

# MORE PERMANENT ESTABLISHMENTS: THE DWINDLING PREPARATORY AND AUXILIARY ACTIVITIES EXCEPTION

## Authors

Neha Rastogi  
Beate Erwin

## Tags

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Nothing is certain in this world, except death and taxes – and even taxes are subject to change. The ever-expanding definition of a permanent establishment (“P.E.”) and ever diminishing exceptions to a P.E. under the O.E.C.D.’s B.E.P.S. Project has made one thing clear – the restrictions local jurisdictions put on activities by foreign taxpayers to trigger taxation are tightening. The dwindling preparatory and auxiliary activities exception is a prime example.

Under U.S. domestic law, a foreign enterprise is subject to taxation in the U.S. if its activities constitute a U.S. trade or business (“U.S.T.B.”) and the income is effectively connected with the U.S.T.B.<sup>1</sup> However, if the foreign enterprise is resident in a country that has an income tax treaty with the U.S., an exception may apply. If the activities of the foreign enterprise, as defined in the applicable income tax treaty, do not rise to a certain level, the foreign enterprise will not be taxable in the U.S. More specifically, as long as the foreign enterprise is not deemed to create a P.E. in the U.S., it will not be subject to U.S. taxation on income related to its U.S.T.B.

This article discusses the meaning of a P.E. in general and a particular exception to the creation of a P.E. that is invariably found in the tax treaties signed by the U.S. As will be shown, the “safe harbor” activities that have so far been treated as *de minimis*, and thus not sufficient to create a P.E., are dwindling.

## PERMANENT ESTABLISHMENT DEFINED

In broad terms, the profits of an enterprise of one country are taxable only in that country (*i.e.*, the home country or country of residence) unless it carries on a business in the U.S. through a P.E.<sup>2</sup> Therefore, the definition of a P.E. is crucial for identifying which country has a primary right to taxation.

In most cases, U.S. income tax treaties define a P.E. to include a fixed place of business in the U.S. through which the foreign enterprise carries on its business either wholly or partly. This includes, *inter alia*, the following examples:

- A place of management
- A branch
- An office

<sup>1</sup> Code §864(c)(1)(A). Special rules apply to certain passive U.S. source income derived by foreign persons. The latter is typically subject to U.S. withholding tax unless it is reduced (up to zero) under an applicable income tax treaty.

<sup>2</sup> U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016), art. 7.

- A factory
- A workshop

However, a foreign enterprise will not be deemed to have a U.S. P.E. if its activities in the U.S. are limited to certain activities that are of a preparatory or auxiliary nature. For example, the U.S.-U.K. Income Tax Treaty provides that a P.E. will not include the following preparatory and auxiliary activities:<sup>3</sup>

- The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise
- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery
- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise
- The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise
- 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
- The maintenance of a fixed place of business solely for any combination of these activities noted, provided that the overall activity of the fixed place of business resulting from the combination is of a preparatory or auxiliary character

Thus, any fixed place of business in the U.S. – like a branch, factory, or warehouse – that carries out exclusively the above mentioned preparatory or auxiliary activities in the U.S. is not a P.E. of the foreign enterprise. For example, an office solely for the purpose of advertising, supplying information or scientific research, or servicing a patent or a know-how contract is not a P.E. if such activities have a preparatory or auxiliary character.

It should be noted that the nature of the activity itself, and not the type of fixed place of business that carries out the activity, must be examined to determine whether the activity is preparatory or auxiliary in nature. Thus, the activity may be carried out by a wholly-owned subsidiary of a foreign enterprise with multiple offices in the U.S., but it may still not be regarded as a fixed place of business if it is merely conducting preparatory or auxiliary activities. Further, a person acting on behalf of an enterprise and concluding contracts in the U.S. that relate to the preparatory or auxiliary activities does not create a P.E. of the foreign enterprise in the U.S.<sup>4</sup>

## PREPARATORY AND AUXILIARY EXCEPTION

The rationale behind the preparatory and auxiliary exception is that, although the fixed place of business may contribute to the productivity of the foreign enterprise,

<sup>3</sup> U.S. Department of the Treasury, *U.S.-U.K. Income Tax Treaty*, (Jul. 24, 2001), art. 5(4).

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

the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to that fixed place of business.<sup>5</sup>

In order to distinguish preparatory or auxiliary activities from those that are not, the decisive criterion is whether the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Further, a fixed place of business does not exercise a preparatory or auxiliary activity if its general purpose is identical to the general purpose of the whole enterprise.<sup>6</sup> For example, where the servicing of patents and know-how is the main purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot be excluded from the definition of a P.E.

Generally, a preparatory activity is carried on in contemplation of executing essential and significant activities of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period of time. This, however, is not always the case, as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else.<sup>7</sup> For example, where a construction enterprise trains its employees at one place before they are sent to remote work sites located in other countries, the training at the first location constitutes a preparatory activity for that enterprise. Overall, the duration of preparatory activities is determined by the nature of the core activities of the enterprise.

An activity that has an auxiliary character, on the other hand, generally is carried on to support, without being part of, essential and significant activities of the enterprise as a whole.<sup>8</sup> For example, a foreign enterprise of Country X maintains a fixed place of business in Country Y solely for the delivery of spare parts to customers for machinery sold to those customers. The fixed place of business will be treated as being engaged in an auxiliary activity since it supports the main business of selling machinery. In contrast, the exception will not apply where the enterprise maintains the fixed place of business not only for the delivery of spare parts but also for the maintenance and repairs of the machinery. These functions constitute after-sale services to the customers that are essential and significant for the trading business.

### **International Practice Unit on Preparatory and Auxiliary Exception to P.E. Status**

On January 29, 2019, the I.R.S. released an international practice unit (“I.P.U.”), titled *Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status*, that provides guidelines on whether an activity has a preparatory or auxiliary character.

The I.P.U. examines whether a U.K.-resident enterprise (“U.K. Co.”) that engages in multiple business ventures which send employees to conduct advertising and marketing activities in the U.S. has a fixed place of business in the U.S. It suggests

<sup>5</sup> O.E.C.D., *Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capital*, (Dec. 18, 2017), para. 58.

<sup>6</sup> O.E.C.D., *Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capital*, (Dec. 18, 2017), para. 59.

<sup>7</sup> O.E.C.D., *Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capital*, (Dec. 18, 2017), para. 60.

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

**“Although the fixed place of business may contribute to the productivity of the foreign enterprise, the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to that fixed place of business.”**

that the facts and circumstances of the case must be examined by reviewing the following information:

- U.K. Co.'s financial statements, interviews with professionals, and internet research to determine if U.K. Co.'s advertising department engages in advertising for enterprises other than U.K. Co (in which case it is unlikely that the activities are of a preliminary or auxiliary nature)
- Whether U.K. Co. earns a considerable profit in comparison to its other businesses such that advertising or marketing activities may be considered more than preparatory or auxiliary
- U.K. Co.'s financial statements to determine if U.K. Co. earns a profit from its advertising and marketing activities in the U.S.
- U.K. Co.'s financial statements and the internet to determine U.K. Co.'s core business(es) and whether marketing merely facilitates or increases other business profits
- Whether (based on financial statements, internet research, and employee interviews) U.K. Co. conducts any other activities through the U.S. that in combination or alone (either through its employees carrying on business in the U.S. or through a dependent agent on behalf of U.K. Co.) may cause U.K. Co. to have a P.E.

The I.P.U. places emphasis not only on the nature of the activities of the employees but also on the manner in which U.K. Co. describes and reports such activities on its website and financial statements. Since the I.P.U. is used by the I.R.S.'s Large Business and International division as a tool to analyze whether a P.E. exists in the U.S., taxpayers should ensure that their actions are consistent with the guidance in order to utilize the preparatory and auxiliary exception.

### **Revenue Ruling 72-418**

On several occasions, the I.R.S. has ruled on the issue of whether a P.E. exists in the U.S. In Rev. Rul. 72-418, the I.R.S. held that a German bank conducting informational, advertising, and investigative activities through a representative's office in the U.S. did not have a P.E. in the U.S.; the U.S. office performed the following activities:

- Investigated and obtained information regarding U.S. commercial and financial matters of interest for German customers.
- Assisted bank customers with information and letters of introduction to U.S. banks.
- Established and maintained contracts with other banks, financial institutions, business corporations, and government agencies.
- Furnished information regarding German commercial and financial matters to the same institutions.
- Advertised for the bank throughout the U.S. in newspapers, periodicals, and by personal contacts.
- Communicated with the U.S. debtors of the bank "on rare occasions."

The I.R.S. observed that the above activities were preparatory in nature and the representative office did not engage in any core banking functions in the U.S. These core functions may include buying, selling, paying, or collecting bills of exchange; issuing letters of credit or receiving money for transmission or transmitting money by draft, check, cable, or otherwise; making loans; receiving deposits or exercising fiduciary powers; keeping or maintaining any books of account for the bank except a record of its own expenses; concluding any contracts on behalf of the bank; or soliciting on behalf of the business.

## LIMITING EXCEPTIONS TO A P.E.

Undoubtedly, the preparatory and auxiliary exception is an attractive one. However, the B.E.P.S. initiative has tightened this exception and made it even harder to claim. As was pointed out by the O.E.C.D., one of the major goals of the B.E.P.S. Project is to ensure that taxpayers do not exploit this exception.<sup>9</sup> In this context, it was noted that activities that were previously considered preparatory or auxiliary may now be core business activities, especially in the digital economy. Accordingly, Article 5(4) of the O.E.C.D. Model Tax Convention on Income and on Capital was amended to include that the maintenance of a fixed place of business solely for an activity or any combination of activities (enumerated above) will be treated as preparatory or auxiliary in nature only if the overall activity of the fixed place of business is of a preparatory or auxiliary character.

For example, an online seller of a variety of goods is a resident in Country R. It maintains warehouses in Country S for the purpose of storing and delivering goods sold online to customers of Country S. The business model of the online seller relies on the proximity to customers and the need for quick delivery. Therefore, the use of warehouses that are closer to customers is an essential requirement for the success of the online seller. Therefore, the storage and delivery activities will not likely constitute preparatory or auxiliary activities. Rather, the warehouses likely will be treated as the P.E. of the online seller in Country S under the new definition. If seen on a standalone basis, the warehouse used to store and deliver the goods would squarely fall within the exception to a P.E. under the old provision since the storage and delivery activities would be treated as auxiliary activities.

Further, paragraph 4.1 was inserted to Article 5 of the O.E.C.D. Model Tax Convention to introduce an anti-fragmentation rule. This rule prevents enterprises from avoiding P.E. status by fragmenting their core business activities into several small operations and allocating the operations among closely related parties such that, if seen independently, each was engaged in a preparatory or auxiliary activity and could therefore claim the preparatory or auxiliary exception to P.E. status.

## ATTRIBUTION OF PROFITS UNDER THE ANTI-FRAGMENTATION RULE

On March 22, 2018, the O.E.C.D. released the final report entitled *Additional Guidance on the Attribution of Profits to a Permanent Establishment under the B.E.P.S. Action 7 Report (Preventing the Artificial Avoidance of Permanent Establishment*



<sup>9</sup> O.E.C.D., *Action 1: Addressing the Tax Challenges of the Digital Economy*, (Oct. 5, 2015), p. 144.

*Status*). This guidance addresses how much profit should be allocated to a P.E. once it has been determined that it exists. The guidance suggests that, after it has been established that a P.E. exists due to activities specified in Article 5(4) of the O.E.C.D. Model Tax Convention, the profits to be attributed to the P.E. are those that would have been derived if it were a separate and independent enterprise performing the activities that caused it to be a P.E.

Regarding the anti-fragmentation rule in Article 5(4.1), the guidance states that the rule applies in two types of cases<sup>10</sup> discussed below.

### **Where There Is an Existing P.E. in the Source Country**

A P.E. exists where a foreign enterprise or a closely related enterprise already has a P.E. in the source country and the activities in question constitute complementary functions of a cohesive business operation. A P.E.'s profits arising from such activities are derived from the combined complimentary activities, considering the profits each one would have derived if it were a separate and independent enterprise performing its corresponding activities.

For example,<sup>11</sup> R.C.O., a bank resident of State X, has a number of branches in State Y that constitute P.E.'s. It also has a separate office in state y where a few employees verify information provided by clients that have made loan applications at these different branches. The results of these verifications are forwarded to the headquarters of R.C.O. in State X where other employees analyze the information and provide reports to the branches where the decisions to grant the loans are made. In this case, the exceptions of Article 5(4) will not apply to the office because another place (*i.e.*, any of the other branches where the loan applications are made) constitutes a P.E. of R.C.O. in State Y and the business activities carried on by R.C.O. at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (*i.e.*, providing loans to clients in State Y).

### **Where There Is No Existing P.E. in the Source Country**

The second situation is where there is no pre-existing P.E. in the source country. In such a case, a determination has to be made whether the combination of activities in the source country by the foreign enterprise and closely-related foreign enterprises results in a cohesive business operation that is not merely preparatory or auxiliary in nature and therefore results in a P.E. If this occurs, the profits attributable to each P.E. are those that would have been derived from the profits made by each activity of the cohesive business operation as carried on by the P.E. if it were a separate and independent enterprise performing the corresponding activities.

For example,<sup>12</sup> Company X is a resident of Country C. It is engaged in the business of selling goods online directly to customers in different countries including Country Y. Company X has a leased warehouse in Country Y. The employees of the warehouse are responsible for the shipment of the goods from the suppliers, stocking

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<sup>10</sup> O.E.C.D., Additional Guidance on the Attribution of Profits to a Permanent Establishment under the B.E.P.S. Action 7 Report, (Mar. 22, 2018), paras. 8 and 9.

<sup>11</sup> O.E.C.D., Commentary on Article 5 of the 2017 Model Tax Convention on Income and on Capital, (Dec. 18, 2017), para. 81.

<sup>12</sup> O.E.C.D., Additional Guidance on the Attribution of Profits to a Permanent Establishment under the B.E.P.S. Action 7 Report, (Mar. 22, 2018), para. 11.

the goods, and delivering the goods using the services of an independent delivery service provider. Company X also has an office in Country Y which is responsible for collecting information from the customers in Country Y. The business activities carried on by Company X at the warehouse and the office likely constitute complementary functions that are part of a cohesive business operation. Therefore, both the warehouse and office are treated as the P.E. of Company X in Country Y. The profits attributable to the warehouse are those that it would have derived if it were a separate and independent enterprise performing the same storage and delivery activities. Similarly, the profits attributable to the office are those that it would have derived if it were a separate and independent enterprise performing the same information gathering activities.

## CONCLUSION

The O.E.C.D. has taken firm steps to limit the preparatory and auxiliary exception to P.E. status. Multinational businesses are no longer able to fragment their core activities to benefit from the preparatory and auxiliary exception. Following recent O.E.C.D. guidance, the exception will apply only when activities are preparatory or auxiliary in relation to the business as a whole.

Now is the time for corporations with worldwide operations to revisit their business structures and run a P.E. risk analysis. If enterprises have split their operations into separate businesses, like procurement, storage, delivery, advertising, and distribution, it is likely that activities which enjoyed the preparatory and auxiliary exception under the old provisions will no longer be recognized as such but will rather create a P.E. in the foreign country.

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