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## GUIDE TO ACRONYMS & ABBREVIATIONS

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<tr>
<th>ACRONYM</th>
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<tbody>
<tr>
<td>BEPS</td>
<td>Base erosion and profit shifting. A reference to the OECD/G20 BEPS Initiative</td>
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<td>DTC</td>
<td>Double (Income) Tax Convention…</td>
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<td>EU</td>
<td>The European Union</td>
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<td>FPOB</td>
<td>Fixed place of business</td>
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<td>MTC</td>
<td>Model Tax Convention on Income and on Capital: Condensed Version 2017</td>
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<tr>
<td>MLI</td>
<td>The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PE</td>
<td>Permanent establishment</td>
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<tr>
<td>UK</td>
<td>The United Kingdom of Great Britain and Northern Ireland</td>
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<table>
<thead>
<tr>
<th>ABBREVIATION</th>
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<tr>
<td>Art.</td>
<td>Article</td>
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<tr>
<td>Complementary &amp; cohesive manner</td>
<td>Abbreviation of the final part of Art. 5(4.1) MTC 2017, which reads: “[provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places,] constitute complementary functions that are part of a cohesive business operation.”</td>
</tr>
<tr>
<td>Preparatory/auxiliary provision</td>
<td>The wording contained in the Art. 5(4)(e) - (f) MTC 2014 specific activity exemptions, stating that the relevant activity must be of a ‘preparatory or auxiliary character’ in order for the specific activity exemptions to apply.</td>
</tr>
<tr>
<td>Preparatory/auxiliary provision, extension of</td>
<td>A reference to the fact that, as a result of the 2017 MTC update, the preparatory/auxiliary provision now applies to all of the Art. 5(4) MTC specific activity exemptions.</td>
</tr>
<tr>
<td>Specific activity exemptions</td>
<td>The provisions detailed at Art. 5(4)(a) - (f) MTC 2014 / 2017.</td>
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ABSTRACT

The PE is a concept under scrutiny. Action 7 of the BEPS Action Plan has laid out a path to defend against artificial avoidance of PE status in light of BEPS concerns that can be associated with moderating business practices.

Out of Action 7 has come an update to Art. 5(4) MTC, with the extension of the ‘preparatory or auxiliary’ provision to all of the specific activity exemptions, as well as new provisions at Art. 5(4.1) MTC and Art. 5(8) MTC, together comprising the new ‘anti-fragmentation rule’

This 2017 MTC update has expanded existing concepts and introduced new concepts that need to be understood and analysed in order to assess the success of the Action 7 work. This alludes to the critical research question of this thesis, which is to critically analyse the extension of the ‘preparatory or auxiliary’ provision and the new anti-fragmentation rule in light of the appropriateness of the reforms as regards established legal principles and norms, to review the success of the reforms as against the objectives and goals of the OECD through the Action 7 work, and to assess whether the goals and objectives ought to have been adjusted or could be adjusted in the future in order to bring about a better solution to the artificial avoidance of PE status.

This is performed in this thesis by first exploring the background to the PE concept in a wider sense, before offering specific critical analyses upon elements contained in the reforms. Amazon, the e-commerce giant, will be followed as a case example in order to give context to the impact of the reforms in practice. This thesis concludes that the need to transform the PE concept in light of the BEPS concerns prevails against the concerns that can be associated with the reforms of the 2017 MTC update.
CHAPTER 1 - INTRODUCTION

1.1 METHODOLOGY

Tax Reform & The PE Concept
The international corporate income tax system is undergoing careful examination. Politicians and policymakers from the EU institutions and the OECD as well as the public are all eager for change. The styles of change and reform that each of these factions demands is varied, but due to the increasing public scrutiny upon our companies, this is often focused upon the idea that there is a need for reform in the realm of international tax in order to adapt to how business practices are developing. To this end, some even radical ideas are gaining traction.

The purpose of this thesis is to focus upon one source of the perceived issues with this ‘culture of tax avoidance’; the PE concept. The PE is the source of much analysis primarily because of its importance within the international tax system, a system that is predicated upon physical presence within a state. In light of this, the OECD (alongside the G20) has through Action 7 of the BEPS Action Plan, ‘titled Preventing the Artificial Avoidance of Permanent Establishment Status’ stated its desire to bring the PE concept in line with the modern business environment, while keeping the concept based upon physical presence. The work initiated with Action 7 has most recently, and for our purposes, relevantly, resulted in the 2017 update to Art. 5 MTC, which defines the PE as well as the PE ‘threshold’, which is the point at which a taxable presence is created.

The Action 7 Reforms To Art. 5 MTC
As a result, the ‘preparatory/auxiliary provision’ has been extended, and a new ‘anti-fragmentation rule’ has been implemented. As will be explicated further in later chapters, the preparatory/auxiliary provision refers to the requirement contained in exemptions (e) and (f) of Art. 5(4) MTC 2014 that

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the relevant activity or combination of activities be ‘of a preparatory or auxiliary character’. The ‘expansion of the preparatory/auxiliary provision’ refers to how this has been extended to all six of the specific activity exemptions with the 2017 MTC update. Similarly, the ‘anti-fragmentation rule’ refers to the new provisions at Art. 5(4.1) and (8) MTC 2017, and the rule aims to prevent the application of a Art. 5(4) MTC 2017 exemption in situations of fragmentation, which is to say where activities have been split up between different places or enterprises.

The specific objective of this thesis is to critically analyse these Art. 5 MTC updates as outcomes of the Action 7 work. This objective may seem quite expansive and it may seem unnecessary to do both. However, the reforms are two parts of one whole, as the need for the preparatory/auxiliary extension gives context to the reasoning behind introducing the new anti-fragmentation rule. The latter was hence born out of the issues with the former, and the objective has been selected despite its wide focus because of the context that would be lacking if, for example, just one of the reforms would have been critiqued.

The objective has been chosen because of the necessity for critical analysis of these Art. 5 MTC reforms, which is so because there appears to be a lack of contemporary academic discourse on these changes, with recent academic commentary favouring the impact of the Action 7’s work upon so-called agency PEs and ‘commissionaire arrangements’. This is natural, as legal scrutiny seems to initially tend towards that which is most potent, and recently PE avoidance through commissionaire arrangements has been a bigger issue. However, this does not reduce the need to examine and critique the work of Action 7 that has targeted the avoidance of (FPOB) PE status stemming from the abuse of the specific activity exemptions, which has of its own accord brought about a substantial recast of the Art. 5 MTC PE definition.

This choice of objective influences the approach this thesis shall undertake, as with reforms that have such a remarkable impact on the structure of the PE threshold, a functional examination of the ideology behind and meaning of the PE concept is necessary to give a foundation to the thesis as a whole. This is undertaken in ‘Chapter 2 - The PE Concept & Art. 5 MTC’.

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This will provide an understanding that will allow for the problems that the OECD has identified with the previous incarnations of Art. 5(4) MTC in advance of the 2017 update to be analysed in ‘Chapter 3 - The Issues With Art. 5(4) MTC 2014’. This will in turn give a platform upon which Action 7 and its objectives can be understood in ‘Chapter 4 - BEPS Action 7’. Once the provisions have been properly understood in these chapters, this foundational understanding can be used to undertake a specific critique of the provisions. In ‘Chapter 5 - The Critique’, the objectives of Action 7 will be critiqued in order to identify how successfully these have been manifested into the 2017 Art. 5 MTC update, in order to understand the appropriateness of this update in the context of established legal principles and norms, and in order to assess the foreseeable success of the reforms as against the tax problems that they purport to provide solutions for. In this way, this thesis seeks to contribute its own analysis to the gap in the critique, and to provide a basis upon which others can continue the analysis as new OECD material is released and the business world continues to develop.

Sociolegal Methodology

In seeking to achieve the objective of assessing the new PE threshold through the new anti-fragmentation rule, it remains important to “reflect critically upon, and then justify explicitly, the appropriateness of the methodology selected for this thesis”. To this end, this thesis undertakes an approach that is based on the belief that a purely legal dogmatic method would not be suitable, as such would not be capable of taking account of the full impact of Action 7 on the business landscape and a thorough critique of Action 7’s outcomes would therefore not be possible. As tax is a concept that marries law, policy, and economics, the financial outcomes of tax reforms are important at the societal level, and so these concerns are accounted for in this thesis to the extent that it is considered appropriate to give a full view.

Hence, this thesis requires a broader scope that encapsulates considerations such as these. To facilitate this, the method of this thesis is to a certain extent ‘sociolegal’, meaning a method that will take account of not only the ‘primary’ international tax legal instruments surrounding the PE threshold, but one that will also take account of ‘other’ sources. These ‘other’ sources include industry and business analyses that make unique reflections upon

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legal reform of the tax rules in a way that accounts for both the legal and the financial outcomes. The ‘other’ sources will, and should, be treated with secondary importance as against the ‘primary’ legal sources, but to achieve a full understanding and critique of Action 7 they should not be ignored, particularly where up-to-date legal academic commentary on the matter is lacking.8

What Is A Positive Tax Reform?

Regarding the objective of this thesis on measuring the success of Action 7 reforms, the question can be asked: what is a positive tax reform? Is it that which increases legal certainty for taxpayers?9 Is it that which aims to increase equality between business entities of varying statures?10 Is it that which results in a higher tax intake?11 Is it that which results in a lower tax intake?12 Is it that which makes its jurisdiction more economically competitive against its international neighbours?13 Depending on whom is asked, and in what context (legal, political, social, economic) all of these, or a combination of these, or none of these, statements may be regarded as true. The issue then is; to what end should this thesis seek in attempting to critically analyse the success of the Action 7 work and the recent Art. 5 MTC update? The only solution the author can comprehend is to work with established assumptions on this: that increased legal certainty and equality and competitiveness between taxpayers is good, but that a higher tax intake can have both good and bad effects for both taxpayers and tax authorities. By relying on these established assumptions, this thesis hopes to deliver a non-partisan analysis and one that is fair between MTC-applying states, which is important since these states will inevitably respond to the 2017 Art. 5 MTC update in different ways.14 The mitigation of a political agenda will cater to a thesis where the legal critique is of a greater value.

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8 Ibid, 34.
Shortfalls & Delimitations

It is also important to reflect upon the fallacies and limitations of undertaking this approach, as this can give comprehension of the limits of the scope of this thesis. The aim of this thesis is to give a rounded critique that goes beyond the pure black letter law. Hence, thorough analysis of business practices of the enterprises that will be affected by the reforms would be desirable here, but this is not possible due to the author’s limited background in this area. The description of the business and economic impact of Action 7’s reform on Art. 5 MTC 2017 is limited to the extent that this provides ostensible or obvious reflections upon the legal outcomes.

Furthermore, as the official BEPS impact assessment has not yet been released the value of the assessment of the impact of Action 7 is largely based on academic and professional predictions. However, as the notion of international law is of a dynamic substance, where further reform of model treaty provisions governing any area of law can almost always be anticipated, the critical analysis of this thesis is conducted with a hope that this can be carried forth in the future. The overall aims of the thesis hence remain very much appropriate.

Moreover, this thesis approaches the preparatory/auxiliary extension and the new anti-fragmentation rule with reference to FPOB PEs only, because there is a separate legal framework for so-called agency PEs. The analysis in this thesis is not applicable to both PE forms.

Furthermore, the approach undertaken by this thesis is limited to the legislative, regulatory and industry perspectives and will not give scope for judicial interpretations of the new Art. 5 under the 2017 MTC. This allows the discussion to be focused on the reasoning behind Action 7, rather than how the courts have interpreted these principles. This is a clear limitation of the value of this thesis as national court judgments provide the best review of new legal measures in terms of real life application. However, with the 2017 MTC update being so new, properly influential cases discussing these new provisions do not yet exist. Additionally, a full comparative analysis of judicial interpretation of the Art. 5 MTC updates would require a length of analysis that would be infeasible to contain within this thesis, bearing in mind its objective. For these reasons, delimiting this discourse to focus on

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the OECD materials themselves is considered to be justified, despite the noted drawbacks.

**Note On The Applicable Law**
The law is correct as of 1 October 2018.
CHAPTER 2 - THE PE CONCEPT & ART. 5 MTC

2.1 THE IMPORTANCE OF THE PE IN INTERNATIONAL TAX LAW

Cross-Border Business: The PE As A Threshold

The PE has been a fundamental aspect of DTCs since the early 20th century, and by remaining a hugely important and dynamic concept in international tax law\(^{16}\) the concept thereby receives a suitably high level of scrutiny. With the increasing level of public awareness of the tax affairs of cross-border enterprises to accompany this, the concept finds itself in a state of evolution.\(^ {17}\) The main use of the PE concept now is to determine the right of a state to tax the profits of a foreign enterprise carrying on business there. This is the basis of Art. 7 MTC, which is central to the operation of the MTC, necessitating a clear and functional definition for the PE for the very functioning of cross-border taxation.\(^ {18}\) The PE herein functions as a tax nexus, creating a ‘threshold’ above which source taxation can be applied to non-resident enterprises, as stipulated at Art. 5(1) MTC 2017.\(^ {19}\) The parameters of this threshold hold vital importance in the determination of whether, and if so to what extent, a non-resident enterprise must pay corporate income tax in a foreign state.\(^ {20}\)

The PE As A Source Rule: The Principle Of The Fair Right To Taxation

The PE concept also simultaneously acts as a source rule, whereby the taxation of profits generated within a state by a foreign enterprise that passes the PE threshold should be reserved for that state (within limitations), but only in such circumstances.\(^ {21}\) Generally speaking, the PE creates a balance between Source State taxation via the principle of territoriality (where states opt to tax profits earned within its own jurisdiction) and the State of Residence taxation via the principle of worldwide income taxation (where a state within which an enterprise’s HQ is located will take the automatic right to tax the profits earned by that

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\(^{16}\) Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 4.

\(^{17}\) Dhuldhoya, ‘The Future…’ (n 5), 1.

\(^{18}\) 2017 Comm. on Art. 5 (n 3), paragraph 1.

\(^{19}\) Almeida and Toledano, ‘Understanding how the various definitions of Permanent Establishment can limit the taxation ability of resource-rich source countries’ (Columbia Center on Sustainable Investment, March 2018), 7.


\(^{21}\) 2013 BEPS AP, (n 4) 34 - 35.
enterprise). By assigning profits to the Source State for tax purposes, the State of Residence is in essence sacrificing at least part of its ‘default’ tax rights over the profits of that enterprise. This is considered appropriate according to the principle that the Source State should be rewarded for ‘its efforts to create, maintain and safeguard good economic conditions’, and for providing education and hospitals and other public services that foreign enterprises benefit from.

In this way, the PE manifests the principle of the fair allocation of taxing rights, acting as a mechanism against international double taxation between states and so is supported from the perspective of policy and administrative considerations. In a situation where an enterprise conducts activity in a foreign state without incorporating a subsidiary company or setting up a local branch in that state, the PE threshold becomes the only realistic mechanism for source taxation to fulfil this source rule. Hence, the PE also acts as a tool against tax avoidance in the Source State, and as a protector of ‘tax sovereignty’ within our hyper-interconnected economies. The PE, it can be said, is an extremely important aspect of international tax law.

2.2 THE GENERAL STRUCTURE OF ART. 5 MTC 2014

Art. 5(4) MTC attempts to manifest the PE concept into the international tax law. However, as shall be seen, this provision has experienced issues in recent times.

Terminology: Provision References

For reference, this thesis suffixes provisions with the year of the relevant MTC, 2014 or 2017, only for where the 2017 MTC update has added or amended the provision. Hence, Art. 5(1) MTC and Art. (2) MTC are stated as such as they are unchanged by the 2017 update, whereas Art. 5(4) MTC

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25 Dhuldhoya, ‘The Future...’, (n 5), 14
26 2017 Comm. on Art. 5 (n 3), paragraph 132.
27 Ibid, Reimer, Permanent Establishment... (n 24), 3.
29 2013 BEPS AP (n 4), 15.
may be followed by 2014 or 2017, as too may the new Art. 5(4.1) MTC and Art. 5(8) MTC, depending on which version of the provision is being discussion.

**The Basic Definition Of The FPOB PE**

Art. 5(1) MTC explains that a PE is a ‘FPOB through which the business of an enterprise is wholly or partly carried on’, which in itself provides a criteria for fulfilling the PE definition. This PE definition is based on physical presence. It is important to note that if this criteria is not fulfilled, then there can be no PE, and therefore the specific activity exemptions under Art 5(4) MTC, and the exception to these exemptions under Art 5(4.1), do not become relevant.

In order to give further detail as to the meaning of the PE concept in the MTC, Art. 5(2) MTC provides six specific examples of PEs, which are business forms or entities or arrangements etc. that should ‘especially’ be regarded as coming within the PE definition for the purposes of the interpreting DTCs. These examples generally constitute places of work, and include ‘placement of management’, ‘branch’, ‘office’, ‘factory’, ‘workshop’, or a ‘place of extraction of natural resources’.

**2.3 THE SPECIFIC ACTIVITY EXEMPTIONS UNDER ART. 5(4) MTC 2014**

**The Ideology Behind The Six Specific Exemptions**

Importantly, it is clear that there is no coverage for warehousing or other storage facilities within these specific PE examples. Instead, such business exploits are specifically covered by the exemptions to the PE definition under Art. 5(4) MTC 2014. The key idea behind the exemptions is to allow a foreign enterprise to maintain a FPOB in the Source State “for the storage, display or delivery of goods without creating a PE there”. The purpose behind having a separate provision containing specific exemptions to the PE definition is due to the fact that some activities can fulfil the general PE criteria at Art. 5(1) MTC 2014 but still not warrant Source State taxation, by virtue of being insignificant in nature. Therefore, Art. 5(4) MTC 2014 is designed to keep the overall outcome of Art. 5 MTC in line with the
principle of the source rule while negating the hampering of cross-border trade by taxing foreign activity that is not by itself profitable.\textsuperscript{30}

**The Structure Of The Provision**

The specific activity exemptions are structured as follows:

Art. 5(4) MTC 2014:

\begin{quote}
Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
\end{quote}

**Terminology: The Preparatory/Auxiliary Provision**

The wording contained in the Art. 5(4)(e) - (f) MTC 2014 specific activity exemptions, stating that the relevant activity must be of a ‘preparatory or auxiliary character’ in order for the specific activity exemptions to apply, is to be referred to as the ‘preparatory/auxiliary provision’ for the sake of brevity during this thesis.

\textsuperscript{30} Reimer, Permanent Establishment... (n 24), 87.
To Assess The Preparatory/Auxiliary Provision: Group The Exemptions Based On Purpose

It can be seen that some of the exemptions share similarities with each other and can be divided into three groups by function. Exemption (a) regards the use of facilities, exemptions (b) - (c) regard the maintenance of a stock of goods or merchandise, and exemptions (d) - (f) regard the maintenance of a FPOB. Despite this, to achieve the objective of this thesis it is necessary to differentiate the six exemptions into two groups based on purpose, according to whether the preparatory/auxiliary provision applies to the exemption. This thesis differentiates between exemptions (a) - (d) and exemptions (e) - (f) in this way.

This differentiation is made despite the surrounding discussion as to whether the preparatory/auxiliary provision in Art. 5 MTC 2014 is indeed limited in its application to exemptions (e) - (f) only. The Commentary on Art. 5 MTC 2014 gives the view that exemption (e) subjects even exemptions (a) - (d) to the preparatory/auxiliary provision, with the word ‘other’ meaning the provision applies to any activity, including the activities contained in the aforementioned exemptions.

The author, and like many states applying the OECD MTC, interpret the provision differently, taking the view that a literal interpretation of the wording of exemptions (a) - (d) indicates activities that are not subject to any other criterion beyond their own terms. The view presented in the Commentary on Art. 5 MTC 2014 appears somewhat bizarre, as the reasoning for containing exemptions (a) - (d) at all would be made largely redundant, other than to formulate a list of example activities that meet the preparatory/auxiliary condition, if exemption (e) were to be so encapsulating. In any case, the OECD has recognised that the significant ambiguity surrounding this matter has been a major of BEPS concerns regarding the specific activity exemptions, and this has invariably encouraged the OECD to introduce reform of Art. 5 MTC 2014 through the 2017 MTC update.

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32 2014 Comm. on Art. 5 (hereinafter “2014 Comm. on Art. 5”), paragraph 21.
33 Kerschner etc., Taxation in a Global Digital Economy… (n 6), 167.
34 Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 16.
2.4 HOW TO ASSESS THE PREPARATORY/AUXILIARY PROVISION

With this in mind, the questions to be addressed now are: how should the preparatory/auxiliary provision in exemptions (e) - (f) be interpreted, what does ‘preparatory or auxiliary’ actually mean, and how should it be assessed? This is fundamental in order to understand why the provision has been expanded in the 2017 MTC update and in order to understand the logic behind the introduction of the new anti-fragmentation rule.

Definitions & Guidance

The Oxford Dictionary definition for ‘preparatory’ states; “Serving as or carrying out preparation for a task or undertaking”, and the definition given for ‘auxiliary’ is; “Providing supplementary or additional help and support”. Putting these definitions into the context of activities of international tax law, a preparatory activity is “one carried on in the perspective and contemplation of the carrying on of what constitutes the core business”, and an auxiliary activity is one that supports, but is not an essential part of, the overall business activity.

Reimer, for example, takes the approach of making a distinction between preparatory and auxiliary activities when approaching the specific activity exemptions because of the value this has within the legal doctrine on Art. 5 MTC 2014, pointing to the fact that the provision uses ‘preparatory or auxiliary’ rather than ‘preparatory and auxiliary’. However, as the use of the terms together in Art. 5(4) MTC has not been affected by the Action 7 outcomes, as shall be discussed, it is not necessary to detail any distinction between the terms themselves for the purposes of this thesis. To fulfil the objective of this thesis in critically analysing Action 7, it is only necessary to see how the terms work together and how the preparatory/auxiliary provision as one legal term has been expanded.

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38 Reimer, Permanent Establishment… (n 24), 93 - 94.
Summary On The Preparatory/Auxiliary Provision: Unimportance
Hence, an interpretation deduced from a combination of the two terms yields the idea that an activity meeting the preparatory/auxiliary provision should hold an element of unimportance, being not of a final nature, and perhaps supplementary or in advance of activity that is of a profitable capacity. With this in mind, the Commentary states that preparatory or auxiliary activity is activity that does not form “an essential and significant part of the activity of the enterprise as a whole”.\(^{39}\) Importantly, this activity must be the *sole* activity of the FPOB in order for the exemption to apply to the entirety of the FPOB.\(^{40}\)

This definition is not always one that is easy to apply. The Commentary confirms that assessing this test can be difficult and that “each individual case will have to be examined on its own merits.”\(^{41}\) Part of the reason for this is because this definition does not completely preclude the FPOB from being in any way profitable in nature, so long as the services it performs are “so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question”. Of paramount relevance for this thesis is that the specific activity exemptions under the 2014 MTC do not apply to several FPOBs of an enterprise which perform complementary functions and are part of a cohesive business operation, as the Commentary precludes such ‘fragmentation’,\(^{42}\) but there is no such coverage for several enterprises conducting activity together through a single FPOB.

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\(^{39}\) 2014 Comm. on Art. 5 (n 32), paragraph 24.

\(^{40}\) Kerschner etc., *Taxation in a Global Digital Economy*… (n 6), 164.

\(^{41}\) 2014 Comm. on Art. 5 (n 32), paragraph 24.

\(^{42}\) Ibid, paragraph 27.1
CHAPTER 3 - THE ISSUES WITH ART. 5(4) MTC 2014

3.1 THE NEW FUNDAMENTAL CONCERN FOR PEs

Artificial Practices & The Avoidance of PE Status
This absence points to an ambiguous and flexible PE definition. As a result, the fundamental concern behind PEs has grown; whereas previously the primary concern was the removal of obstacles causing double taxation due to the negative impact that this can have on international trade, this has recently been joined by the need to prevent BEPS concerns through practices enable the artificial avoidance of PE status by non-resident enterprises.

These BEPS concerns have arisen because as tax regimes and most tax law remains state-specific, constrained by political, legal and administrative boundaries, enterprises operate in a globalising playing field, largely at their own behest to employ artificial practices that ‘subvert’ the source rule. This playing field encapsulates a growing digital economy with a growing e-commerce market, meaning that the continuing reliance of the current PE concept upon physical presence has created huge difficulties for Source States to tax these digital transactions. It is for this reason that the aforementioned BEPS concerns with the PE definition have materialised, as it has become increasingly possible to economically operate in another state without accruing a taxable presence there. For some, the impact of this is exceptionally far reaching: “What is at stake is to restore the confidence of our people in the fairness of our tax systems”.

3.2 ISSUES WITH THE EXEMPTIONS THEMSELVES

A Change In The Nature Of Core Business Activities & The Fragmentation Of Business Activities

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43 Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 5.
44 2017 MTC (Intro), 9.
46 2013 BEPS AP (n 4), 9 / Reimer, Permanent Establishment… (n 24), 3.
48 2015 FRA7 (n 20), 9, 13 / Kerschner etc., Taxation in a Global Digital Economy… (n 6), 165.
The OECD has pinpointed two sources of these artificial practices which have specifically caused BEPS concerns for the Art. 5(4) MTC 2014 exemptions. These are a change in the nature of core business activities, and the fragmentation of business activities.\textsuperscript{50}

Developments in how cross-border business is conducted has dramatically affected how exemptions (a) - (d) operate in practice. The dawn of e-commerce has made it possible for the activities listed in these exemptions, based around storage and delivery of stock and the collection of information for business purposes, to become the sole function of an FPOB. This allows such FPOBs to obtain a PE exemption where it is no longer appropriate, in light of the BEPS concerns.\textsuperscript{51}

The change in the nature of core business activities has coincided with developments making it ever easier for (multiple) enterprises to restructure FPOBs in a way that provides opportunities for tax advantages.\textsuperscript{52} A PE may be linked to a single enterprise only under the 2014 MTC.\textsuperscript{53} Therefore, in order for the Source State tax authority to ensure the activity of an FPOB meets the PE threshold, it must do so by relating the necessary degree of activity to just one enterprise. In principle, a single enterprise cannot fragment operations among different FPOBs in order to avoid the PE threshold,\textsuperscript{54} as mentioned above. However, there is an issue when there are multiple enterprises organising and operating different FPOBs but in a cohesive manner, as together they may both be able to avoid the PE threshold for the relevant FPOBs where this would not be so if all FPOBs were related to just one enterprise. The result again is the imposition of PE exemptions for those ‘artificially’ structured FPOBs where it is possibly no longer appropriate.

\section*{The Attractive Deficiency In The Law}

The new global business playing field, then, has opened up an involuntary ‘deficiency’ in the law,\textsuperscript{55} where a state may wish to attribute income to a PE but finds no PE within its territory to attribute the income to. This deficiency is attractive because avoiding PE status and Source State taxation holds financial incentives, in that it means the enterprise can take

\textsuperscript{50} 2015 FRA7 (n 20), 10.
\textsuperscript{51} Kerschner etc., \textit{Taxation in a Global Digital Economy}… (n 6), 164.
\textsuperscript{52} 2015 FRA7 (n 20), 10.
\textsuperscript{53} 2014 Comm. on Art. 5 (n 32), paragraph 5.1.
\textsuperscript{54} Ibid, paragraph 27.1.
\textsuperscript{55} Dos Santos and Lopes, ‘Tax Sovereignty…’ (n 2), 300.
advantage of a tax difference between the Source State and the State of Residence.

**Amazon’s UK Fulfilment Centres: A Case Example**

The benefits offered by Art. 5(4)(a) - (d) MTC 2014 are appealing to no enterprise more so than the ‘indirect’ e-commerce enterprise; those enterprises which engage in electronic transactions while adopting conventional delivery methods. A case example that can be analysed to demonstrate this is Amazon, which has been the focus of much scrutiny during the Action 7 work. For Amazon, which has its headquarters in Luxembourg, the use of specific activity exemptions for Source State operations does not always necessarily mean a lower percentage of tax payable, but does often mean that the enterprise can attribute more costs against its tax in line with Luxembourg domestic law.

The Amazon UK structure can be analysed as an example of a PE-avoidance technique that is replicated across the OECD member states. The structuring of Amazon’s UK operation is not extremely complex but it is important, and its ‘fulfilment centres’ are critical to the operation as a whole. Following the transfer of ownership of Amazon’s UK business to Amazon EU SARL in Luxembourg in 2006, the question arose of whether Amazon EU SARL’s activity in the UK created a PE. The fulfilment centres in principle meet the Art. 5(1) MTC 2014 PE definition as they are FPOBs through which the business of an enterprise is wholly or partly carried on. However, these FPOBs purport to only maintain and deliver stock sold on Amazon.co.uk, without participating in sales. Amazon EU SARL has had a PE in the UK since 2015, which is registered in London. However, the profits recorded in the UK by the PE since have been unsubstantial. Amazon states that this is because e-commerce is a ‘low margin business’.

The majority of profits are attributed to Amazon EU SARL in Luxembourg. The issue is that it cannot be known exactly how much tax the UK PE is paying on these low profits, as Amazon is not obligated to

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56 2015 FRA1 (n 23), 55.
58 Kerschner etc., *Taxation in a Global Digital Economy*… (n 6), 164.
publicly disclose the exact details of tax paid in the UK as an EU member state nor as an OECD member state under the current transparency rules.\textsuperscript{62}

However, some assumptions can be made. Among the subsidiaries of Amazon EU SARL, Amazon UK Services Ltd handles warehouse operations and provides fulfilment services.\textsuperscript{63} The author’s research of Amazon EU SARL and Amazon UK Services Ltd, including study of the yearly accounts of each,\textsuperscript{64} has not yielded absolute surety on which enterprise owns and which enterprise runs the fulfilment centres. However, the official nature of business that Amazon UK Services Ltd has registered with the UK’s Companies House is “Other business support service activities not elsewhere classified”.\textsuperscript{65} On this basis, it is reasonably assumed that Amazon UK Services Ltd runs the fulfilment centres with the sole activity of the maintenance and delivery of stock. Subcontracting the running of warehouses to an independent enterprise while retaining responsibility for conducting online sales is an effective way to separate activity from the sales made on Amazon.co.uk and hence ensure the activity can be deemed as auxiliary.\textsuperscript{66} Amazon EU SARL itself, meanwhile, most likely retains ownership, or at least disposal, of the fulfilment centres. This would make them PEs of the Luxembourg enterprise\textsuperscript{67} but for the satisfaction of the Art. 5(4)(a) and (b) MTC 2014 exemptions.

This may not be absolutely accurate; there seems to be a shroud of secrecy surrounding much of Amazon’s behaviour. Nonetheless, Amazon UK is used as a case example of an operation that certainly could exist under the 2014 MTC, and hence the example, which will recur throughout this thesis, is still valuable in demonstrating the faults of that legal structure.


\textsuperscript{66} Medus, ‘Digital Business…’ (n 37), 17.

\textsuperscript{67} 2014 Comm. on Art. 5 (n 32), paragraph 4.2.
CHAPTER 4 - BEPS ACTION 7

4.1 PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

Introduction To The BEPS Project
The issues with Art. 5(4) MTC 2014 are best recognised by the very existence of the work initiated by Action 7 and the 2017 MTC update. It is now pertinent to explore the foundations and objectives of Action 7 and the final structure of Art. 5 MTC 2017 in order to assess whether the reform is necessary and effective, or otherwise.

The aim of Action 7, on “Preventing the Artificial Avoidance of Permanent Establishment Status”, is to operate alongside Action 6 to prevent situations of the taxation of cross-border income that result in no or very low tax rates. The 2015 ‘Final Report on Action 7’ concluded two years of investigation initiated by the 2013 BEPS Action Plan to combat the BEPS concerns associated with Art. 5 MTC 2014. Whereas the BEPS Action Plan was one of “the first substantial renovations of the international tax rules in almost a century”, born out of political pressure to ensure large enterprises such as Amazon ‘pay their fair share’, the Final Report adopts a more pragmatic perspective on bringing the suggestions into actual legal reform.

The BEPS Action Plan has been designed to stimulate reform via the design of ‘principles’, ‘minimum standards,’ ‘best practices’ or ‘recommendations’ MTC and associated commentary reform proposals. This stimulation is of course indirect only as the authority of the OECD is not sovereign over its member states and the work it produces is not legally binding. In any case, the work of the OECD is greatly influential and thereby effective, and in the context of the BEPS project, policymakers have been keen to implement the resulting measures quickly.

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68 2013 BEPS AP (n 4), 19.
69 2015 FRA7 (n 20), 3.
70 Ibid.
71 Ibid, 305.
72 Ibid, 306.
73 Ibid, 305.
74 Gurría, Taxing Multinational Enterprises” (n 48), 2.
The Definition Problem & The Ideology Behind Action 7

The form of Action 7 has developed throughout the BEPS Action Plan, a ‘Discussion Draft’ in 2014 - 2015, a ‘Revised Discussion Draft’ later in 2015, and the Final Report, which arrived later again in 2015. All through these developments, Action 7 has pointed to the issues with the allocation of profit to PEs (the attribution problem), and the need to ‘develop changes to the PE definition’ as a result of the artificial practices and the ambiguity surrounding the OECD’s proposed interpretation of Art. 5(4)(e) MTC (the definition problem). It is this definition problem that this thesis is concerned with, as there is work that has been conducted separately regarding the PE attribution of income rules.

The Implementation Of The Substantive Outcomes Of Action 7

Action 7 has now brought into the MTC a ‘reformulated’ Art. 5(4), a new Art. 5(4.1), and a new Art. 5(8) to complement the new Art. 5(4.1), as well as an update to the Commentary on Art. 5 MTC. This thesis uses the term ‘reformulated’ to describe how Art. 5(4) MTC has been amended between the 2014 and 2017 OECD-recommended versions because the provision has not undergone complete adjustment so much as a methodical repositioning and expansion of the effect of the provision’s key term, namely the preparatory/auxiliary provision.

These updates introduced by the 2017 MTC reform can be implemented directly into DTCs if those DTCs were to be bilaterally renegotiated. As stated above, the updates to Art. 5 can also be introduced via the MLI, which has been in force since 1 July 2018. In the context of the work of Action 7, Art. 13 MLI, on ‘Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions’, allows states to introduce the OECD’s specific activity exemption amendments and anti-fragmentation rule into DTCs without the need for renegotiating these DTCs.

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57 2015 FRA7 (n 20).
58 2013 BEPS AP (n 4), 19.
60 This new Commentary replaces paragraphs 21 to 30 in order to explain the extent of the scope of the new-look PE exemptions under Art. 5(4).
63 2016 MLI, Preamble, 1 / Kerschner etc., Taxation in a Global Digital Economy… (n 6), 203.
the scope of this thesis, but it suffices to point out that there are multiple options of implementation for states.\textsuperscript{84}

The substantive outcomes of Action 7 shall now be considered in turn.

\textbf{4.2 THE EXPANSION OF THE PREPARATORY/AUXILIARY PROVISION}

\textbf{The Reformulation}

It was the ‘Focus Group on Artificial Avoidance of PE Status’ that initially recommended this expansion of the preparatory/auxiliary provision in order to combat the issues that had arisen for Art. 5(4) MTC 2014.\textsuperscript{85} The Final Report on Action 7 moreover recommended that this should be joined by an update to the commentary on Art. 5 in order to clarify the meaning of ‘preparatory or auxiliary’.\textsuperscript{86} The outcome of the reformulation of the MTC has been as follows:

Art 5(4) MTC 2017:

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“Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
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\textsuperscript{84} Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 10, 24.


\textsuperscript{86} 2015 FRA7 (n 20), 28.
As can be seen, the descriptions of the relevant activities for the exemptions remain unchanged, while the preparatory/auxiliary provision has been expanded by deletion from within exemptions (e) - (f), and re-insertion as a separate statement at the end of the provision in such a way as to apply to all six exemptions, (a) - (f). The effect of this is that exemptions (e) - (f) are practically unchanged, yet exemptions (a) - (d) are for the first time subject to the preparatory/auxiliary provision.

4.3 ANALYSIS OF THE REFORMULATION

**Lowering Of The PE Threshold: Increased PE Exposure**

While the reformulation has brought no new change upon the meaning of the preparatory/auxiliary provision itself, the expansion of the provision is nonetheless significant as it effectively lowers the PE threshold. As discussed above, the specific activity exemption at Art. 5(4)(e) MTC 2014 acts as a general restriction on the scope of the PE definition by including ‘any other activity’, and the new 2017 Commentary confirms that this general restriction is still applicable. Though there was disagreement as to whether this subjected even exemptions (a) - (d) to the preparatory/auxiliary provision under the 2014 MTC, the relevance of this debate has been reduced by the reformulation definitively adding the test to those exemptions. Therefore, an enterprise operating in a Source State must prove that each and all of its FPOB activities are preparatory or auxiliary in nature in order to satisfy an Art. 5(4) MTC 2017 exemption. As a result, Art. 5(4) MTC 2017 with an extended preparatory/auxiliary provision is on

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87 Dhaldhoya, ‘The Future...’ (n 5), 11.
88 2014 Comm. on Art. 5 (n 32, paragraph 21.
89 2017 Comm. on Art. 5 (n 3), paragraph 58.
90 Kerschner etc., Taxation in a Global Digital Economy… (n 6), 167.
the whole more onerous to satisfy than the same provision under the 2014 MTC, and finding a PE in the Source State is more likely.

**The OECD: Developing A PE Test Increasingly Economic In Nature**

This aspect of the reformulation reveals an underlying development in the OECD’s reform of Art. 5 MTC. The 2017 MTC update has widened the use of economic analysis within the Art. 5(4) MTC test through the preparatory/auxiliary expansion, as it increases the relevancy of relationships between the (objective) activities being conducted and the (subjective) core business nature of the specific enterprise itself. Hence, if an activity of the enterprise’s FPOB in the Source State is reasonably substantial in an objective sense, or if the activity entails a notable proportion of employees or assets, then that activity is much more likely to be above the preparatory/auxiliary provision limit. That enterprise as a result ought to be on alert for the more probable prospect of being required by the Source State tax authority to prove by ‘business specific evaluation’ that the activities are indeed preparatory or auxiliary in nature.92

The need to focus within the internal workings of the business operation has pulled the exemption test away further from one that is plainly prescriptive in nature and towards one that necessitates both taxpayers and regulators conducting their own evaluations more often, with the enterprise no doubt hoping its own evaluation matches the tax authority’s. As e-commerce enterprises have been specifically in mind during the Action 7 work, the additional administrative burden for these enterprises to reassess all FPOB activities in light of the new PE test will be considerable for these enterprises in states where the reformulated Art. 5(4) MTC 2017 has been adopted.

**Impact Of The Reformulation: The Amazon Case Study Continued**

However, with the OECD’s scepticism and targeting of Amazon, for example, this is perhaps the very point: that the enterprises which make up the e-commerce market, with a huge global impact ($1.6 trillion in 2015)93 ought not to be able to avoid Source State PE status through, for example, the use of exemptions (a) and (b). Enterprises adopting these exemptions with inventory stored in foreign states, such as Amazon, are absolutely

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91 Dhuldhoya, ‘The Future…’ (n 5), 11.
92 Ibid / Batheja, Treaty Abuse and Permanent Establishments: Proposed Changes to Article 5(3) and (4) of The OECD MC, found in Blum, Seiler (eds), Preventing Treaty Abuse (Series on International Tax Law, Vol. 101, 2016) (hereinafter “Batheja, Treaty Abuse and PEs…”).
going to be affected by the Art. 5(4) MTC update\(^{94}\) as it must under Art. 5(4) MTC 2017 prove that the activities of each of its fulfilment centres are ‘preparatory or auxiliary’ as against the main business model of the enterprise as a whole.

### 4.4 THE NEW ANTI-FRAGMENTATION RULE

**Targeting Operations Split Among Different Places Or Multiple Enterprises**

The new ‘anti-fragmentation rule’ is the more consequential of Action 7’s Art. 5 MTC amendments, creating an ‘exception to the [Art. 5(4) MTC 2017] exemptions’. As mentioned in ‘Chapter 1 - Introduction’, the preparatory/auxiliary provision is also a key part of the anti-fragmentation rule at the new Art. 5(4.1) MTC 2017:

Art 5(4.1) MTC 2017:

> “Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if 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 and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b) 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 carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.”

**Breakdown Of The New Rule**

The new rule works by looking at whether the relevant enterprise itself has a PE at another place in the same state [subparagraph (a)], and whether a single enterprise is operating at two different places or whether the

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94 Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 20.
enterprise has any ‘closely related enterprises’ conducting activity in the same place or in the same state in a manner surpassing the preparatory/auxiliary provision when analysed together [both subparagraph (b)]. The rule applies to deny the benefit of Art. 5(4) MTC 2017 where the activities of the relevant multiple enterprises or places are working in a ‘complementary & cohesive’ manner [final paragraph].95

**Terminology: Complementary & Cohesive Manner**

‘Complementary & cohesive manner’ shall be forthwith used to abbreviate the requirement contained in the final paragraph for the sake of brevity and simplicity.

### 4.5 THE DEFINITION OF CLOSELY RELATED

**The New Art. 5(8) MTC 2017**

On the matter of ‘closely related’ as contained in Art. 5(4.1)(b) MTC 2017, the OECD has inserted a new, separate provision at Art. 5(8) MTC 2017 to define the term, meaning the anti-fragmentation rule is essentially split into two parts. The provision is centred upon ‘control’, and it can be best understood as comprising two halves:

Art 5(8) MTC 2017:

“For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.

[...] In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in

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Semantic Analysis Of The Provision

The reason that the provision has been split in two here rests upon the use of the term ‘shall’. The ambiguity stemming from the use of ‘shall’ is well discussed in the context of legal semantics. In the context of Art. 5(8) MTC 2017, the first question that can be asked of the provision is whether it offers an exhaustive definition of the meaning of ‘closely related’. The provision states in part one that closely related means control, and thereafter in part two the provision offers a specific criteria as to this control. The issue is that the use of ‘shall be considered’ implies that the criteria offered is mandatory, but by a literal reading it is unclear as to whether this is exhaustive. The obscurity in this situation is revealed by considering the alternative wordings that could have been chosen. For example, the use of ‘is to be considered’, or ‘shall only be considered’ would have provided both a mandatory and a comprehensive obligation.

Fortunately, the Commentary clarifies the reasoning for the use of ‘shall’, at paragraphs 119 - 121. It is explained that the provision is just a general rule for the definition of ‘control’ for the use of ‘closely related’ in the new Art. 8 MTC 2017. The Commentary explains that this would include situations where control is exercised through the holding of rights “similar to those that it would hold if it possessed” 50% of the beneficial interests of the enterprise. The Commentary, however, does not explain what these similar instances may include.

Background: Comparison With ‘Connected’ and ‘Associated’

The choice of ‘closely related’ in the new Art. 5(8) MTC 2017 provision was one of three options, which included ‘associated’ (as suggested in the 2014 discussion draft), and ‘connected’ (as mentioned in the revised 2015 discussion draft). The decision to dismiss the latter came mainly as a decision to be more ostensibly specific as to the meaning of the term, which the respondents in the 2015 Revised Discussion Draft stated was necessary. Indeed, the term is often used in everyday language in such a variety of manners (legally, physically, socially, etc.) and to such a variety

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96 2017 Comm. on Art. 5 (n 3), paragraph 120.
97 Ibid.
100 See, generally, 2015 Revised Discussion Draft (n 74).
of degrees (highly connected, tenuously connected, periodically connected, etc.) that the use of ‘connected’ in Art. 5(8) could have proven imprecise and possibly misleading.

The difference between ‘closely related’ and ‘associated’ is far less clear. ‘Associated’ is a term used in Art. 9 MTC to define two enterprises based in different states, where the profits of the enterprise in one state may be taxed by the Source State tax authorities because it “participates directly or indirectly in the management, control or capital” of the Source State enterprise, and conditions are imposed between the enterprises that differ from conditions that would be imposed between independent enterprises. The Commentary states that this definition overlaps with the new definition for ‘closely related’ as both share the notion of ‘control’. Nonetheless, this is as far as the definitions of the terms can be related as the Commentary does not elucidate fully on what amounts to a sufficient degree of control for the purposes of Art. 9 MTC, leaving the exact meaning unclear. All that can be pulled is that the definition for ‘closely related’ at Art. 5(8) MTC 2017 is in a relative sense far more specific than the definition for ‘associated’ at Art. 9 MTC. This is so with the former providing at least an indicative percentage value where the latter lacks this.

4.6 COMPLEMENTARY FUNCTIONS AND COHESIVE BUSINESS MANNER

‘Complementary & Cohesive Manner’

The Commentary does not give much away as to how ‘complementary’ and ‘cohesive manner’ should be interpreted, opting to instead offer contextual examples. The first example provided regards a banking enterprise with a number of PEs in a Source State, where that bank processes information provided by clients to the bank’s PEs which is then sent to the group headquarters in the State of Residence. The Commentary goes on to explain that, in this case, Art 5(4.1)(a) MTC 2017 is applicable, preventing the benefit of an Art. 5(4) MTC 2017 exemption, as the activities of the office and the PEs are conducted in a complementary & cohesive manner as

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101 2017 Comm. on Art. 5 (n 3), paragraph 119.
103 2017 Comm. on Art. 5 (n 3), paragraph 81.
104 Ibid.
part of a business operation to provide loans in the Source State. The Commentary also states that the anti-fragmentation rule’s subparagraph (b) would similarly be activated in the case of two enterprises using the same warehouse, where one enterprise stores goods there, and the other enterprise delivers these goods to customers.

4.7 ANALYSIS OF THE NEW RULE

The Preparatory/Auxiliary Condition
The first point to address is why subparagraph (b) only and not subparagraph (a) of the new rule contains the preparatory/auxiliary condition. However, it should be noted that as subparagraph (a) regards a single enterprise operating through multiple places, with one of those places constituting a PE for that enterprise, the prior application of Art. 5(4) MTC 2017 would preclude PE status for any activity that was of a preparatory or auxiliary nature. Hence, the preparatory/auxiliary condition is applied to the situation stated in Art. 5(4.1)(a) MTC 2017 in advance of application of the anti-fragmentation rule, negating the need to contain the condition within that part of the new rule.

A ‘Backstop’ Exception To The Art. 5(4) Exemption
What the provision has come to be known as reveals its key purpose; the anti-fragmentation rule is designed “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.” In its absence up until the 2017 MTC update, it has been ‘relatively easy’ for enterprises to continue to (ab)use the Art. 5(4) MTC 2017 PE exemptions through fragmentation. In this way, the new anti-fragmentation rule complements the reformulated Art. 5(4) MTC 2017 as a ‘backstop’ (definition: ‘An emergency precaution or last resort’), aiming to prevent an inappropriate application of the Art. 5(4) MTC 2017 exemption from delivering an iniquitous Art. 5 MTC 2017 outcome overall.

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105 Ibid.
106 Ibid
107 Ibid, paragraph 79.
As stated above, some OECD-member states have postulated that the new rule is the sole necessary change to issue an effective resolution to the issues that arose from Art. 5(4) MTC 2014. Thus, many states have adopted the new Art. 5(4.1) MTC 2017, including the UK, for which the new anti-fragmentation rule ‘will be incorporated into its tax treaties as the MLI is implemented’,\(^\text{110}\) which occurred on 1st October 2018.\(^\text{111}\) The fact that many states made their intention to opt to leave Art. 5(4) MTC unchanged from the 2014 to 2017 versions will invariably have had an impact on the OECD’s decision to create a new, separate, backstop rule, rather than to completely rewrite Art. 5(4) and contain the anti-fragmentation provisions within this. This gives states a simple choice of whether to adopt each, none, or both of the provisions.

**Formalisation Of Commentary On Single Enterprise, Multiple Places & Extension To Multiple Enterprises**

As stated above, under the Commentary to Art. 5(4) MTC 2014, multiple places of a single enterprise were not to be treated as ‘separated organisationally’ where they each performed complementary functions.\(^\text{112}\) Art. 5(4.1)(a) MTC 2017 formalises this Commentary into the main body of the MTC. This reasoning of the OECD has also been extended to multiple legally separate but closely related enterprises at Art. 5(4.1)(b) MTC 2017.\(^\text{113}\) Although this provision mentions only ‘two enterprises at the same place’, the provision does apply to ‘two or more’ closely related enterprises.\(^\text{114}\) As it is very possible for several enterprises, perhaps all comprising part of the same corporate group, to work in a complementary & cohesive manner, this new provision seeks for enterprises to be assessed as a unit, where all can be closely related to each other, rather than in a series of duos.

**The Impact Of The New Anti-Fragmentation Rule**

Neither Art 5(4.1)(a) nor (b) MTC 2017 will create a PE for the enterprise(s) of its own accord; rather the rule just prevents the enterprise(s) from benefitting from the Art. 5(4) MTC 2017 exemptions.\(^\text{115}\) However, if an FPOB does meet the Art. 5(1) MTC criteria and the anti-fragmentation


\(^{112}\) 2014 Comm. on Art. 5 (n 32) / 2015 FRA7 (n 20), 10.

\(^{113}\) Kerschner etc., *Taxation in a Global Digital Economy…* (n 6), 210.

\(^{114}\) Ibid, 194.

\(^{115}\) Ibid, 206.
rule applies to prevent the application of a specific activity exemption to this FPOB, then this will in effect ‘create’ a PE. Hence, an enterprise, or a group of closely related enterprises, that conducts multiple activities in the Source State may find that the cumulative effect of these activities meets the preparatory/auxiliary condition, meaning a PE may be imposed where it previously did not exist.\textsuperscript{116}

Thus, the new anti-fragmentation rule has made it more important than ever for enterprises to justify the reasons for “allocating various functions and risks along their value chains” within a state. Importantly, artificiality is not an element in the new rule. Hence, an enterprise that has split up its operation for the practical reason of focusing expertise on particular aspects of the overall business with no abusive or ‘artificial’ intentions may still fall foul of the new rule and risk an increased likelihood of new PEs.\textsuperscript{117}

**The Impact Of The Rule: The Amazon Case Study Continued**

Carrying on the analysis of Amazon’s UK operation, according Art. 5(4.1) (b) MTC 2017 Amazon EU SARL could hypothetically be deemed to be closely related to Amazon Services UK. This is so if the two enterprises are deemed to be operating in a complementary & cohesive business manner through the fact that Amazon EU SARL organises the online sales from Luxembourg and Amazon Services UK organises the storage and delivery of the goods, and overall these activities cannot be deemed of a preparatory or auxiliary character. The outcome of this would be that Amazon EU SARL’s UK fulfilment centres will be deemed ineligible for the Art. 5(4) MTC 2017 exemptions, therefore greatly increasing PE exposure.

\textsuperscript{116} Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 24.

\textsuperscript{117} Blum, Seiler (eds), *Preventing Treaty Abuse* (Series on International Tax Law, Vol. 101, 2016), 394.
CHAPTER 5 - THE CRITIQUE

5.1 CRITIQUE OF ACTION 7

This chapter shall now engage in specific critical analysis of each of the elements of the new Arts. 5(4), 5(4.1)and 5(4.8) MTC 2017. Much analysis has already been conducted through the previous chapters, however this is an opportunity to look into the Action 7 reforms of Art. 5 MTC in light of their intended outcomes and their appropriateness in light of established legal norms and principles. Reference should be made to previous chapters for further context behind the discussions contained in this chapter.

Artificiality & The Approach Of Action 7

Firstly, the basis of Action 7 can be assessed. The very foundation of Action 7 being aimed at artificial practices and yet having resulted in the 2017 Art. 5 MTC updates contains is possibly inappropriate. The issue with the targeting of ‘artificial’ structures is that when such a scheme or structure is perfectly in accordance with the relevant law or treaty, as Amazon’s UK operation seems to be, for example, then critiquing this structure on the basis of artificiality expands far beyond a strictly legal argument. Indeed, every corporate/business structure is in a sense ‘artificial’; no such structure occurs by matter of nature or by default, all are planned and organised and all have varying objectives, whether those be for competitive reasons, for legalistic reasons, or for tax (minimisation) reasons. All corporate structures, when within the confines of the legal and regulatory restraints, are legitimate, and thus to claim, after the fact, that they are to someone’s mind ‘artificial’ dramatically decries the principle of rule of law.

However, while Action 7 adopts this in title, in practice it has been more targeted. The 2017 Art. 5 MTC updates implement understandable albeit imperfect tests to allow or disallow the specific activity exemptions to PE status in discernible circumstances that have led to BEPS concerns.118 The basis of the Action 7 work is of course political in nature. The need to remould the PE definition in the first place came from a focus wider than the law itself, and if this had been manifested into law with a term as equivocal as ‘artificial’ it would have been problematic in the context of the rule of law. The issue now, just as it was at the release of the BEPS Action

118 Reimer, Permanent Establishment... (n 24), 3.
Plan in 2013, is that taxpayers cannot be clear on what reform Action 7 or others similar BEPS actions covering the PE concept may enact in the future. As shall be discussed repeatedly during this critical analysis, legal certainty, or the lack thereof, in this way is one of the major shortfalls of the Action 7 work itself.

Tax Sovereignty Issues
Another general argument that can be presented is regarding the possible breach of national tax sovereignty brought about by Action 7 and the BEPS movement as a whole. This may not be brought on directly, as OECD member states choose to be a part of that soft-law organisation and each of the states have the reserved right not to employ any of the MTC updates. On the other hand, there may be pressure from states which may benefit from the 2017 Art. 5 MTC updates upon others to invoke the Action 7 updates on Art. 5 MTC. This pressure could be felt in reality with a resistance to conclude tax treaties with a state that does not identify the PE definition problem that the OECD has sought to rectify.

This argument can be readily addressed, however. In the fight against cross-border corporate tax avoidance, international cooperation and coordination is essential. If Action 7 did not contain any incentive for states to change, then it would be largely redundant. Membership of the OECD brings about innumerable benefits that is predicated upon the willingness of the member states to engage in reforms. Using a tax sovereignty argument to counter the appropriateness of the work of Action 7 would be to ignore international tax norms and the need for multilateral action to combat the reality of artificial avoidance of PE status occurring, and would thus be giving too much weight to an incongruent concept.119 The economies of the OECD member states are converging of their own accord as a result of the globalising economy, and to prevent coordination of the tax systems that regulate these converging economies for the benefit of protecting national sovereignty would prove expensive.120

Implementation Issues
As of 27th September 2018, the MLI has 84 signatory states. The implementation of the 2017 MTC updates is and will be much quicker for MLI-signatory states. However, it is revealing that many states have made

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119 Rocha, Christians (eds), *Tax Sovereignty in the BEPS Era* (n 69), 73 - 75.
120 Ibid, 78 - 79.
various reservations on Art. 13 MLI, but not all of these have made reservations on the 2017 Art. 5 MTC updates. This is possible as Art. 13 MLI is not a ‘minimum standard’, and therefore states can opt against its adoption.

Hence, it seems that states want the implementation of the anti-fragmentation rule to be at their own behest, but they do not seem to want to implement it immediately and automatically. This reveals Action 7’s practical issue of to what extent states will adopt it and amend their own domestic law. Indeed, how quickly or effectively the reform will be introduced cannot be concluded with much surety, given how recently the MLI came into force, but this critical analysis ought to be kept in mind for the upcoming months and years.

5.2 CRITIQUE OF THE REFORMULATION OF ART. 5(4) MTC: LIMITATIONS ON THE IMPACT

Lack Of Adoption: To What End?

In any case, the impact of the preparatory/auxiliary extension to all of the specific activity exemptions under Art. 5(4) MTC 2017 has a significant issue. Not many states have adopted the reform, including the UK, having opted to “stick to a large extent to the pre-BEPS wording” of Art. 5(4) MTC through reservations on the provision. These states are of the belief that the activities listed at Art. 5(4)(a) - (d) MTC 2017 are ‘intrinsically’ preparatory or auxiliary, in accordance with the ‘longstanding traditional interpretation’ of the provision. These states believe that it is the fragmentation of activities by enterprises that has been the cause of BEPS concerns regarding Art. 5(4) MTC 2014, and so the


122 2017 Comm. on Art. 5 (n 3), paragraphs 210 - 212: Chile and Mexico have made reservations on Art. 5(4) MTC 2017, however this does not include states that have opted to continue to use Art. 5(4) as described under the MTC 2014, which includes the UK. Finland, Luxembourg, Sweden and Switzerland have reserved the right not to use Art. 5(4.1) MTC 2017.

123 Art. 28(1)(k) MLI 2016 / Art. 13 (6) MLI 2016.


126 Reimer, Permanent Establishment… (n 24), 99 / 2017 Comm. on Art. 5 (n 3), paragraphs 31, 78.

127 Blum, Seiler (eds), Preventing Treaty Abuse (Series on International Tax Law, Vol. 101, 2016), 391 / 2017 Comm. on Art. 5 (n 3), paragraph 78.


UK, for instance, does not believe that the change in the PE threshold is necessary.

It can thus be argued that the reformulation of Art. 5(4) MTC for the 2017 MTC update, though appropriate in light of modernising business practices, is itself rendered unnecessary by the sheer extent of states that have not amended their interpretation of the activities listed in exemptions (a) - (d). Despite this, at least for Finland, Luxembourg, Sweden and Switzerland, which have reserved the right not to use Art. 5(4.1) MTC 2017, the update is significant.

5.3 CRITIQUE OF THE REFORMULATION OF ART. 5(4) MTC: LEGAL CERTAINTY ISSUES

Promoted Or Relegated?

It is difficult to say absolutely whether the reformulation has brought about an overall improved legal certainty for taxpayers and tax authorities. In one sense, the fact that the reformulation removes the differentiation in application of the preparatory/auxiliary provision that existed under the 2014 MTC [between the specific activities at exemptions (a) - (d) and the catch-all provisions at exemptions (e) - (f)] does allow all parties applying the provision to understand very clearly that any activity in the Source State must pass the preparatory/auxiliary provision in order to meet any exemption. Under the 2017 MTC, there is no ambit for enterprises, such as Amazon, to attempt to structure its operation in a way so that certain FPOBs may avoid PE status by way of solely storing goods without further, deeper assessment of the activity, unaware of whether the Source State tax authority will agree that the activity of those FPOBs is indeed solely focused on storage of goods. This simultaneously brings about a greater degree of certainty as to how cross-border enterprises shall structure their operations and how both taxpayers and tax authorities shall interpret those provisions under the 2017 MTC.

At the same time, legal certainty has been relegated by the prospective-only effect of the reforms, meaning there is a differentiation between DTCs concluded before and DTCs concluded after the 2017 MTC update. Though the impact of this is reduced by the coming into force of the MLI on 1 July

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130 2017 Comm. on Art. 5 (n 3), paragraphs 210 - 212.
131 Blum, Seiler (eds), Preventing Treaty Abuse (Series on International Tax Law, Vol. 101, 2016), 391.
2018, many states have made various reservations on Art. 13 MLI, as discussed above. This has created a mix of states for which the new provisions are now in force for its completed DTCs, other states for which only the new provisions without reservations are now in force for its completed DTCs, and other states for which none of the new provisions are in force.

Having said that, MTC reforms having a prospective-only effect are very much the norm, and in so being, contain within themselves a certainty. The reformulation should in summary be seen as a positive change to the specific activity exemptions that will make assessment and application easier for all parties involved.

5.4 CRITIQUE WITH RELEVANCE FOR THE REFORMULATED ART. 5(4) & THE ANTI-FRAGMENTATION RULE: THE IMPACT ON TAX AUTHORITIES & TAXPAYERS

As both the preparatory/auxiliary extension and the new anti-fragmentation rule have lowered the PE threshold, some repercussions will be shared between these reforms. These shared repercussions shall now be discussed.

**Increased Administrative Burden: Reformulation A Step Too Far?**

The increased exposure for enterprises operating in states that have adopted the Art. 5(4) MTC immediately (through the MLI or otherwise) has brought with it an increased administrative burden. For some enterprises, this will entail the administration of dealing with the possibility of more PEs in the Source State. For other enterprises, this will entail dealing with the possibility of the establishing of an initial PE in the Source State. Both of these will demand a greater use of resources for the enterprises involved for making source deductions etc., mainly in administrative terms, but with obvious yet important economic implications too.\(^{132}\) Enterprises such as Amazon, for example, may not feel a notable effect, but other enterprises might.

However, this critique of the Action 7 work should not be given too much weight. If foundations must be adjusted, then hands must get dirty. The administrative ‘difficulties’ associated with the Art. 5 MTC 2017 reforms

\(^{132}\) 2017 Comm. on Art. 5 (n 3), paragraphs 133 - 134.
should not be used to allay an attempt to cease the application of outdated exemptions in the digital age.\textsuperscript{133} The same reasoning can be applied to nullify the argument that these increased administrative burdens could have serious implications for cross-border trade.\textsuperscript{134}

While this argument is not completely without merit, for enterprises operating in modern, globalised economies it is unlikely to have any kind of meaningful effect. Enterprises will continue to do business and find customers across borders if it makes sense in business terms, and though this may be affected by the increased PE exposure risk from the 2017 MTC update, the administrative burden associated with this risk alone is perhaps insignificant.

**Increased Economic Analysis: A Necessary Evil?**

The increased administrative burden is not the only difference that the reforms have brought to assessing exemptions to PE status. The reformulated specific activity exemptions and the new anti-fragmentation rule share a significantly increased used of economic analysis in their assessment.\textsuperscript{135} There is a concern that this will bring difficulties for the national tax authorities to apply, as the preparatory/auxiliary extension means situations previously exempted from PE status under Art. 5(4) MTC 2014 will have to be reassessed, and entirely new concepts will need to be assessed under the new anti-fragmentation rule.\textsuperscript{136} The same concern applies for taxpayers, including smaller cross-border enterprises with less resources and so less ability to conduct the necessary reassessments of previously exempted FPOBs, as well as larger enterprises with generally more tax issues to be concerned with and hence a higher propensity to be affected by any tax reform.

Thus, the new, increased economic analysis could result in an increased likelihood of expensive disputes arising between tax authorities and taxpayers disagreeing on how a specific activity exemption or provision of the anti-fragmentation rule should be applied. Some critics of the 2017 Art. 5 MTC reforms suggest that the onset of the digital age has not even necessitated such a drastic overhaul of the structure for exempting PE status, and that Art. 5(4) MTC 2014 is fully competent to impose correct

\textsuperscript{133} Ibid, paragraph 138.
\textsuperscript{134} Dhuldhoya, ‘The Future…’ (n 5), 11 - 12.
\textsuperscript{135} Ibid, 11.
\textsuperscript{136} Dos Santos and Lopes, ‘Tax Sovereignty…’ (n 22), 311.
exemptions for digital business models that, in reality, share the same key characteristic as standard business models; they depend on the value added by the intellect of a human being.\(^{137}\)

The PE concept is becoming more outdated as time goes on, and so the battle to impose ‘fair’ tax for Source State activity is similarly becoming more difficult for tax authorities. The assessment of multiple enterprises as if one unit under the anti-fragmentation is not strictly in accordance with the principle of legal separation, which will be discussed below. However, this, in the opinion of the author, is necessary in order to force a shift of the easily-manipulated Source State tax rules for cross-border operating enterprises. Given Amazon's prominence in the e-commerce market and in Western economies generally, the imposition of increased economic analysis seems a small price to pay to attempt to restore balance between Amazon and its competitors. The risk of non-compliance from smaller enterprises, then, is outweighed by this restorative benefit.

5.5 CRITIQUE WITH RELEVANCE FOR THE REFORMULATED ART. 5(4) & THE ANTI-FRAGMENTATION RULE: EXTENDED USE OF THE PREPARATORY/AUXILIARY PROVISION

New Provision, Same Problems?
The most important aspect of the the Art. 5 MTC updates is the preparatory/auxiliary provision. This provision is present in Art. 5(4) MTC 2014, it has been the main subject of the Art. 5 MTC 2017 update, and features as a condition within the new Art. 5(4.1) MTC 2017. As has been analysed above, the ‘preparatory or auxiliary character’ condition has been expanded across Art. 5 MTC without amendment of the terms themselves. In this sense, the provision is pivotal to the potential success of the 2017 Art. 5 MTC update as a whole; if there are any issues with the condition itself, then the update is unlikely to be effective in its fight against artificial practices and the avoidance of PE status.

The issue with the preparatory/auxiliary provision is in its subjectivity, as indeed the 2017 Commentary insists that ‘each individual case will have to be examined on its own merits’\(^ {138}\). This comes to a head with the assessment of certain enterprises.

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\(^{137}\) Kemmeren, ‘Should the Taxation of the Digital Economy Really Be Different?’ (EC Tax Review, 2018/2), 73.

\(^{138}\) 2017 Comm. on Art. 5 (n 3), paragraph 59.
An Issue With The Preparatory/Auxiliary Provision: A Demonstration

To continue the case study, as a large scale e-commerce retailer with an important supply chain function, Amazon’s storage facilities, for example its UK fulfilment centres, will be particularly affected by the reformulation of Art. 5(4) MTC.

However, consider this example. Imagine the hypothetical Enterprise A, based in State A, that has a State B-based wholly-owned subsidiary, Enterprise B. Imagine that Enterprise B makes the equivalent of €10m of physical sales per year of bicycles\textsuperscript{139} to State A customers through Enterprise B shops located throughout State A, and the equivalent of €10k of online sales of textbooks per year to State A customers from EnterpriseB.com, a website based in State B. Enterprise B stores and distributes its bicycles from its State A stores, and stores and distributes its textbooks from a completely separate warehouse also based in State A. Imagine that there are no force of attraction rules in State A domestic law, and the profits of the online sales of textbooks cannot be attributed to the Enterprise B bicycle shop PEs under Art. 7 MTC 2017.\textsuperscript{140}

This would initially bring about the question of whether the Enterprise B textbook warehouse meets the preparatory/auxiliary provision under Art. 5(4) MTC 2017 for its presence in State A.\textsuperscript{141} The issue is that this specific storage facility is far less ‘essential and significant to the activity of the enterprise as a whole’\textsuperscript{142} than the more clear-cut example of Amazon’s UK fulfilment centres, as discussed above, given that the total sale value of textbooks is so low vis-a-vis the total sale value of bicycles. Without Enterprise B having such an important ‘supply-chain function’ as Amazon does, it has not been especially ‘targeted’ by the Action 7 work and the 2017 Art. 5 MTC update. Hence, this question on the application of Art. 5(4) MTC 2017 in this albeit very specific example remains unanswered.

The inability for Enterprise B as a taxpayer to answer whether it meets a specific activity exemption in this case thereby also leaves it unaware as to whether it should prepare for the possible application of the anti-fragmentation rule too. Despite this, the preparatory/auxiliary provision should not itself be regarded as ineffective because of this. The above

\textsuperscript{139} This example relates to physical goods only, given that the tax of digital goods is otherwise regulated.

\textsuperscript{140} This is unlikely, but at least possible.

\textsuperscript{141} For the sake of this discussion, the application of the new anti-fragmentation rule under Art. 5(4.1) MTC 2017 can be ignored.

\textsuperscript{142} 2017 Comm. on Art. 5 (n 3), paragraph 24.
example is possible but it is also very specific. With the continuing reliance of the PE concept upon physical presence in the Source State, and without a new or developed concept based on digital presence, more of which will be discussed below, the need to have a provision that exempts ‘unimportant’ activity from Source State taxation continues to be necessary. With this necessity in mind, it is difficult to currently envisage any feasible alternative to the preparatory/auxiliary provision in seeking to uphold the source rule within the MTC, despite the issues of subjectivity present within the current provision as it stands in the reformulated Art. 5(4) MTC 2017.

5.6 CRITIQUE OF THE ANTI-FRAGMENTATION RULE: INTERPRETATION OF THE RULE

There are other critiques that can be made specifically about the new anti-fragmentation rule itself.

Not Enough Commentary?
The first is of the Commentary that supports the provision. It is true that the Commentary cannot be regarded with too much substance, as its legal value is limited to being an interpretive tool used to assist in applying the MTC. Nonetheless, it is still a useful means of obtaining the intention behind those provisions, which can help to understand the ‘bigger picture’. If MTC-applying states have at least some regard for the Commentary guidance, this can encourage coordination as to the application of the provisions of the MTC.

However, the Commentary on Art. 5(4.1) MTC 2017 is only 1.5 pages, or 3 paragraphs, long, and this opts to explain the new rule through two contextual examples rather than engaging in deeper analysis. These examples are helpful, but very limited as even the reasoning provided for how the anti-fragmentation rule would rule in each example is insubstantial. The specific meaning of closely related enterprises on the other hand is well detailed, with its own provision at Art. 5(8) joined by paragraphs 119 - 121 of the Commentary. These paragraphs give more detail as to how the 50% automatic rule applies and the context surrounding it.

143 2017 Comm. on Art. 5 (n 3), paragraphs 79 - 81.
144 Ibid, paragraph 81.
However, in terms of the structure of the anti-fragmentation rule it is not entirely clear why ‘closely related enterprise’ is specifically defined with its own provision and Commentary, yet ‘complementary functions’ and ‘cohesive business manner’ do not enjoy the same status. The latter two are not new legal concepts to the same extent as closely related enterprises, with its notion of 50% beneficial interest etc., but they are no less important elements of the new rule. The substance of these terms will be discussed in more detail below, but in the specific context of the existence of Commentary to assist with the interpretation of these terms, it is certainly lacking. In the opinion of the author, it must be the case that it is the intention of the OECD to leave a strong element of subjectivity in the interpretation of ‘complementary functions’ and ‘cohesive business operation’ in order that they can be applied by national tax authorities in a domestically appropriate manner. However, the issues associated with leaving the interpretation of new terms with such indeterminacy for tax authorities and taxpayers alike has already been discussed as regards the legal certainty issues impeding coordination on the interpretation of the terms.

Value Of The New Rule: Of Merely Declaratory Character?
As Art. 5(4)(e) MTC 2014 applies the preparatory/auxiliary provision to any activity of an FPOB, some believe that the new anti-fragmentation rule is of a ‘merely declaratory character’. The belief follows that, by purposive interpretation, with a substance-over-form approach, the separate application of the ‘all-encompassing’ Art. 5(4)(e) MTC 2014 to two FPOBs of the same enterprise or multiple enterprises using the same FPOB would be sufficient, and negate the need for an ‘exception to the exemption’ through any anti-fragmentation rule.

However, though this view is realisable it is not actually widely realised, as it is a view that is simply not taken up by enough MTC-applying states. For this reason, it should not be considered an argument sufficient to reduce the PE definition problem and the necessity of the anti-fragmentation rule.

Reach Of The Rule: Too Far?
The anti-fragmentation rule itself is designed to target activity that is split up among different places or enterprises in an exploitative manner. There is an issue inherent within this, though, as the activities can be ‘fragmented’

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145 2014 Comm. on Art. 5 (n 32), paragraph 21.
146 Reimer, Permanent Establishment... (n 24), 100.
merely as a natural side product of moving into a new business area.\textsuperscript{147} For example, some enterprises may prefer to use local group members to share information with rather than to use third parties, because indeed this information could be commercially sensitive.\textsuperscript{148} The new rule seems to presume that there is something “inherently suspicious about a global business conducting activities [through]… different entities or different locations”.\textsuperscript{149}

This is a notable issue. If the outcomes of Action 7 do not align with its intentions, which is to target ‘artificial practices’, the very foundation of the reforms would be proven to be unstable. This possibly over-extensive reach of the new anti-fragmentation rule can be demonstrated further by analysing more closely the terms contained within it, which shall now be conducted.

5.7 CRITIQUE OF THE ANTI-FRAGMENTATION RULE: THE NEW CONCEPT OF CLOSELY RELATED ENTERPRISES

The Legal Separation Principle: Something Had To Change?
The OECD considered a number of options as to how to phrase and structure Art. 5(4.1) MTC 2017.\textsuperscript{150} It is not possible to analyse all of the options considered in the public discussion drafts, however it is possible to consider one which is particularly interesting vis-a-vis this thesis. ‘Option I’ opted essentially to eliminate the preparatory/auxiliary provision from the new rule, with the rest in effect as it stands in Art. 5(4.1) MTC 2017.\textsuperscript{151} The implementation of Option I would have resulted in a rule narrower in approach and effect, as the functions of multiple enterprises would have been assessed only to the extent of whether these functions were complementary, without being interested in whether this function had a preparatory or auxiliary character. Industry responses in the 2015 Revised Discussion Draft have expressed disappointment with the failure to implement Option I or a similar Option, stating for example that Art. 5(4.1) MTC 2017 will be ‘difficult to operate in practice’ due to the movement away from the ‘widely agreed concept of separate entity reporting’.\textsuperscript{152}

\textsuperscript{147} Kerschner etc., \textit{Taxation in a Global Digital Economy}… (n 6), 199.
\textsuperscript{148} Ibid, 205.
\textsuperscript{149} Blum, Seiler (eds), \textit{Preventing Treaty Abuse} (Series on International Tax Law, Vol. 101, 2016), 393.
\textsuperscript{150} See, generally, 2014 - 2015 Discussion Draft (n 73).
\textsuperscript{151} 2014 - 2015 Discussion Draft (n 73), 19 - 20.
\textsuperscript{152} 2015 Revised Discussion Draft (n 74), 46.
The concept of separate entity reporting refers to what is possibly the most controversial aspect of the anti-fragmentation rule: the rule can trigger a PE for a foreign enterprise on the basis of activities carried on by other enterprises. Hence, the new rule in essence ‘lifts the corporate veil’ and breaches the legal separation principle. This differs from the respect for the typical separate entity approach for attributing profit among business entities, for example. Nonetheless, to assess how separate legal structures interact with each other is not absolutely outside of the parameters of the domestic or international law, though it is generally well respected. The issue is that though Amazon and similar enterprises have been targeted by the new Art. 5 MTC, the reforms will similarly impact enterprises such as Enterprise B, storing textbooks from which it makes sales of only €10k per year, to do the same. It could even be said to enable Enterprise B to sell textbooks online in this way, as this must entail significant start-up costs, including costs incurred to set up a separate warehouse facility and the costs taken on to move into a new market. These costs would possibly make this activity economically infeasible without separation of this activity from the profits made from the sales of €10m of bicycles per year. The downside of this is that State B residents are left without the increased competitiveness in the textbook market. As the OECD exists to facilitate cross-border trade among its member states, this is a relevant issue.

It may well be the case that enterprises will have to pay higher taxes overall due to being unable to take advantage of specific activity exemptions in some states of operation as a result of the new anti-fragmentation rule. However, the principle of legal separation can be reduced in this example because though markets may lose out on some competition, the actors in that market will be forced to participate in a fairer manner, making the advantage of Amazon over Enterprise B, for example, less prominent. Given how the PE concept is being manipulated, as facilitated by the legal separation principle, it has been the very point of the Action 7 work to introduce a reform that seeks to overturn the norm and impose ramifications upon enterprises thriving while avoiding PE status. With this, it is inevitable that this will have a certain disregard for established legal principles. Moreover, as Art. 9 MTC engages in a similar assessment of separate, ‘associated’ enterprises, the assessment required under Art. 5(4.1) MTC is by no means new.

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153 Blum, Seiler (eds), Preventing Treaty Abuse (Series on International Tax Law, Vol. 101, 2016), 393.
154 Batheja, Treaty Abuse and PEs… (n 90), 391 - 394.
The Definition Of Closely Related Enterprise: A Missed Opportunity?
The effect of Art. 5(8) MTC 2017 in unison with Art. 5(4.1) MTC 2017 is
dramatic: it essentially grants tax authorities the power “re-write the
accounts of the enterprises if, as a result of the special relations between the
enterprises, the accounts do not show the true taxable profits arising in that
State”,155 This is alike Art. 9 MTC and the concept of associated
enterprises, as mentioned, except now introduced to the assessment of
possible PEs. The importance of the term can hardly be underestimated. It
seems like a missed opportunity of the new provision that neither it nor the
associated Commentary explicate upon “similar to those that it would hold
if it possessed” 50% of the beneficial interests of the enterprise’.156 In other
words, it cannot be known for sure just how ‘close’ a enterprise must be.
This is a failure to establish the provision’s limitations.

This gap is presumably left in order to leave the interpretation of ‘similar
instances’ to domestic tax authorities in order to interpret it in a
domestically appropriate manner. However, for taxpayers interpreting the
new term this leaves an especially significant degree of uncertainty. Despite
the OECD’s decision to use ‘closely related’ instead of ‘associated’ in order
to keep the definition relatively narrow, the inclusion of “similar” in the
provision leaves the definition open-ended. For the sake of taxpayers, it is
hoped that national tax authorities will provide guidance as to how ‘similar’
will be interpreted within that state. Reference to Art. 3(2) MTC would
suggest that the term would be interpreted in accordance primarily with the
domestic tax law of the state applying the provision. However, as the new
anti-fragmentation rule can effectively impose PEs where they previously
did not exist, there can be a significant degree of tax revenue at risk for
MTC-applying states. Therefore, disagreements on the meaning of ‘similar’
could again lead to international disputes, imputing costs and administrative
burdens for cross-border operating enterprises.

5.8 CRITIQUE OF THE ANTI-FRAGMENTATION RULE: THE
NEW CONCEPT OF COHESIVE BUSINESS OPERATION

Cohesion: What Degree of Synergy Is Required?
The concept of ‘cohesion’ has an everyday meaning that is not necessarily
obscure but when this is applied to a legal situation, there is - as with any

155 2017 Comm. on Art. 5 (n 3), paragraph 2.
156 Ibid, paragraph 120.
legal term - a certain level of subjectivity. It does help when looking at how cohesive should be interpreted to remember that the scope of the anti-fragmentation rule encompasses only single-enterprise or multiple ‘closely related’-enterprises situations, and so the necessary ‘cohesion’ sought is between business entities with strong links already established. But ‘cohesive’ is not the narrowest term that could have been used to describe the requisite degree of synergy necessary,\(^\text{157}\) and in fact its possible meanings can be quite wide. For example, when used in the phrase ‘social cohesion’, the term refers to people with something in common in some respect, possibly with similar goals or interests, who possibly mutually benefit from these similarities. Thus, for Art. 5(4.1) MTC 2017, do business operations that are merely socially cohesive count? Or must there be a shared a business or financial interest too? This is not clear.

In a similar vein, associated enterprises share ‘some commonality and synergies’, which is to mean a degree of cohesion that is not necessarily significant.\(^\text{158}\) However, this can only be of limited guidance as to the necessary degree of cohesion for closely related enterprises because, with the decision not to use the concept of associated enterprises in Art. 5(4.1) MTC 2017, it is most likely the case that this is not the degree of synergy of community or synergy that the OECD had desired. The issue is, again, with the fact that the Commentary does not assist much with interpreting exactly what degree of synergy is required, instead opting to explain through contextual examples without clear definitions or explanations. Once again, failing to be specific can mean taxpayers are left unsure as to how the relevant tax authorities will interpret the term.

To carry on the example of Enterprises A and its subsidiary, Enterprise B, bear in mind that Enterprise B could be selling textbooks online to State A customers from its State B-based website as a separate operation to the sales of bicycles it makes to State A customers, which could be without any intended cohesion. With the facts given in the previous Enterprise B discussions, the sales of textbooks and bicycles would not likely meet the definition of complementary & cohesive manner under the anti-fragmentation rule. However, what if the textbooks sold from its State A textbook warehouse were ‘bicycle maintenance manuals’ of some sort, possibly even advertised for sale in the Enterprise B stores in State A (though still sold online)? In this case, is it possible that Art. 5(4.1)(b) MTC

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\(^{157}\) Kerschner et al., *Taxation in a Global Digital Economy*… (n 6), 201.

2017 would apply to deem the combination of activities of Enterprise B in State A from its textbook warehouse and its bicycle stores as being of a complementary & cohesive manner? This is also unclear. This subtle difference highlights how the new terms and the anti-fragmentation rule as a whole lack complete foresight to deal with such situations, albeit that this one is very specific. It also raises questions about the suitability of the complementary & cohesive manner provision overall, which will be played out as 2017 Art. 5 MTC reforms come properly into effect.

5.9 CRITIQUE OF THE ANTI-FRAGMENTATION RULE: SIGNIFICANCE OF THE RULE

To Where Will The PE Go?
The example of Enterprises A and its subsidiary, Enterprise B, can be carried on once again in order to demonstrate a further issue with the new rule. This situation is very close to that of the case study of Amazon EU SARL and Amazon UK Services Ltd in the UK discussed above, making this hypothetical example of particular relevance.

Imagine that Enterprise B no longer sold bicycles in State A stores and instead its only activity was the online sale of textbooks to State A customers from its State B-based website. Now imagine that Enterprise A has another wholly-owned subsidiary, Enterprise C, which is based in State C. Enterprise C assists Enterprise B with the sale of textbooks in State A by running the textbook warehouse and delivering the textbooks. Enterprises B and C will be deemed to be closely related under Art. 5(4.1)(b) MTC 2017, fulfilling the provision to prevent use of the specific activity exemptions for either enterprise. As a PE can be associated to multiple enterprises under the new rule, the question arises: as both enterprises meet the Art. 5(1) MTC PE definition regarding the activity of each vis-a-vis the textbook warehouse, which of the two enterprises will be ‘given’ the PE with the application of the anti-fragmentation rule? Is it both enterprises, with the rule applying to each enterprise separately? Or is it that both enterprises will be considered together as a foreign ‘group’, sharing the PE? Or will one enterprise be considered a ‘principal’ taxpayer, and to the principal shall be ‘given’ the PE?

159 Kerschner etc., Taxation in a Global Digital Economy… (n 6), 201.
160 Ibid, 201 - 206.
The first option seems the most likely outcome, given the possible complexities and subjectivities involved with the latter two. However, the Commentary is once again silent on how exactly it should be assessed, and yet the importance of this question should not be understated. For example, the new rule will have implications for the application of the DTCs such as those that may exist between State A-State B and State A-State C. There are also profit attribution problems, although these are being dealt with separately under the Action 7 work. The Commentary ought to have given interpretive advice regarding these issues, rather than leaving taxpayers and tax authorities alike in limbo - something that this critique has shown to be a recurring theme.

5.10 SUMMARY ON THE CRITIQUE

In summary, the reformulated Art. 5(4) MTC 2017 and the new Art. 5(4.1) MTC 2017 are imperfect provisions. However, this seems inevitable given the scale of the challenge faced by the OECD. Additional Commentary may have been welcomed by taxpayers and tax authorities alike, however the lack of this is reduced by its legal value if it did exist. These issues should be borne in mind for the future, but should not be used to reduce the necessity of the reforms on the whole.

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162 Blum, Seiler (eds), Preventing Treaty Abuse (Series on International Tax Law, Vol. 101, 2016), 395.
CHAPTER 6 - THE FUTURE OF THE PE CONCEPT

6.1 A CURSORY LOOK AT A POSSIBLE FUTURE DEVELOPMENT

The Extant PE Concept: Need For An Economic Concept?
In light of the seemingly unsolvable issues with the 2017 Art. 5 MTC reforms put forward by this thesis, the question comes to mind of what the future of the PE concept holds. This is actually the realm of Action 1 of the BEPS Action, however it can be approached here briefly to reflect upon how the work of the BEPS Project may be carried on in the future.

As discussed in ‘Chapter 1 - Introduction’, the OECD has opted to maintain the idea of physical activity creating a taxable presence through the Action 7 work, which continues into the 2017 MTC Commentary. This thesis has highlighted the shortcomings that are associated with this, and how the limited impact of the reforms can be associated with the outdated physical presence basis. Even after the Action 7 reforms, Art. 5 MTC 2017 remains rigid and narrow when compared to the flexibility of internationally operating enterprises. The issue is that the 2017 update can only ever be a ‘stop-gap’ solution to an ever-developing problem; it seeks to mitigate the flow of issues stemming from artificial practices without fixing the PE definition issue facilitating these artificial practices in the first place.

On the other hand, it does appear that the reformed provisions will at least be very effective in stemming this flow. Despite not resolving the PE’s definition problem totally, by widening the PE concept the 2017 Art. 5 MTC update has made it substantially more difficult for enterprises to deliver goods within a state without creating a Source State PE. The question is, as this widening of the PE concept through the 2017 MTC update has entailed formulating a test that has grown increasingly economic-based, and as a total and unequivocal solution to the PE definition problem within the current international tax system may be impossible, will the time come when this should be embraced fully?

164 2015 FRA1 (n 23).
165 2017 Comm. on Art. 5 (n 3), paragraph 143.
168 Khee and Syrett, ‘Impact of OECD BEPS Action 7…’ (n 1), 5.
Action 1 has postulated as much: “fully dematerialised digital activities” with a significant digital presence could theoretically constitute a PE. So long as the law holds onto the principle of legal separation, which is by all means an appropriate thing to do in how it allows enterprises to be operationally agile and therefore competitive and robust, there will be a growing consensus that it is necessary to reform the physical presence-based PE concept. This will be a significant challenge, but one that can reap benefits with the restoration of international tax relations damaged by the artificial practices of cross-border operating enterprises.

At the same time, move away from the PE’s reliance on physical presence and the law enters new waters. That is not to say necessarily that those waters cannot be charted, but a complete reassessment of the very foundation of an important tax nexus within international tax law will not likely be plain sailing. In this sense, perhaps the Art. 5 MTC reform brought by the Action 7 work is a two-way damage mitigation method: it goes some way to preventing enterprises avoiding PE status in certain circumstances, while choosing not to approach the perils of a complete overhaul of the tax system. An overhaul of this proportion would invariably have caused issues far more difficult to solve than those caused by the 2017 Art. 5 MTC reforms. In this way, the OECD has attempted and, in the opinion of the author, largely succeeded in striking a precarious legal balance. Future reform is inevitable, but the current reforms should be seen as a stepping-stone taking the PE concept towards those future improvements, rather than a new path in the wrong direction.

171 Kerschner etc., Taxation in a Global Digital Economy… (n 6), 184.
172 Dos Santos and Lopes, ‘Tax Sovereignty…’ (n 22), 305.
CHAPTER 7 - CONCLUSION

This thesis set out to provide an in-depth analysis of the background to Art. 5 MTC and the concept of the PE itself. This provided a basis upon which to critically analyse how the OECD is developing this concept forward through the work of Action 7 of the BEPS Project. This thesis has explored the expansion of the preparatory/auxiliary provision to cover all of the specific activity exemptions in Art. 5(4) MTC 2017 in order to prevent misuse of exemptions (a) - (d), particularly by enterprises such as Amazon. This thesis has also explored the new provisions at Arts. 5(4.1) and 5(8) MTC 2017, that together form the new anti-fragmentation rule, which aims to prevent abuse of the specific activity exemptions occurring when a single enterprise splits its operations among different FPOBS or multiple enterprises collude in order to keep their activities below the PE threshold. This thesis has detailed how the new rule will go some way to preventing the issues associated with artificial practices, but that ultimately this comes at a cost falling predominantly at the foot of taxpayers. Legal uncertainty is the preponderant currency of this cost, that is also joined by a significantly increased administrative burden and a certain inappropriateness of the reforms vis-a-vis established legal norms and principles. This may lead to the risk of expensive international disputes as the effects of the reforms come to fruition in the coming months and years.

However, this thesis seeks to reduce the weight of these oppositions to the Art. 5 MTC 2017 reforms by pointing out that such costs are usually inevitable for such dramatic reforms, and that dramatic reform is justified in this circumstance by the problem that the OECD and national tax authorities have faced. No longer are the suspicious public and the tax authorities content with statements such as those from Amazon that it pays ‘all taxes required this required of it, in the UK and every country of operation’. The cost of legal disputes from the Action 7 reforms is outweighed by the opportunity presented to reestablish equality between large cross-border enterprises with the capacity to artificially fragment their operations in a way that is tax efficient, and other enterprises for which no such choice exists.

The Art. 5 MTC 2017 are flawed, but should still be regarded as a success.

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