law of some countries). In such a case, it would be difficult to consider that a separate enterprise has been set up.[60]

The proposed paragraph 10.3 applies a distinction between partnerships and joint ventures. The term ''joint venture'' is used regarding cases in which the companies are carrying on business separately. The OECD proposes that the following factors be applied to distinguish between the two forms of cooperation:

- liability for each other's activities;
- common ownership of assets or joint employment responsibilities; and
- profit-sharing.[61]

Another relevant factor may be whether there is a clear legal and factual separation between the businesses of the parent company and the subsidiary. In *Nokia Networks*, an Indian tax tribunal emphasized that an artificial allocation of value from services provided in India by an Indian subsidiary to supplies made abroad by a Finnish parent company had caused the subsidiary to realize losses.[62] This was one of the reasons why the boundaries between the business of the parent company and of the subsidiary were held to be blurred. The court determined that the subsidiary constituted a PE of the parent company.

III. Subsidiary PE Under Agency Rule

A subsidiary may trigger an agency PE for its parent company under article 5(5) if the following conditions are met:[63]

- the subsidiary is authorized to conclude contracts in the name of the parent company[64] relating to the business proper of the parent company[65];
- the subsidiary habitually exercises the authority[66];
- the activities are not of a preparatory and auxiliary character under article 5(4); and
- the subsidiary does not qualify as an independent agent under article 5(6).

In *Zimmer*[67] and *Dell*,[68] the first condition was not met because subsidiaries acting as commissionaires did not conclude contracts that were legally binding on other group companies. It was thus not sufficient that contracts were ''economically'' binding on the group companies. After discussing both decisions, the 2011 discussion draft failed to adopt a common view on whether the first condition under article 5(5) refers to legally or economically binding agreements.[69] However, because the discussions took place before the Norwegian Supreme Court overturned the lower court's decision in *Dell*, it now ought to be easier for member countries to agree that contracts should be legally binding on the principal to a create an agency PE, provided the members are also able to agree that the result in *Roche Vitamins Europe Ltd.* is inconsistent with article 5 of the OECD model tax convention. Further support for this view is now found in *Boston Scientific*, in which the Italian Supreme Court upheld a decision that a Dutch principal did not have a PE in Italy through an Italian commissionaire.[70]

The other key question under the agency rule is whether the subsidiary is legally and economically independent of the parent company,[71] including whether it is acting outside its ordinary course of business.[72] If the independence test is not satisfied, the subsidiary is deemed to carry on the business of its parent company. As mentioned above, the independence test must take into account whether the taxpayer assumes entrepreneurial risk. (See Section II.B.3.) The application of a

[60]OECD, *supra* note 6, paras. 54 and 55.

[61]OECD, *supra* note 6, para. 56.

[62]*Motorola Inc., Ericsson Radio Systems AB and Nokia Networks OY v. DCIT*, 815, 1798, 1963, 1964, 2455, 2510, 2511 and 2516, Income Tax Appellate Tribunal, New Delhi, June 22, 2005. *See* J. Kariya and R. Gandhi, ''Taxation of Telecom Suppliers' Turnkey Contracts in India,'' *Tax Notes Int'l,* Sept. 26, 2005, p. 1197, *Doc 2005-15974*, or *2005 WTD 187-10*.

[63]Para. 41 of the commentary on article 5 of the OECD model tax convention.

[64]Paras. 32 and 32.1 of the commentary on article 5 of the OECD model tax convention.

[65]Para. 33 of the commentary on article 5 of the OECD model tax convention.

[66]Para. 33.1 of the commentary on article 5 of the OECD model tax convention.

[67]Supreme Administrative Court of France, Mar. 31, 2010, Case No. 304715.

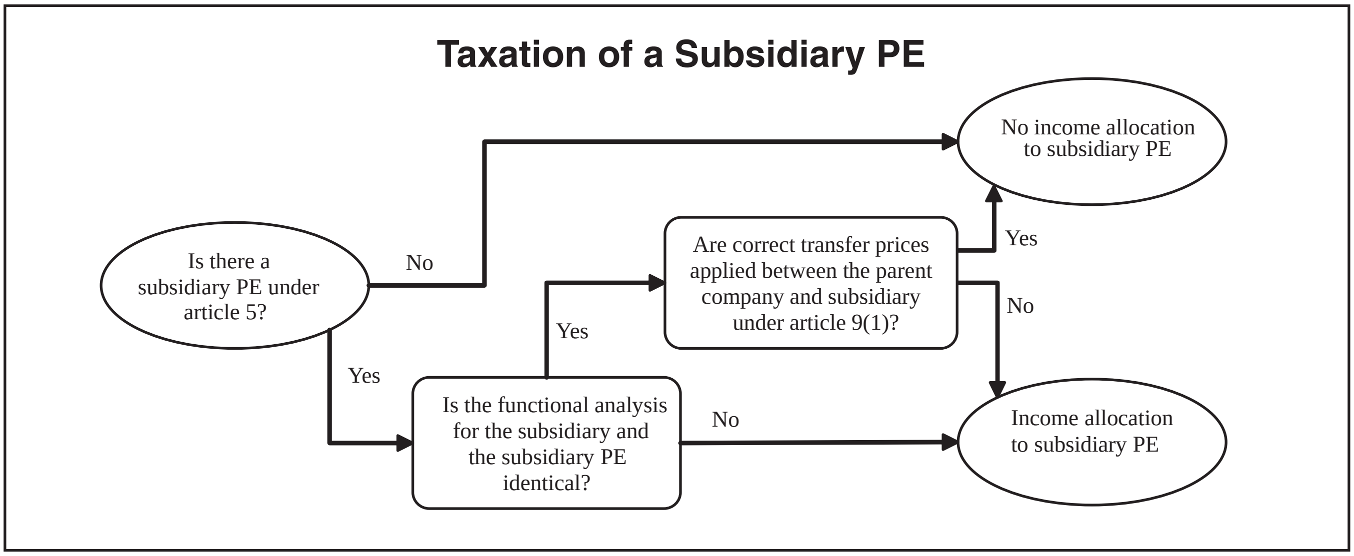
[68]Supreme Court of Norway, Dec. 2, 2011, in *Dell Products mot Staten*, Case No. 2011/755.

[69]OECD, *supra* note 6, para. 114.

[70]Supreme Court of Italy, Mar. 9, 2012, in *Boston Scientific*, Case No. 3769.

[71]Para. 37 of the commentary on article 5 of the OECD model tax convention.

[72]Paras. 38.7 and 38.8 of the commentary on article 5 of the OECD model tax convention.



cost-plus method is a fact that may indicate that a taxpayer is not exposed to entrepreneurial risk. For example, in *Zimmer* the use of a cost-plus method was one of the reasons given by the Court for its finding that a French subsidiary was dependent on a foreign principal. The Court did not dispute that the method resulted in correct transfer prices. In *Interhome*, the French Supreme Administrative Court came to the same conclusion because a French subsidiary received subsidies from its Swiss parent company on an ongoing basis to survive.[73] The need for the subsidies may have been due to the application of incorrect transfer prices.

IV. Income of a Subsidiary PE

When a subsidiary PE exists, an income allocation must be made between: (1) the parent company and the subsidiary; and (2) the head office of the parent company and its PE in the source state. This article addresses only income allocation in the second relationship.

Income allocation to a subsidiary PE must accord with the authorized OECD approach (AOA) that underlies the new interpretation of article 7 adopted by the OECD in 2008. Under the AOA, profits may be attributed to a subsidiary PE if the assets and risks of the subsidiary and the subsidiary PE are not identical. This situation may arise because a legal, contractual allocation of risks and intangibles must be made under article 9, whereas an economic, factual allocation must be made under article 7. For example, if a subsidiary is actively managing a particular risk, which has contractually been transferred to the parent company, the risk must be the allocated to the parent company under article 9 and to the subsidiary PE under article 7.

The AOA is incompatible with the single-taxpayer approach under which there is no basis for allocating profits to a subsidiary PE, provided the transfer prices accord with the arm's-length principle.[74] The acceptance of the AOA under tax treaties concluded before 2008 is still uncertain. For example, in *Morgan Stanley* the Indian Supreme Court held that no profits should be allocated to a subsidiary PE because the transfer prices between the parent company and the subsidiary were on an arm's-length basis.[75]

In many instances, the AOA and the single-taxpayer approach will produce identical results, provided that correct transfer prices are applied between the parent company and its subsidiary. That is, even if a subsidiary PE exists, no additional profits will be subject to source state taxation.

The figure illustrates PE taxation of a subsidiary PE.

V. Conclusion

This article addresses subsidiary PEs and the interaction between transfer pricing and PEs. The control

[73]Supreme Administrative Court of France, decision of June 20, 2003, Case No. 224.407.

[74]Para. 26 of the commentary on article 7 of the OECD model tax convention (2008); and paras. 46-48 and 227-247 of ''2010 Report on the Attribution of Profits to Permanent Establishments,'' OECD, July 22, 2010.

[75]*DIT (International Taxation) v. Morgan Stanley and Co. Inc.*, (2007) 292 ITR 416, Supreme Court. This aspect of the decision has been confirmed in *SET Satellite (Singapore) Pte. Ltd. v. Deputy Director of Income Tax*, Income Tax Appeal 944, 2007 (High Court Bombay, Aug. 22, 2008); *BBC Worldwide Ltd. v. Dy. Director of Income Taxes*, Delhi ITAT, ITA 1188/Del/06 (2010); and *Rolls Royce PLC v. DDIT*, MA 55-60/DEL/2008, Income Tax Appellate Tribunal, Jan. 30, 2009.

exercised by a parent company over its subsidiary does not in itself give rise to a PE according to article 5(7). On the other hand, a subsidiary PE may be triggered if the general conditions for a PE are met under the main rule or the agency rule.

A subsidiary PE may basically arise when:

- a parent company itself is carrying on business through the premises of its subsidiary (main rule);
- a parent company's business is carried on by its subsidiary (main rule and agency rule); and
- a parent company and its subsidiary are carrying on a common business (main rule).

The key question normally is whether business carried on by a subsidiary must be attributed to the subsidiary or the parent company under article 5. This issue is not governed by the OECD model tax convention and must, in principle, be resolved on the basis of domestic law.

The 2011 discussion draft addresses the first and third situations. The more controversial second situation is not subject to a real analysis, because the discussion draft merely concludes that a contract manufacturer does not normally constitute a PE of the principal. A reservation is made for situations whereby a parent company disposes of the premises of the subsidiary and the business carried on by the subsidiary must be attributed to the parent company. The discussion draft may be criticized for not taking the analysis a step further and elaborating on the circumstances when such a situation may exist. The OECD ought to analyze this issue in the context of paragraph 10 of the commentary. This situation deserves more attention, because a subsidiary PE may easily arise under a plain reading of paragraph 10 of the commentary, as evidenced by court cases including *Roche Vitamins Europe Ltd.*

Articles 5 and 9 are interrelated in the sense that the application of incorrect transfer prices and the application of correct transfer prices — albeit under a method that insulates the subsidiary from entrepreneurial risks, such as the cost-plus method — are facts that may trigger a subsidiary PE. The purpose of article 9 is to supplement article 7 in relation to the taxation of business profits. Hence, when the OECD considers that a secondment normally does not give rise to a PE for the parent company provided the subsidiary is the economic employer, this means that the secondment does not qualify as a service under article 9. If a subsidiary PE exists, the application of correct transfer prices under article 9 means that no profits must be allocated to the subsidiary PE under article 7, provided the assets and risks of the subsidiary and the subsidiary PE are identical. Hence, in this situation the net income attributed to the subsidiary PE will be zero. In other cases, the application of the AOA may mean that additional income must be attributed to the subsidiary PE.

From a tax policy perspective, the OECD should reconsider the issue of subsidiary PE taxation as a whole. In particular, it is undesirable to deem a subsidiary to be carrying on the business of its parent company under the main rule of article 5 (situation 2) because it creates great uncertainty and discourages international trade and investments. It is doubtful whether there is a real need for subsidiary PE taxation in this situation, because abuse may be addressed by domestic transfer pricing rules, and because the AOA often will not allow more profits to be allocated to the source state. ◆