



Newsletter n. 6/2021

The Permanent Establishment: risk of fragmentation of a “*cohesive business operation*” within the OECD MC.

In a globalized and modern world, it is common for a large number of enterprises to operate in more than one country. In case of cross-border activities, it is relevant to understand which State has the right to tax the profits produced by the operating enterprises.

The concept of Permanent Establishment (PE) is the tool through which States may tax business profits earned by resident of other contracting State, thanks to its function of allocation of profits given by art. 7, par. 1, of the OECD MC.

In accordance to art. 5, par. 1, OECD MC, a PE is a “*fixed place of business through which the business of an enterprise is wholly or partly carried on*”. And, as said before, art. 7, par. 1, OECD MC establishes that contracting State cannot tax the profits of an enterprise of the other contracting State “*unless it carries on business ...through a PE situated therein*”. It is also relevant to underline that what is necessary for having a PE is the creation of value through a fixed place of business; it is not important the human presence.

In order to find a just balance between the State’s right to tax and the freedom to organize the business in other jurisdiction, paragraph 4 of art. 5 OECD MC, establishes that many activities, even if conducted

STUDI
COLLEGATI
LINKED LAW
FIRMS

ARGENTINA
*Buenos Aires
Cordoba
Mendoza
Rosario
Salta*

AUSTRIA
Wien

BRAZIL
*São Paulo
Rio de Janeiro*

CHILE
Santiago de Chile

CHINA
*Beijing
Shanghai*

COLOMBIA
Bogotá

CZECH
REPUBLIC
Prague

ECUADOR
Quito

GREECE
Athens

INDIA
*Mumbai
New Delhi*

IRELAND

MÉJICO
Ciudad de Méjico

PANAMA
Ciudad de Panama

PERÙ
Lima

POLAND
Warszawa

UNITED
KINGDOM
London

SWITZERLAND
*Bern
Zurich*

UKRAINA

URUGUAY
Montevideo

VENEZUELA
Caracas



through a fixed place of business, are excluded from the definition of PE because of their *preparatory* or *auxiliary* character.

The list of exceptions to the existence of a PE is not that short, so it is easy to understand why the par. 4.1. provides a rule to avoid the abuse of “*PE fragmentation*”. As it can be read in the OECD commentary, the purpose of par. 4.1. is to “*prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity*”. So, if the activities carried on constitute complementary functions that are part of a *cohesive business operation*, the exceptions of par. 4 do not apply, and the activities of that place of business (its profits) will be taxed in accordance to the ordinary PE rule.

In a more specific way, par. 4.1. of art. 5 OECD MC, establishes that par. 4 (*preparatory or auxiliary activities*) shall not apply to a fixed place of business if:

1. First condition

1a) the *fixed place of business* is used or maintained by an enterprise and

1b) the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State.

2. Second condition

2a) that place of business or other place constitutes a PE for the enterprise or the closely related enterprise or

2b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business



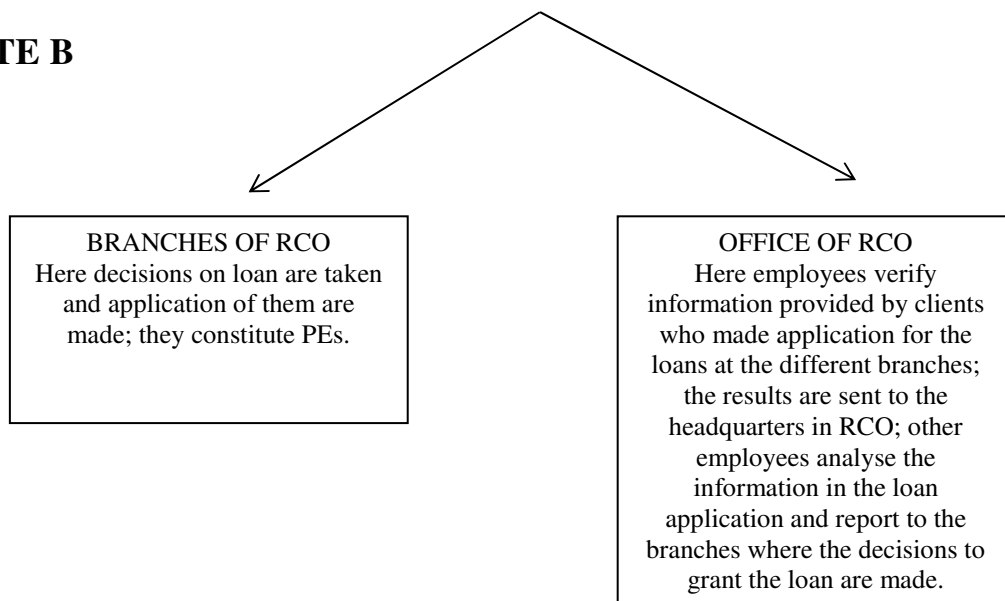
activities constitute complementary functions that are part of a *cohesive business operation*.

An example may help the understanding of this fundamental rule.

STATE A

RCO (A BANK
RESIDENT IN A) HEAD
QUARTER

STATE B



In this case, we have a fragmented business in which different types of activities are performed by different subjects, in order to make possible to declare that the office of RCO has only an auxiliary and preparatory role.

Par. 4.1 does not accept that construction.

As a matter of fact, par. 4.1 obliges to consider the “*whole picture*” of the operations. “Branches of RCO” constitute a PE in B; the business activities of “Office of RCO” and “branches of RCO” constitute complementary functions which are part of a cohesive business operation.

authors

Gianluca Pisani and Giovanni Moschetti