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Permanent Establishments Through Related Corporations Under the OECD Model Treaty

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PRÉCIS

Cet article porte sur l'assertion de plus en plus courante par un pays, dont un membre d'un groupe multinational est résident, qu'un autre membre non-résident du groupe a aussi une présence imposable dans le pays — un « établissement stable (ES) en vertu d'une convention fiscale de ce pays.

En faisant des affaires à l'étranger indirectement par l'intermédiaire d'une filiale qui y est constituée, par opposition à une succursale, les sociétés mères multinationales s'attendent généralement à ce que leurs bénéfices soient à l'abri de l'impôt dans le pays étranger. À cet égard, les conventions fiscales bilatérales prévoient généralement qu'une société non-résidente n'a pas d'ES dans un pays signataire d'une convention du seul fait qu'elle y contrôle une société résidente. Depuis quelques années, cependant, on observe une tendance croissante — certains diront alarmante — de la part de certains pays importateurs de capitaux nets à prétendre que les activités d'une société étrangère exercées de concert avec une société affiliée sur place ou par l'intermédiaire d'une telle société créent un ES de la société étrangère, sous la forme d'un « ES qui est une société affilié ».

L'article traite en trois parties de l'importance et de la pertinence de cette notion d'ES qui est une société affiliée. La première partie porte sur les dispositions pertinentes de l'article 5 (établissement stable) de la convention modèle de l'OCDE, en particulier les notions de « lieu fixe d'affaires » et d'« agent dépendant » pour conclure qu'une filiale peut créer un ES pour son actionnaire qui est une société. L'auteur montre que les règles actuelles résultent d'un long débat, qui a commencé à la Société des nations au début du 20e siècle et s'est poursuivi à l'OCDE, quant à savoir si l'influence prépondérante d'une société mère sur les affaires de ses filiales devrait avoir plus d'importance que le fait que les filiales sont des personnes morales distinctes. Pour mieux saisir la teneur juridique du débat, la deuxième partie de l'article examine de vieux jugements du R.-U. et du Canada où il était prétendu (souvent par une administration fiscale ou un contribuable) que deux sociétés liées devraient être considérées en fait comme une unité légale (un seul contribuable aux fins de l'impôt). Cette jurisprudence contient des principes directeurs encore pertinents à ce jour, hors du contexte des conventions, pour la

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détermination du revenu, des biens ou des activités d'une société qui peuvent être attribués à ses actionnaires. Cette timide reconnaissance des personnes morales dans ces jugements annonçait partiellement les récents développements au sujet des ES qui sont des sociétés affiliées.

À la lumière de l'histoire de la notion d'ES qui est une société affilié, la troisième partie de l'article porte sur le rôle que la forme juridique a joué dans de récents jugements de tribunaux à l'étranger portant sur ces ES. Ces causes portent sur les réalités commerciales des multinationales — par exemple, partage de services de gestion ou de biens de valeur qui bénéficie à l'ensemble du groupe multinational — qui posent un défi aux contribuables qui cherchent à rattacher les sources de profits à une entité juridique ou à une administration précise exclusivement. Compte tenu de cette jurisprudence et du commentaire actuel de l'OCDE, on observe aujourd'hui deux tendances opposées dans la façon de concevoir l'ES qui est une société affiliée : l'approche traditionnelle continue à privilégier la forme juridique tandis qu'une autre, davantage axée sur les faits, cherche à tenir compte des rôles partagés par les membres de multinationale dans les activités productrices de bénéfices. L'auteur fait remarquer que les enjeux dans le débat entre les deux tendances tiennent à la fois de la certitude dans la planification fiscale et de la question de savoir quel pays aura le droit d'imposer les sources de profits élevés du groupe multinational.

ABSTRACT

This article deals with the increasingly common assertion by a country in which a multinational group member is resident that another, non-resident member of the group also has a taxable presence in the country—a "permanent establishment" where a tax treaty applies.

Multinational parent companies generally expect that conducting business in a foreign country indirectly by means of a locally incorporated subsidiary, as opposed to a branch, will effectively shield the parent company's own commercial profits from the taxing jurisdiction of the foreign country. Supporting this expectation, bilateral income tax treaties generally provide that a non-resident corporation does not have a permanent establishment in a treaty state merely because it controls a corporation resident in that state. In recent years, however, there has been an increasing—some would say alarming—trend in certain net capital-importing countries to assert that activities of a foreign company conducted in coordination with or through a local affiliate result in a permanent establishment of the foreign company, in the form of an "affiliated corporation PE."

The article examines the significance and justifiability of the affiliated corporation PE concept in a three-part discussion. The first part reviews the relevant provisions of article 5 (Permanent Establishment) of the OECD model tax treaty, particularly the "fixed place of business" and "dependent agent" bases for finding that a subsidiary can give rise to a permanent establishment for its corporate shareholder. The current rules are shown to have resulted from an extended debate, beginning at the League of Nations in the early 20th century and subsequently continued by the OECD, about whether more weight should be given to a parent company's preponderant influence over its subsidiaries' affairs or to the fact that the subsidiaries have distinct legal personality. In order to better grasp the legal terms of that debate, the second part of the article reviews early UK and Canadian cases in which it was claimed (often by a taxing authority or a taxpayer) that two related corporations should be regarded as, in effect, a legal unity (a single taxpayer for tax purposes). This case law provides guideposts that are relevant to

this day, outside the treaty context, in determining when the income, property, or activities of a corporation may be attributed to its shareholder. In their wavering respect for corporate legal personality, these decisions partially anticipate recent developments regarding affiliated corporation PEs.

Building on the history of the affiliated corporation PE concept, the third part of the article considers the role that legal form has played in recent foreign court decisions dealing with affiliated corporation PEs. These cases deal with business realities of multinational enterprises (MNEs)—for example, shared managerial services or valuable intangibles that benefit the MNE group as a whole—that pose a challenge to taxpayers seeking to link generators of profits exclusively with one specific legal entity or jurisdiction. From a review of these cases and the current OECD commentary, there emerge two conflicting trends in contemporary thinking about affiliated corporation PEs: the traditional approach continues to privilege legal form, while another, more factually intensive approach aims to factor in the shared roles of MNE members in profit-generating activities. The author observes that the stakes in the contest between the two trends involve both certainty in tax planning and the question of which countries will have a right to tax the high-profit sources of income of a particular MNE group.

KEYWORDS: PERMANENT ESTABLISHMENTS ■ TAX TREATIES ■ MULTINATIONAL CORPORATIONS ■ AGENCY ■ CORPORATE VEIL

CONTENTS

Is there a bridle for this Proteus
That turns and changes like his draughty seas?

—W.B. Yeats, "At the Abbey Theatre"

In Greek mythology, the sea-god Proteus was able to foretell the future but would change his shape in order to avoid being captured and made to speak—whence, the adjective "protean," meaning "capable of assuming many forms." In the pantheon of international tax, this trait is found in the concept of a permanent establishment or taxable presence in a country, which may take such disparate forms as a place of management, an oil well, a computer server, or a relationship with a dependent agent—examples that bespeak the various organizational, physical, economic, and legal ties of a non-resident to a jurisdiction that can give rise to a permanent establishment. In bilateral tax treaties, the permanent establishment concept generally is

used to identify the degree of objective presence of a non-resident in a country sufficient to establish the country's right to tax certain of the non-resident's business profits.

The interweaving of the different components of the concept is perhaps nowhere more evident than in assertions that a company has a permanent establishment at or through a parent, subsidiary, or sister company ("an affiliated corporation PE").[1] Such assertions frequently arise in the context of large multinational enterprises (MNEs), which often change the location and the legal (if not the economic) structure of their activities in order to minimize costs, including the effective tax rate on worldwide group activities. Affiliated corporation PEs may thus at times challenge a jurisdiction's commitment to respect the separate legal personality of corporations. The idea that one company within an affiliated group can be the permanent establishment of another is an inherently unstable and contested notion: it involves various intermingled aspects of the permanent establishment rules, a sometimes selective regard for legal form, and the competing claims of the countries where parent and subsidiary reside. Though the concept of an affiliated corporation PE is often lacking in analytic clarity, this does not mean that it is without logical coherence or not susceptible to some elucidation.

This article expounds and critically examines the law in respect of affiliated corporation PEs and certain domestic law analogues. There is remarkable continuity in the legal issues and analysis in these contexts—specifically, in the increasing claims by jurisdictions that a subsidiary is a permanent establishment of its parent company; in the considerable body of Canadian tax jurisprudence applying non-treaty tax law to affiliated corporations' intermingled business activities; and ultimately in certain early UK non-tax decisions establishing and also contesting the corporation as a distinct legal person, a status that overlaps with that of a corporation as a separate taxpayer in its own right.[2]

The discussion is divided into three parts. The first part summarizes the tax treaty rules relevant to affiliated corporation PEs and introduces some of the key issues that these rules raise by outlining aspects of their historical evolution. The second part considers how the terms of debate for this international tax issue were cast or anticipated in certain early UK corporate law and tax decisions, which pose some of the issues at stake in an especially perspicacious manner. I will show how the principles established in those decisions, and the legal and policy dilemmas that they created,

1 The use of the term "affiliated corporation PE" should not be construed as suggesting a new category of permanent establishment. Rather, the term is used as shorthand to refer to related-company dealings that give rise to a permanent establishment based on the traditional categories (for example, fixed place of business, dependent agent).

2 The principle that a corporation is a separate taxpayer, distinct from its other corporate and non-corporate shareholders and other related persons, is of course not inviolable, as seen, for example, in the attribution of foreign income to the shareholders of a legally separate corporation in controlled foreign corporation regimes, such as Canada's foreign accrual property income rules. See Robert Couzin, *Corporate Residence and International Taxation* (Amsterdam: IBFD Publications BV, 2002), 16.

were carried over into a succession of 20th-century tax cases, both Canadian and English, in which courts were asked to draw aside the corporate veil on the basis that the subsidiary was the mere instrument of its parent. The lists of relevant factors developed in these cases suggest guidelines that may be used in a contemporary treaty analysis of affiliated corporation PEs. The third part of the article discusses a number of recent foreign court decisions in which MNE subsidiaries have been treated as permanent establishments of foreign parents, in what might be considered an indirect attempt to tax a portion of worldwide residual group profits in a local jurisdiction without having to undertake a full transfer-pricing analysis. These contemporary court decisions, as well as the recent report of the Organisation for Economic Co-operation and Development (OECD) on the allocation of business profits, are analyzed as attempting to both apply and overcome an inherited tradition in which legal form and legal personality have structured debates about the rights of source countries[3] to tax the business profits of non-residents.

AFFILIATED CORPORATION PEs IN TAX TREATIES

The Function of the Permanent Establishment Concept in International Tax

The allocation of business profits to a permanent establishment is a treaty analogue of, and limit upon, the rule in the internal law of most countries that subjects non-residents to taxation on a net basis (that is, gross income less allowable deductions) in respect of income from, or effectively connected with, a trade or business carried on in the country. Canada, for example, imposes "ordinary" income tax—that is, tax assessed under part I of the Income Tax Act—on income from a business carried on by a non-resident person in Canada.[4] By entering into a bilateral income tax convention with another country, however, Canada will curtail the circumstances in which it can so tax the residents of the other country.

Where a tax treaty applies, the existence of a permanent establishment is a threshold that must be met in order for a country to tax a non-resident on its business profits earned within the country. The function of such a threshold requirement is to identify those non-resident taxpayers with a sufficiently robust economic connection to a jurisdiction to justify taxation therein.[5] A lesser degree of commercial activity or

3 The term "source country" is used here to refer to the country in which the permanent establishment is located and the relevant business profits arise. In practice, however, source of income and situs of permanent establishment may not coincide: a resident of country A can have a permanent establishment in country B, which earns income sourced to country C.

4 Subsection 2(3) and subparagraph 115(1)(a)(ii) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

5 See Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003), 55-108, at 65 and 98.

presence generally is required under the internal law of most countries for a finding that a non-resident carries on a trade or business within the country than is required under tax treaties to find that the non-resident also has a permanent establishment in the country. Thus, under appropriate circumstances, taxpayers with foreign commercial activities often rely on the permanent establishment "test" to protect their commercial profits from taxation by a country with which their nation has a bilateral tax treaty.

The full relevance of the permanent establishment test is its relation to the tax treaty rule governing the allocation of business profits. Most of Canada's tax treaties currently in force are based on the model tax treaty drafted and periodically revised by the OECD.[6] If under such a treaty it is determined that a non-resident enterprise has a permanent establishment in a country, the next question is what, if any, are the profits on which that permanent establishment should pay tax. Article 7 (Business Profits) of the OECD model allows the source country to tax only those notional profits that the permanent establishment would have made if it had dealt as an independent enterprise with the non-resident enterprise. Since the latter enterprise will generally be subject to tax on the same profits in its country of residence, that country typically will grant relief from double taxation, through a foreign tax credit or exemption regime.

In general, as summarized by Arthur J. Cockfield, a permanent establishment is meant to represent a "fixed physical presence within the source country that lasts for a significant period of time and performs integral aspects of a cross-border transaction."[7] Permanent establishment status usually applies to branches and other parts of a non-resident enterprise that do not have separate legal personality. Owing to the many different ways of organizing commercial endeavours, the term "permanent establishment" cannot be encapsulated in a single lapidary formula. It is explained in article 5 (Permanent Establishment) of the OECD model by means of a combination of definition, examples, carve-outs, and exceptions to exceptions. The relevant elements of article 5 are the following:[8]

6 Herein referred to as "the OECD model." Unless otherwise noted, references in this article are to the current version: Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2005) and the accompanying commentary ("the commentary").

7 Arthur J. Cockfield, "Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test" (2003) vol. 38, no. 3 *Canadian Business Law Journal* 400-24, at 402, reprinted in (2004) vol. 33, no. 7 *Tax Notes International* 643-54.

8 For a discussion of the various elements of the permanent establishment article in tax treaties, see Richard G. Tremblay, "Permanent Establishments in Canada," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 38:1-69. A more detailed examination of article 5 as it applies to agency arrangements in particular can be found in John F. Avery Jones and David A. Ward, "Agents as Permanent Establishments Under the OECD Model Tax Convention" [1993] no. 5 *British Tax Review* 341-83, appearing also in (1993) vol. 33, no. 5 *European Taxation* 154-81.

- Paragraph 1: For purposes of the treaty, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
- Paragraph 2: The term "permanent establishment" includes, among other things, a place of management, a branch, and an office.
- Paragraph 5: Notwithstanding paragraphs 1 and 2, a non-resident generally is deemed to have a permanent establishment in a contracting state if a person (a so-called dependent agent) acts on behalf of the non-resident and has, and habitually exercises, in the contracting state an authority to conclude contracts in the name of the non-resident.
- Paragraph 6: A non-resident does not have a permanent establishment in a contracting state merely because it carries on business in that state through an agent of an independent status acting in the ordinary course of its business (an independent agent).
- Paragraph 7: The fact that a company that is a resident of a contracting state controls or is controlled by a company that is a resident of the other contracting state does not by itself constitute either company a permanent establishment of the other.

These rules in article 5 of the OECD model serve as markers of the scope and limits of a country's ability to tax a non-resident's commercial profits. The various building blocks of the permanent establishment concept—and, of course, paragraph 7 in particular—all come into play in the analysis of affiliated corporation PEs. The story of how some of these elements came to assume their current form casts light on the tax policy tensions involved in potentially treating a company as having a permanent establishment at or through its affiliate.

Development of Treaty Provisions Relevant to the Affiliated Corporation PE Concept

When the core provisions of bilateral income tax treaties were being formulated in the early 20th century, there was hesitancy over whether corporate affiliation should give rise to a permanent establishment.[9] After all, the influence or control that is generally exercised by a parent company over its subsidiaries might give rise to an argument that a parent has a place of business through or in respect of its foreign subsidiary. So, in the first draft of the League of Nations model tax treaty, which is in some respects the forerunner of the OECD model, article 5 stated:

9 For a comprehensive history of the development of the permanent establishment article, see Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer, the Netherlands: Kluwer, 1991), 71-101 and 540-41.

> The real centres of management, *affiliated companies*, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments.[10]

Remarkably, affiliated companies and unincorporated branches were listed in succession as types of permanent establishments, as if legal form had little to do with the concept. This mode of thinking would soon change. In the draft model of the following year (1928), the reference to affiliated companies was dropped. However, a number of bilateral tax treaties remained in force treating affiliated companies as permanent establishments.[11]

During this period, a US lawyer, Mitchell B. Carroll, conducted a study for the League of Nations on the allocation of business profits that had a significant impact on the evolution of the model tax treaty, including its permanent establishment provisions.[12] Carroll included as one of the essential prerequisites for a regime of business profits allocation the tenet that subsidiaries should be treated as independent enterprises, which in his view meant doing away with the notion of the affiliated corporation PE. Although Carroll's study was focused on allocation of profits, he considered that the question of allocation depended to some extent on ascertaining the boundaries of the taxable units among which profits should be allocated. In the context of article 5, this meant identifying the relevant "undertaking" sought to be taxed in the host jurisdiction (corresponding, today, to the "enterprise" in the OECD

10 "Draft of a Bilateral Convention for the Prevention of Double Taxation," in League of Nations, *Double Taxation and Tax Evasion*, League of Nations doc. C.216.M.85.1927.II (Geneva: League of Nations, 1927), article 5 (emphasis added). This and other League of Nations materials have been made publicly available by the Sydney Electronic Text and Image Service, of the University of Sydney, from United States, Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions*, vol. 4 (Washington, DC: US Government Printing Office, 1962) (herein referred to as "LHUSTC") (online: http://setis.library.usyd.edu.au/oztexts/parsons.html). This particular treaty provision is found in LHUSTC, at 4125.

11 The issue was unsettled enough that in 1929 the International Chamber of Commerce, made up of representatives of international businesses, felt it necessary to urge in a code of principles for eliminating double taxation that a subsidiary company be excluded from the permanent establishment definition. International Chamber of Commerce, "Annex to Resolution I Passed at the Amsterdam Congress of the International Chamber of Commerce," July 8-13, 1929, cited in the Carroll report, infra note 12, at paragraph 623.

12 Mitchell B. Carroll, *Taxation of Foreign and National Enterprises*, vol. 4, *Methods of Allocating Taxable Income*, League of Nations doc. C.425(b).M.217(b).1933.II.A (Geneva: League of Nations, 1933) (online: http://setis.library.usyd.edu.au/oztexts/parsons.html — item 5). For discussion of the influence of the Carroll report on the evolution of article 7 in OECD-based tax treaties (allocation of business profits to a permanent establishment), see David A. Ward, "Tax Treaties: An Eroding Set of Rules," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 41:1-21, at 41:12; and Richard J. Vann, "Tax Treaties: The Secret Agent's Secrets" [2006] no. 3 *British Tax Review* 345-82, at 361-63. I am indebted to Vann's article for bringing to my attention much of the tax treaty history discussed here, including Carroll's discussion (rejection) of affiliated corporation PEs.

model and the "business" in the Canada-US treaty).[13] For Carroll, this meant clarifying the issue of whether two related corporations form a single taxable unit or undertaking:

> It is evident from the tenor of Article 5 and its commentary that the term "undertaking" or enterprise includes, when referring to a corporation, merely the corporate entity and its own branches, forming a part of the single corporate entity, and does not include subsidiary corporations organised in the same or other countries which are themselves separate legal entities.[14]

In other words, in identifying the relevant taxpayer, the country seeking to impose its tax on a non-resident's local activities should not seek to consolidate two or more members of the corporate group into one non-resident "undertaking." Each separate legal entity was to be treated as a separate taxpayer.

This was only part of the analysis, however, for recognizing the boundaries of the undertaking or enterprise to be coterminous with those of a single non-resident corporation did not conceptually preclude the corporation from having a permanent establishment at, through, or in respect of its legally separate local affiliate. Carroll went further and recommended "that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities."[15] The assumption that treating a subsidiary as a separate legal entity logically precludes its being a permanent establishment of another enterprise would later be rejected.

Carroll anticipated that tax authorities might worry that such unqualified deference to legal form could nurture tax-avoidance behaviour. In his view, denying that a legally distinct subsidiary could be a permanent establishment would not enable companies to artificially shift profits away from the true location of the relevant profit-making activities:

> [I]f it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.[16]

Thus, transfer-pricing adjustments based on the arm's-length principle are preferred to admitting the possibility of the affiliated corporation PE. (The interplay between these two choices is a recurring theme of Carroll's study.) Interestingly,

13 The main rule of article 5 in the 1928 League of Nations model stated, "Income . . . from any industrial, commercial or agricultural *undertaking* and from any other trades or professions shall be taxable in the State in which the permanent establishments are situated": League of Nations, *Double Taxation and Tax Evasion*, League of Nations doc. C.562.M.178.1928.II (Geneva: League of Nations, 1928), in LHUSTC, supra note 10, at 4162 (emphasis added).

14 Carroll, supra note 12, at paragraph 623.

15 Ibid., at paragraph 628.

16 Ibid.

Carroll did not make this choice because he thought it better approximated commercial practice: he observed, in fact, that at the time "the great majority" of parent companies treated their foreign subsidiaries as "mere branches of the entire concern," without independent local books and records, and did not price transactions with them as if they were independent enterprises.[17] That he nonetheless rejected the affiliated corporation PE as a possibility is explained by the commitment to legal form exhibited in his discussion of the "undertaking." He observed, for example, that even though no profit is realized by the corporate group as a whole when a sale is made by one group member to another, the jurisdiction in which the seller is based is entitled to tax the transaction because the seller is a separate legal entity and, in matters of taxation, "[e]conomic fact must inevitably give way to the definite principles and provisions of law under which business is conducted."[18] Thus, in Carroll's influential report, although a subsidiary might be economically integrated with, and almost entirely absorbed by, a parent company, its separate legal personality meant, "in principle," that the subsidiary should not be treated as a permanent establishment of its parent. Carroll's reasoning is based on sound premises. The subsidiary is itself subject to tax by its country of incorporation on its worldwide income, or at least on its domestic-source income. Because the subsidiary is a separate legal entity, the source-country tax on the subsidiary is not a proxy for a tax on the non-resident corporation.[19] Consequently, and in light of the availability of the transfer-pricing mechanism, the subsidiary itself should not be a permanent establishment.

Carroll's recommendation, it has been said, led to the adoption of what became paragraph 7 of article 5 found in most tax treaties.[20] In the 1933 League of Nations model, the first step was taken in the direction of something like article 5(7) by the inclusion of the express statement that a permanent establishment "does not include a subsidiary company."[21] This flat denial of the possibility that a subsidiary could be a permanent establishment was diluted in later models, so that by 1946 the wording resembled today's less categorical rule that the mere fact that a non-resident is in a control relationship with a company resident (or carrying on business) in another treaty country does not of itself give rise to a permanent establishment in that country.[22] In one sense, this clause and its interpretation by the League of Nations and

17 Ibid., at paragraphs 4 and 6.

18 Ibid., at paragraph 626.

19 See Arnold, supra note 5, at 68.

20 Vann, supra note 12, at 362.

21 "Draft Convention Adopted for the Allocation of Business Income Between States for the Purposes of Taxation," in League of Nations Fiscal Committee, *Report to the Council on the Fourth Session of the Committee*, League of Nations doc. C.399.M.204.1933.II.A (Geneva: League of Nations, 1933), in LHUSTC, supra note 10, 4243-47, at 4246.

22 See article V(8), "Model Bilateral Convention on the Prevention of the Double Taxation of Income and Property," in League of Nations Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations doc. C.88.M.88.1946.II.A (Geneva: League of Nations, 1946), in LHUSTC, supra note 10, 4323-4435, at 4397: "The fact that a parent

subsequently the OECD is consistent with Carroll's view of the primacy of legal form over commercial reality. Indeed, the commentary by both bodies states that the rule follows from the principle that, for the purpose of taxation, a subsidiary company constitutes an independent legal entity.[23]

In another sense, however, the current version of article 5(7) represents a retreat from the Carroll position, in that it provides that control does not "of itself" make one company the permanent establishment of the other. This is not the same as denying on principle that a corporation can be, or can give rise to, a permanent establishment of a related corporation. The wording of article 5(7) opens the door to factors other than control that might make a company the permanent establishment of a related company.

On what grounds other than mere control might an affiliated corporation PE be found to exist? As discussed above, in general under article 5, a non-resident can have a permanent establishment in a state if, among other things, it carries on its business through a fixed place of business located in that state (article 5(1)) and/or an agent in that state has and habitually exercises the authority to enter into contracts on the non-resident's behalf (article 5(5))—unless the agent is independent (article 5(6)). Article 5(7) does not suspend the application of these rules in the case of related-company dealings. As early as 1963, the OECD commentary on article 5(7) recognized that an affiliated corporation PE could arise on the basis of agency:

> Where, however, the subsidiary company, on behalf of its parent company, carries on an activity within the provisions of paragraph 4 of the Article [currently paragraph 5: agent not of an independent status], that subsidiary company is deemed to be a permanent establishment of the parent company.[24]

This is a very broad exception to article 5(7), since there are potentially many instances where dealings between a subsidiary and its parent company would give rise to a permanent establishment based on dependent agency. It may be noted, however, that this rule poses no challenge to the separate legal personality of each company, for a principal-agent relationship can only exist between two distinct legal persons.[25] If this represents an erosion of foundational League of Nations thinking on the issue, it is not severe.

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company, the fiscal domicile of which is one of the contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State."

23 "Commentary on the Model Bilateral Convention on the Prevention of the Double Taxation of Income and Property," in *London and Mexico Model Tax Conventions: Commentary and Text*, supra note 22, in LHUSTC, supra note 10, 4323-4435, at 4337; and paragraph 40 of the commentary on article 5 of the OECD model.

24 Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963), paragraph 23 of the commentary on article 5.

25 For an alternative view of article 5(5) as not incorporating the legal concept of agency, see Chang Hee Lee, "Instability of the Dependent Agency Permanent Establishment Concept" (2002) vol. 27, no. 11 *Tax Notes International* 1325-34, at 1326-27.

Recently, however, the OECD has begun to move incrementally in a different direction. In 2003, the commentary on article 1 (Personal Scope) was revised to state that under certain circumstances, not necessarily involving agency, a subsidiary may have a permanent establishment at parent company headquarters by virtue of being managed there.[26] This statement, which shows a greater willingness to find a permanent establishment on the basis of actions taken behind what is sometimes styled the corporate façade, attenuates the protective force of article 5(7). In 2005, the OECD moved still further in this new direction by redrafting its commentary on article 5(7) to explain that agency is now one of two bases on which an affiliated corporation PE can arise under article 5:

> *A parent company may, however, be found, under the rules of paragraphs 1* [fixed place of business] or 5 [agent not of an independent status] of the Article, *to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary . . . that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent* under paragraph 1. . . . Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent.[27]

The OECD indicates here that a line is crossed if the parent carries on business at the premises of the subsidiary, such that there are two legal entities present at the same locale. Separate legal personality and separate jurisdictions of residence seem no longer, for permanent establishment purposes, to create a presumptive firewall between related corporations. The addition or acknowledgment of the fixed place of business category as a basis for an affiliated corporation PE represents a further erosion of the Carroll model.

The discussion above has presented the basic elements of the affiliated corporation PE "rules." The mere fact that two corporations are in a control relationship will not make one the permanent establishment of the other. Nonetheless, where the subsidiary's premises constitute a fixed place of business through which the parent carries on its own business, or where the subsidiary is the parent's dependent agent, there will be an affiliated corporation PE. It is far easier to state the rules than to grasp their practical import and application. In particular, the distinction between the parent's business and the business of the subsidiary is often difficult to discern, especially where functions, benefits from intangibles, and service and product lines

26 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, 2003), paragraph 10.2 of the commentary on article 1.

27 Paragraph 41 of the commentary on article 5 of the OECD model (emphasis added).

within an MNE cut across legal entity boundaries.[28] This difficulty and attempts to meet its challenges are illustrated in the discussion of early non-treaty-based case law that follows. The legal issues raised by the OECD's guidance on affiliated corporation PEs are not new; for a long time, courts have had to determine when one corporation is acting as the agent of a related corporation, and when a subsidiary's business is subsumed within the parent corporation's business.

LEGAL PERSONALITY AND RELATED COMPANY ENMESHMENT: SELECTED CASES[29]

The discussion that follows reviews both tax and non-tax domestic law cases in which courts have had to ask the sorts of questions that the OECD believes are appropriate in ascertaining whether an affiliated corporation PE exists. In part, this mingling of commercial-law decisions with tax decisions is due to historical accident: the evolution of questions as to when a parent corporation should be charged with its subsidiary's liabilities (tax or otherwise) took place through a process of cross-fertilization between cases of both types.[30] Writing from a civil-law perspective, Jean Pierre Le Gall has written that "tax specialists . . . tend to consider the concept of the PE Subsidiary [that is, the affiliated corporation PE] as being exclusively tax-related and do not take into account that it derives from commercial [law] or is at least found in commercial or civil law."[31] A more substantive reason for considering commercial-law cases is that in Canada and countries with a similar tax system, income tax consequences are generally determined by applying the rules of

28 See J. Scott Wilkie, "Policy Forum: Attribution of Profits to a Permanent Establishment" (2005) vol. 53, no. 2 *Canadian Tax Journal* 396-400, at 396: "Because contemporary business is likely to be conducted on functional lines across entities and other organizational manifestations of business presence within an enterprise, rather than merely between legally distinct members of the enterprise, the traditional expectations and tools of international tax analysis are called into question in quite fundamental ways."

29 The non-treaty-based case law examined in this section is exclusively from common-law jurisdictions (the United Kingdom and Canada). For an overview of the civil-law versions of cases that have pierced the corporate veil, see Jean Pierre Le Gall, "Can a Subsidiary Be a Permanent Establishment of Its Foreign Parent? Commentary on Article 5, Par. 7 of the OECD Model Tax Convention," presented as the David R. Tillinghast Lecture on International Taxation at the New York University School of Law, September 26, 2006.

30 For instance, in one of the leading early English commercial-law cases taken to have established the principles on which a subsidiary would be found to be the agent of its parent company and carrying on its business, the court distilled those principles after having "looked at a number of cases—*they are all revenue cases*—to see what the courts regarded as of importance for determining that question": *Smith, Stone & Knight*, infra note 42, at 121 (emphasis added). In turn, a commercial-law case like *Smith, Stone & Knight* may be invoked by tax courts in making agency determinations. See, for example, *Denison Mines Ltd. v. MNR*, 71 DTC 5375 (FCTD); aff'd. 72 DTC 6444 (FCA); *De Salaberry Realties Ltd. v. MNR*, 74 DTC 6235 (FCTD); and *1462 Investments Ltd. v. The Queen*, 95 DTC 376 (TCC).

31 Le Gall, supra note 29.

the taxing statute to the actual legal relationships between the parties,[32] and it is thus relevant to a tax specialist to be familiar with the grounds on which a court will determine that, under agency law for example, a company is carrying on the business of its shareholder rather than its own business. Finally, the non-tax cases bear a certain factual kinship to tax-avoidance cases. In a 1995 commercial-law decision, a UK court stated that a person is ordinarily entitled "to organise and conduct its affairs in the expectation that the court will apply the principle of *Salomon v A Salomon & Co Ltd*."[33] It is not entirely surprising that a non-tax decision regarding legal personality, in speaking of the right to "organise and conduct" one's affairs in a certain way, echoes the language used in certain famous tax-avoidance cases,[34] for the deliberate use of legal form to avoid liabilities or obtain certain benefits is not unique to tax. This is demonstrated in the first instance by the House of Lords' decision in *Salomon v. Salomon & Co.*[35]

The Salomon Decision

In 1892, Aron Salomon transferred the manufacturing business that he had carried on as a sole proprietor to a joint stock company. The relevant corporate statute required a minimum of seven shareholders, each of whom had to hold at least one share, in order to validly form a corporation. Six of Salomon's family members were allotted one share each; and Salomon, in consideration for the transfer of the business, was allotted 20,001 shares, as well as debentures with a floating security over the corporate assets. After incorporation, the business was carried on as before. It is unclear whether a board of directors was ever appointed. Bad times ensued, and the company became unable to pay its trade debt, which was subordinated to the debentures. The liquidator of the company sought to overcome the company's limited liability so that its trade creditors could reach Salomon's personal assets.

Two lower courts held that Salomon could not rely on limited liability under the statute, on the basis, in fact, of the primary ground on which an affiliated corporation PE may exist, namely, agency, or the controlling shareholder's conduct of its business through the company. That the House of Lords rejected the arguments of both courts and the manner in which it did so in this seminal case are therefore worth noting.

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32 See, for example, *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669, at paragraph 39 (SCC): "[A]bsent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases."

33 *Acatos & Hutcheson v. Watson*, [1995] 1 BCLC 218, at 223 (Ch. D.). The *Salomon* decision is discussed below.

34 See, for example, *Helvering v. Gregory*, 69 F. 2d 809, at 810 (2d Cir. 1934) (aff'd. sub nom. *Gregory v. Helvering*, 293 US 465 (1935)) ("Any one may so arrange his affairs so that his taxes shall be as low as possible"); and *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1, at 19 (HL) ("Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be").

35 [1897] AC 22 (HL).

Commenting on the finding by the court of first instance that the company was the agent of its dominant shareholder, Lord Herschell distinguished between a popular meaning of "agent" and the legal meaning of the term. He observed that while, in some sense, all companies could be said to carry on business for and on behalf of their shareholders, this does not give rise to an agent-principal relationship for legal purposes.[36] More pointedly, Lord Halsbury identified an inconsistency in the lower court combining the agency argument with the argument that this was a corporation utterly absorbed into the business of its shareholder:

> I observe that the learned judge (Vaughan Williams J.) held that the business was Mr. Salomon's business, and no one else's, and that he chose to employ as agent a limited company. . . . [T]hat very learned judge becomes involved by this argument in a very singular contradiction. Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. Salomon. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not.[37]

Two important and distinct ideas work their way through this passage. One is that a non-existent legal person cannot be an agent of another person. The second idea, an assertion more than a reasoned conclusion, is that the separate legal personality of a controlled company necessarily implies that the business carried on by it must be its own.

Applying similar assumptions, the House of Lords also rejected the validity of another assault, not based on agency, on the separate legal personality of Salomon & Co. The Court of Appeal had found that the legal consequences (such as limited liability of the company formed) of an admittedly valid incorporation procedure could be denied under the circumstances, owing to the alleged motives of the controlling shareholder—the defrauding of creditors—which, in the court's view, went against legislative intent. The House of Lords, however, could find no intent in the corporate statute that had been violated, all of its requirements having been complied with. As Lord Halsbury pointed out, a corporation is an artificial creation of the legislature, and in determining whether a real company exists, it is "essential to the artificial creation that the law should recognise only that artificial existence—quite apart from the motives or conduct of individual corporators."[38] Once the corporation has been validly formed, artificiality begets reality, so to speak, such that the corporation forthwith has "legal existence with . . . rights and liabilities of its own." Thus, while the House of Lords could freely admit that both before and after the

36 Lord Herschell made a similar complaint in another case, *Kennedy v. De Trafford*, [1897] AC 180, at 188 (HL): "No word is more commonly and constantly abused than the word 'agent.'" For a Canadian case expressing this sentiment, see *Pullman v. The Queen*, 83 DTC 5080, at 5082-83 (FCTD).

37 Supra note 35, at 31.

38 Ibid., at 30.

incorporation of a "one-man" business, the business may be carried on in the same way, with the same individual taking all the profits and being in absolute control of decisions, it could still disagree with the lower courts' view of the company as but an "alias" for its shareholder: "It is not another name for the same person; the company is ex hypothesi a distinct legal persona."[39]

As we shall see, later courts in commercial-law and tax cases have not always agreed with some of the fundamental assumptions in *Salomon*. While they accepted that a validly incorporated entity is a distinct legal person, they were to challenge the notion that the separate legal personality of a controlled company implies that the business carried on is invariably distinct from that of its controlling shareholder. That development was to prove important for international tax, since the possibility that a separately incorporated company can carry on the business of a related entity is at the heart of the affiliated corporation PE concept.

Subsequent UK Decisions

Although the House of Lords in 1897 did not find Salomon & Co. to be the agent of Aron Salomon, subsequent courts came to hold the view that a corporation could be found to be the agent of its dominant shareholder without doing any violence to corporate personality. In a 1908 income tax decision, *Gramophone and Typewriter, Limited v. Stanley*, the Court of Appeal echoed the *Salomon* decision by stating that, once incorporated, a business is presumed to be the business of the corporation and not that of its shareholder(s), no matter how dominant the shareholder(s) may be.[40] The court went on, however, to admit the possibility of an agency relationship as between shareholder and corporation:

> I do not doubt that a [controlling shareholder] may cause such an arrangement to be entered into between himself and the company as will suffice to constitute the company his agent for the purpose of carrying on the business, and thereupon the business will become, for all taxing purposes, his business. Whether this consequence follows is in each case a matter of fact.[41]

This passage shows that while the notion of agency respects—and in a sense depends upon—the boundaries of legal persons, it is premised on the partial erasure of another line, namely, that between the business of the principal and the business of the agent, asserting identity between the two: "the business [of the company/agent] will become, for all taxing purposes [the shareholder/principal's] business."

Subsequently, instead of merely being entertained as a possibility, the assimilation of the business of a corporation with the business of its sole shareholder

39 Ibid., at 42, per Lord Herschell.

40 [1908] 2 KB 89, at 95-96 (CA).

41 Ibid., at 96.

through agency principles was applied to related companies in the 1939 case of *Smith, Stone & Knight v. Birmingham Corpn.*[42] This was a test case for the agency hypothesis insofar as it involved a properly incorporated subsidiary with very little legal or economic independence. The parent company had acquired a manufacturing business operated in partnership form and subsequently incorporated the business. The new subsidiary's name had been placed on the business premises and on stationery. The parent company sought compensation from the city of Birmingham for expropriation of the subsidiary's factory, arguing that the business carried on at the factory nominally occupied by the subsidiary was the parent's business. The issue before the court was whether "the subsidiary was carrying on the business as the [parent] company's business or as its own."[43] The court found that the subsidiary was an agent of the parent company:

> Indeed, if ever one company can be said to be the agent or employee, or tool or simulacrum of another, I think the [subsidiary] company was in this case a legal entity, because that is all it was. There was nothing to prevent the claimants [the parent company] at any moment saying: "We will carry on this business in our own name." They had but to paint out the [subsidiary] company's name on the premises, change their business paper and form, and the thing would have been done. I am satisfied that the business belonged to the claimants; they were, in my view, the real occupiers of the premises.[44]

Translating the court's finding into the terminology of the permanent establishment article, one would say that here dependent agency principles were applied to arrive at a fixed place of business result: having found that the subsidiary was the agent of the parent company, the court concluded that the parent company was the real occupier of the subsidiary's premises. Because the case conceptually cuts across both categories that can give rise to an affiliated corporation PE, the factors that led to the court's conclusion are worth noting. The principal factor appears to have been the fact that at no time was the subsidiary treated as a separate profit-and-loss centre, with the ability to pay dividends or retain earnings. In fact, the subsidiary's profits were not paid out as dividends but merely "allocated" to other divisions of the parent company. In addition, the subsidiary had no separate books and records; instead, its finances were reflected in the parent's books. A second factor considered was the passivity of the subsidiary's board of directors. The decision to distribute profits in the manner described, for example, was made by the parent company, not by the directors of the subsidiary. A third factor had to do with expertise. The subsidiary lacked the personnel to carry out its purported business functions: it had one manager and no other

42 [1939] 4 All ER 116 (KB).

43 Ibid., at 121.

44 Ibid.

employees. All these circumstances tended to show that it was the parent company's business that was carried on at the premises of the subsidiary.[45]

It should not be assumed, however, that affiliated companies risk being treated as having formed an agency relationship only if one of them demonstrates little independent functioning. Indeed, in a 1957 case, *Firestone Tyre Co., Ltd. v. Lewellin*,[46] the House of Lords held that a US parent company exercised a trade in the United Kingdom through its wholly owned subsidiary as agent in circumstances where there was no issue of excessive control by the parent company. The *Firestone* case is of particular relevance here, since it applies agency in the context of an MNE and does so in considering a legal issue (carrying on business within a jurisdiction) that bears a significant family resemblance to the permanent establishment issue. The facts in *Firestone* are worth considering in some detail because the court's conclusions are based on findings as to the implied legal relationships—what has been termed the "legal substance" of transactions—as well as their most immediately apparent legal form.[47]

The taxpayer, Firestone Tire and Rubber Co. of Akron, Ohio ("Akron"), was the parent company of a number of US and foreign subsidiaries that manufactured and sold rubber and tires. One of these subsidiaries, Firestone Tyre and Rubber Co., Ltd. located in the UK town of Brentford ("Brentford"), manufactured products using the Firestone trademark owned by Akron. Brentford's products were ordered and purchased by third-party distributors throughout Europe. A master agreement entered

45 *Smith, Stone & Knight* became an important case because it identified several questions that are relevant in determining whether a subsidiary has been acting as the agent of its parent company: (1) Were the profits treated as the profits of the parent company? (2) Were the persons conducting the business appointed by the parent company? (3) Was the parent company the head and the brain of the trading venture? (4) Did the parent company govern the adventure, decide what should be done, and decide what capital should be embarked on the venture? (5) Did the parent company make the profits by its skill and direction? (6) Was the parent company in effectual and constant control?

46 [1957] 1 All ER 561 (HL).

47 It has been suggested that there is a limited sense in which UK and Canadian courts deciding tax cases will readily accept that substance prevails over form. The concept is well explained in a passage from a treatise (*Simon's Income Tax*, 2d ed., vol. 1 (London: Butterworths, 1965), 50) cited with approval by Bowman J in *Continental Bank of Canada et al. v. The Queen*, 94 DTC 1858, at 1869 (TCC): "The true principle, then is that the taxing Acts are to be applied in accordance with the legal rights of the parties to a transaction. It is those rights which determine what is the 'substance' of the transaction in the correct usage of that term. Reading 'substance' in that way, it is still true to say that the substance of a transaction prevails over mere nomenclature." The term "legal substance" was used recently in this sense by Miller J in *CCLI (1994) Inc. v. The Queen*, 2006 DTC 2695, at paragraph 26 (TCC): "It is one thing to pit legal form against economic substance, but what if the question is framed as legal form versus legal substance? There are many examples where the courts find the legal form mischaracterizes the legal substance (a common example is a contract between an employer and employee that stipulates the contract is one of an independent contractor)." See Jinyan Li, "'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) vol. 54, no. 1 *Canadian Tax Journal* 23-56, at 43.

into in the United States between the US company and each distributor conferred on the distributor exclusive rights to sell Firestone products within a territory. The House of Lords called these agreements "one of the basic treaties on which the international organisation of Akron was built up."[48] The master agreement fixed many of the terms of sale, including price. Under the agreement, the distributor was supposed to place orders with Akron; however, in practice, the distributors sent their orders directly to Brentford.

The principal factual ambiguity pertains to who was the seller of tires manufactured by Brentford. Was Akron the seller of tires that were manufactured for it by contract with Brentford, or was Brentford the seller of tires to parties (and under terms) that happened to be pre-approved by Akron? Brentford did not solicit customers or otherwise try to build a market for its goods; tires were shipped only to European distributors authorized by Akron. Until 1939, Brentford would receive orders from the authorized distributors, deliver goods in fulfillment of each order, and deposit payment from the distributor into Akron's UK bank accounts. According to the taxpayer, Brentford's only profit in respect of the sales was indirect, derived from its manufacturing and delivery fee of cost plus 5 percent under the contract with Akron. Following the outbreak of the Second World War, when the UK government imposed strict limits on the outbound flow of currency, Brentford put the monies received from distributors in its own bank account and, after subtracting its manufacturing fee, entered in its books a debt to Akron for the balance. Akron included the products shipped out of Brentford to European distributors in its own sales ledgers. Thus, during the war, although the US connection to the selling operations had grown increasingly remote, Brentford and Akron continued to treat the sales to European distributors as sales by the US company.

The United Kingdom sought to tax Akron on the wartime European sales proceeds less the fee it paid Brentford, on the basis that Akron was exercising a trade in the United Kingdom through Brentford as its agent. Akron argued that the place of contract is the key factor in determining where a trade is exercised and that the relevant agreements governing the Firestone sales were those made outside the United Kingdom—that is, the master agreements between Akron and its distributors, to which the UK subsidiary was not a party. As a matter of contract law, the House of Lords took a different view, finding that each time a distributor placed an order with Brentford, an offer was made that was accepted by delivery of the goods or some earlier action on the part of Brentford. Implicitly, this meant that the seller of the tires was the UK manufacturing subsidiary.[49] Because the (unwritten) contracts of

48 Supra note 46, at 568.

49 The House of Lords furthermore cited the well-known statement that, in any event, the fundamental criterion in determining where a trade is exercised is where the operations take place from which the profits in substance arise: see *Smidth & Co. v. Greenwood*, [1921] 3 KB 583, at 593 (CA); aff'd. [1922] 1 AC 417 (HL). It found that those operations—manufacturing, selling, and initiating delivery—took place largely in the United Kingdom.

sale were made in the United Kingdom, a trade was exercised in the United Kingdom. This left only one question outstanding, namely, whether that trade belonged to Akron or Brentford.

To answer that question, the UK court invoked agency. There was never any doubt that the UK subsidiary had to be taxed on the portion of the European sales equal to its manufacturing and delivery fee of cost plus 5 percent. The amount in issue was the residual profit earned by the two companies combined on third-party sales. Today, we might say that if Brentford's role in the profit-generating operations was so substantial during the war years that a 5 percent profit margin was insufficient compensation, one possible solution would have been an upward transfer-price adjustment of the fees paid to Brentford and taxed in its hands by the United Kingdom. It is unclear whether this option was available to the UK tax authorities at the time.[50] A different way of taxing the residual profit—and the one chosen by the UK courts in *Firestone*—was to treat the US parent company as exercising a trade of manufacturing and selling tires in the United Kingdom through an agent, the UK subsidiary:

> [T]he effect of the agreement . . . and the course of the dealings between Akron and Brentford was to set up standing arrangements whereby Brentford agreed to hold goods of its own at the disposal of Akron and to sell the same on Akron's behalf to customers approved of by Akron and subject to terms imposed by Akron; and, further to account to Akron for the proceeds of the sales less the cost of the goods sold plus five per cent.[51]

In this description, based on agency, the uncertainty as to the identity of the seller of Firestone products is resolved in the US company's favour, because the UK company had to account to it for sales proceeds less a commission. However, the House of Lords had also found, in determining where the relevant contracts were made, that the seller of the goods was the UK company. How can this contradiction be explained?

One explanation may lie in the fact that the complex legal relationships created within the Firestone group were themselves riddled with inconsistency. Far from being the type of corporate shell that might be described as a mere instrument of its shareholder, during the war years the UK subsidiary became in one sense too operationally independent, unsettling through a course of conduct the arrangements that had been carefully planned in an attempt to keep contractual and selling activity outside the United Kingdom. This is not a unique situation: under conditions of international business and modern communication facilities, the relations created by both written and implied agreements between members of an MNE, and between the MNE and third parties, can be, as in *Firestone*, so richly layered and textured that the relevant legal relationships may become capable of multiple characterizations,

50 See Vann, supra note 12, at 357.

51 *Firestone*, supra note 46, at 567, quoting the decision of the tribunal of first instance, the Special Commissioners of Income Tax.

resulting in a picture of the overall network of relations that may not be internally consistent.

A second explanation of the inconsistency in *Firestone* addresses the question of whether the case is an example of substance-over-form judicial reasoning.[52] Seemingly countering the proposition that economic substance prevailed in the case, at each individual step in the analysis, the House of Lords in traditional fashion aimed first to determine the actual legal relationships between the parties in order to then apply the provisions of the taxing statute. To determine where the relevant trade was exercised, the court used contract law to find that unwritten sales agreements were formed in the United Kingdom; and to determine which legal entity exercised that trade, the court used agency law to find that the trade was exercised by Akron through Brentford as its agent—even though Brentford was supposed to have entered into contracts in its own name and thus was impliedly described as a principal in the previous step.[53] The analysis at each step is expressed in terms of legal form alone. The failure to note or the willingness to overlook inconsistencies in the description of the legal relationships between the parties at different parts of the analysis suggests a results-driven reasoning that reaches the same disposition as might be reached by expressly applying an economic substance approach. It is in this sense that *Firestone* can be considered a substance-over-form case.

A different judicial response to the difficulties involved in determining who is carrying on a particular business within a corporate group is to run somewhat more roughshod over legal boundaries than courts do in attempting to apply agency principles. There was a period, some decades ago, when UK courts at times simply disregarded the separate legal personality of a subsidiary over which the parent company exercised what was considered excessive control.[54] The pendulum in UK

52 This issue is canvassed by Vann, supra note 12, at 351-52. In his view, if substance prevailed over form in *Firestone*, it did so to the extent that agency was interpreted in a commercial rather than a strictly legal sense.

53 One of the Law Lords tried to address this difficulty with the following statement: "It is true that the goods sold belonged to Brentford and not to Akron, but this fact does not show conclusively that Brentford was selling the goods on its own behalf and not as agent." *Firestone*, supra note 46, at 567. Vann has commented (supra note 12, at 351) that this defensive assertion "seems curious as the general view is that, if an agent is selling goods on behalf of another, title passes from that other to the buyer, not from the agent."

54 See, for example, *H. Holdsworth, Ltd. v. Caddies*, [1955] 1 All ER 725 (HL) (in which an argument based on separate legal identities of subsidiaries within a group was dismissed as being "too technical"); *Merchandise Transport Ltd. v. British Transport Commission*, [1962] 2 QB 173 (CA) (the corporate veil was pierced because one of two companies was so much under the control of the other that the court regarded them as one commercial unit); *Littlewoods v. McGregor*, [1969] 3 All ER 855, at 860 (CA), per Lord Denning MR (a tax case in which it was held that the courts were entitled to draw aside the corporate veil "to see what really lies behind," and on that basis the parent company was treated as the owner of land that had been transferred to a subsidiary); and *DHN v. Borough of Tower Hamlets*, [1976] 3 All ER 462, at 467 (CA), per Lord Denning MR (three companies were treated as one on the basis that the group was "virtually the same as a partnership in which all the three companies are partners").

and Canadian law has to some extent swung away from this kind of disregard for corporate legal form.[55] A characteristic and more modern statement appears in a 1987 UK case in which the court was urged to accept the argument that a parent company and its subsidiary ought to be treated as a single legal person because the parent treated its subsidiary essentially as a branch. To this one judge responded:

> [Counsel] contends that from a practical point of view it makes no difference whether B.T.T.C. was a branch of B.T. or a subsidiary. . . .
>
> The reality of the matter is that B.T.T.C. is not a branch of B.T. That is not the way in which B.T. has chosen to organise its business as a bank.[56]

In other words, legal substance is not to be set aside on the basis of economic or "practical" characterizations. Another judge in the case responded in a way that echoes the 1933 Carroll report to the League of Nations:

> [Counsel] suggested beguilingly that it would be technical for us to distinguish between parent and subsidiary company in this context; economically, he said, they were one. But *we are concerned not with economics but with law*. The distinction between the two is, in law, fundamental and cannot here be bridged.[57]

These statements are more in line with current domestic approaches to tax avoidance in Canada and the United Kingdom, as well as with the OECD's guidance on affiliated corporation PEs, summarized above. The rejected approach—disregarding the separate legal personality of an affiliated entity—is perhaps the most direct way of achieving the result obtained by means of sometimes tenuous agency arguments. Indeed, as will emerge from the discussion of Canadian law that follows, within the application of agency principles to parent-subsidiary relations there is an element that is not unlike the disregarding of legal personality.

Canadian Cases

The analytical tools developed in the UK jurisprudence were soon put to work by Canadian courts to respond to what were perceived as tax-avoidance arrangements between related companies. The courts tested the limits of the *Salomon* principle and demonstrated the elasticity of agency arguments in responding to situations where selective incorporation appeared to be used to reduce the overall tax liability of a vertically integrated enterprise. Although the legislative schemes at issue in the decisions discussed in this section are no longer in force, the tax-avoidance concerns and analytic responses found in the decisions anticipate more recent assertions in

55 Regarding current judicial attitudes in the United Kingdom, see Leonard Hoffmann, "Tax Avoidance" [2005] no. 2 *British Tax Review* 197-206.

56 *Bank of Tokyo Ltd. v. Karoon*, [1987] AC 45, at 53 (CA), per Ackner LJ.

57 Ibid., at 64, per Goff LJ (emphasis added).

the tax treaty area that a corporation has a permanent establishment at or through a related corporation.

In dealing with a federal tax on sales of goods by their manufacturers imposed by the Special War Revenue Act, 1915, Canadian courts were repeatedly called upon to identify the boundary, if any, between the businesses of related corporations involved in the manufacture and sale of goods. In the typical fact pattern found in a number of cases,[58] operations were restructured such that a corporation that both manufactured and sold a product to third parties was replaced by a dual corporate structure—a manufacturing company and a selling company. Since the tax at issue was imposed on sales by manufacturers, taxpayers took the position that, after the restructuring, the relevant sales price was the price on the intercompany sale by the manufacturing entity to the selling entity, rather than the higher price charged by the selling entity to third parties. The Crown argued for the latter price and tried to overcome the difficulty that the tax was levied on manufacturers' sales, not on sales by distributors, by arguing either that one entity was the agent of the other or that the two entities should be treated as a single taxpayer.

One instance in which the government's arguments prevailed was the Supreme Court of Canada's decision in *Palmolive Manufacturing Co. (Ontario) Ltd. v. The King*.[59] The facts in the case followed the general pattern. Until 1924, a Canadian subsidiary of the Palmolive Company of Delaware manufactured and sold Palmolive products in Canada. In 1924, a newly incorporated Canadian subsidiary of the Palmolive Company ("MfrgCo") took over the manufacturing function in Canada. From then on, MfrgCo sold manufactured product to the previously existing Canadian subsidiary ("SellerCo"), which then sold the product to third parties. The taxpayer (MfrgCo) candidly admitted that the objective of placing manufacturing and selling in different entities was to pay less sales tax. The Supreme Court frustrated that objective by in effect disregarding the intercompany sale.

The court in *Palmolive* hesitated between legal formalism and substance-over-form reasoning. On the one hand, the court made findings that were based on agency and contract law authorities. Because SellerCo dictated the quantity of goods to be produced and the method of their manufacture, MfrgCo was said to be the agent of SellerCo, on the basis of an 1876 agency case apparently dealing with the outsourcing of manufacture to cottage dwellers.[60] Because the prices for sales between MfrgCo and SellerCo were determined by the US parent company, and because those prices were approved on behalf of each subsidiary by the same individual (acting as manager of each company), the court called into question whether a contract of sale truly existed between the two related companies. Thus, there were grounds within

58 In addition to the decisions discussed in this section, other similar cases decided under the Special War Revenue Act (RSC 1927, c. 179) included *A-G Can. v. Coleman Products Co.*, [1929] 1 DLR 658 (Ont. SC) and *The King v. Noxzema Chemical Co.*, [1942] 2 DTC 51 (SCC).

59 [1933] SCR 131.

60 *Dixon v. London Small Arms Company*, [1876] 1 AC 632 (HL).

the laws of agency and contract on the basis of which the court could disregard the intercompany sale.

On the other hand, the court also seems to have looked to something like economic substance. Writing for the court, Cannon J stated that "the character and substance of the real transaction must, for taxation purposes, be ascertained and the tax levied on that basis," and "we must, as matters of fact, identify the producer of the goods and determine the real price received by such producer."[61] While one might have considered the producer of the goods to be the entity that manufactured them and that entity alone, the court found otherwise, noting the close managerial and operational ties between the two companies: both had the same two senior officers; the selling company dictated manufacturing method and quantity; the manufacturing company shipped goods to customers on the instructions of the selling company (which therefore never handled the goods); and the manufacturing knowhow and product trademarks belonged to the selling company, which licensed them to the manufacturing company. Cannon J took a dim view of these intercompany arrangements:

> In this case, it is abundantly clear that the Palmolive soap is produced and sold to the public by a combination of these two incorporated departments of a foreign company doing business here in order to reach the Canadian consumer. While the two companies are separate legal entities, yet in fact, and for all practical purposes, they are merged, the [manufacturing] company being but a part of the [selling] company, acting merely as its agent and subject in all things to its proper direction and control.[62]

Thus, in the court's view, the manufacturing company was what one might term an absorbed agent—both an agent acting on behalf of a principal and itself a part of the principal. Conceiving of an absorbed agent requires a kind of double vision, in which boundaries of corporate personality alternately disappear and reappear. It may be observed that, in a Canadian income tax context, perhaps one of the benefits of having a statutory general anti-avoidance rule is that, in principle at least, courts may no longer need to do this kind of violence to general legal categories when seeking to counter tax avoidance.

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61 *Palmolive*, supra note 59, at 140. The allusion to economic substance appears to betray the influence of one of the US decisions that Cannon J referred to in support of his analysis. In *Southern Pacific Co. v. Lowe*, 247 US 330, at 337 (1918), the US Supreme Court wrote, "[I]t was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before." For more concrete evidence of the influence of the US case on the *Palmolive* decision, see infra note 62.

62 *Palmolive*, supra note 59, at 140. Parts of this passage are closely based on the 1918 *Southern Pacific* decision, supra note 61, at 337, where the US Supreme Court wrote, "While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control."

In other cases, the respect of Canadian courts for legal formality prevailed. For example, in *The King v. Plotkins*,[63] a 1939 case involving the same sales tax statute as in *Palmolive*, the Exchequer Court rejected the Crown's argument that a selling entity should be either merged with or treated as an agent of a related oil refining entity. The two companies had the same manager, shared a single bank account, occupied the same premises, and shared profits and losses annually. However, they were controlled by different shareholders, and the marketing company obtained 40 percent of its oil from sources other than the refining company. The court held that each company was an independent trading unit. Independence in the relevant sense, however, did not preclude operational interdependence:

> [The two companies'] business relations were of course intimate and probably so designed for their mutual advantage, but that does not of itself constitute them a single business enterprise for the purposes of the tax, or otherwise.[64]

Thus, close operational and managerial interrelatedness between legally related corporations need not lead to an agency finding or a merging of entities. This position anticipates the OECD's reaction to Italy's *Philip Morris* case, discussed in the next section.

Cases like *Plotkins* and *Palmolive* illustrate that sometimes, when it is asserted that, for tax purposes, one company is conducting the business of another closely integrated company, the objective may be an intrajurisdictional transfer-price adjustment. In a sense, the cases dealing with the federal sales tax on manufacturers represent an attempt by the government to adjust the sales price on manufactured goods. The same tactic is often used interjurisdictionally in income tax cases.[65] It prefigures the situation in a tax treaty context where a source country asserts that a company has a permanent establishment through an affiliate in order to increase the extent of profits attributable to the source country.

The difference between synergistic integration and utter absorption of the subsidiary's business with that of related entities was further explored in a line of Canadian cases dealing with a special municipal tax that, by its very nature, called for an inquiry as to whether a company carries on its own business or that of another group member. The tax in issue was the city of Toronto business assessment tax on profits or gains from trade.[66] Amounts received by a parent company headquartered in Toronto

63 [1939] 4 DLR 128 (Ex. Ct.).

64 Ibid., at 136.

65 For example, in *Dominion Bridge Co. Ltd. v. The Queen*, 75 DTC 5150 (FCTD), the Canadian-resident parent company and its offshore subsidiary were treated as a single entity, so that the cost of raw materials to the parent had to be computed by reference to the costs incurred by the subsidiary when purchasing the materials rather than the higher price at which they were sold to the parent.

66 This tax was imposed pursuant to the Assessment Act, RSO 1927, c. 238 (later RSO 1937, c. 272).

from subsidiaries (wherever situated) were included in the parent's tax base for purposes of business assessment if those amounts were respected as payments of passive income from separate corporate entities, and were excluded if they were characterized as income from the parent company's own business. A parent company subject to the tax thus had an incentive to argue that, irrespective of legal entity boundaries, a single business was carried on by the parent and its subsidiaries acting together.

Although the Toronto business assessment tax might sound obscure, a surprising number of taxpayer appeals made their way to high-level courts. *Toronto v. Famous Players Can. Corp.* was one such case.[67] Famous Players, a Toronto-based corporation, and its subsidiaries owned and operated movie theatres. Courts at all levels found that, for purposes of the business assessment tax, the income that Famous Players derived from its subsidiaries was income from its own business. This conclusion was based primarily on two factors. First, Famous Players had "virtual control" of not only the policy but also the day-to-day management of its subsidiaries. An executive committee of the Famous Players board of directors made all contracts and bookings, fixed admission prices, and bought supplies for the subsidiaries. Second, Famous Players generally treated the controlled companies' profits as its own. In most cases, no separate books and records were kept for each subsidiary, and after operational expenses were paid out of box office receipts, net profits of each subsidiary were deposited on a weekly basis into the parent company's bank account.

The Supreme Court of Canada commented on and refined the analysis employed in *Famous Players* in a later municipal business assessment tax case, *Aluminum Company of Canada Ltd. v. City of Toronto*:

> By the decision of this Court in the case of *City of Toronto v. Famous Players' Canadian Corporation Ltd.*, it is now settled that the business of one company can embrace the apparent or nominal business of another company where the conditions are such that it can be said that the second company is in fact the puppet of the first; when the directing mind and will of the former reaches into and through the corporate façade of the latter and becomes, itself, the manifesting agency. In such a case it is not accurate to describe the business as being carried on by the puppet for the benefit of the dominant company. The business is in fact that of the latter. This does not mean, however, that for other purposes the subsidiary may not be the legal entity to be dealt with.[68]

The notion here is that the subsidiary is admitted for legal purposes to be a separate person ("the legal entity to be dealt with"), but that separate legal personality does not guarantee that the subsidiary will be found to have its own business distinct from the business of its parent. The court made it clear that this method of treating

67 [1935] 3 DLR 685 (Ont. Co. Ct.); aff'd. [1935] OR 314 (Mun. Bd.); aff'd. [1935] 3 DLR 327 (Ont. CA); aff'd. [1936] SCR 141 (SCC).

68 [1944] SCR 267, at 271, per Rand J. This passage was referred to in 1994 as "illustrat[ing] the special relationship sought by the courts in order to justify treating two corporations as one for tax purposes": *Buanderie centrale de Montréal v. Montréal*, [1994] 3 SCR 29, at 47, per Gonthier J.

a subsidiary as carrying on the business of its parent company does not require an agent-principal relationship.

In applying these principles to the facts in *Aluminum Company of Canada*, the Supreme Court found that the subsidiaries of Aluminum Company were carrying on their own business and not that of the parent company. The court agreed that the parent company was interested in controlling, in one way or another, every step in a vertically integrated process. However, the standard the court had set was a high one: in order to be treated as conducting the parent company's business, the subsidiaries must be found to have no independent functioning of their own. In this case, that standard was not met:

> There is no doubt of the control of policy generally by the parent company. There is also a degree of connection in directorate personnel, but it is quite impossible to say, for instance, that the [subsidiary] company does not function in its own right as a corporate body exercising discretion, directing its local affairs and generally serving the purpose for which its incorporation was intended. It is not a puppet company and the business which it actually carries on is its own.[69]

As the court put it, treating the subsidiaries as carrying on the parent company's business would have confused the scope of the business that was properly and legally attributable to the parent company's premises with "a totality of co-ordinated operations between self-functioning members of an industrial family."[70]

Thus, a key question, as it evolved in the Canadian case law, was not whether, in carrying on a business, the subsidiary companies are influenced by or provide a benefit to the parent company, but whether they function as corporations; that is, do they in fact carry on a business, and does their board manage that business? This is consistent with familiar principles enunciated in an analogous tax area, corporate residency. Central management and control of a foreign subsidiary (and thus its residence for income tax purposes) will be considered to be located in the parent

69 *Aluminum Company of Canada*, supra note 68, at 271.

70 Ibid., at 272. In a later Canadian case, the Exchequer Court rejected more strongly the notion that control of, and integration with, a subsidiary's activities by a parent company should lead to a finding that the subsidiary carries on the parent's business. See *United Geophysical Co. of Canada v. MNR*, 61 DTC 1099, at 1102 (Ex. Ct.) (emphasis added): "While it is clear that a business can be carried on by a company as agent for a disclosed or an undisclosed principal, unless the company which carried on the business is nothing but a sham the mere fact of ownership by a person of all the shares of that company will not make the company's business that of the owner of the shares, *nor will complete and detailed domination by that owner of every move the company makes be sufficient to make the company his agent or the business his own, for the company, if legally incorporated, has a legal existence and personality of its own, distinct from that of the owner or owners of its shares*. The same applies where the owner of the shares is itself an incorporated company." Referring to the general reluctance of courts to find a subsidiary to be acting as the agent of its parent company, one commentator has described *United Geophysical* as a "case in which this reluctance was taken to an extreme": Constantine A. Kyres, "Carrying On Business in Canada" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1629-71, at 1652.

company's jurisdiction if the subsidiary's board merely stands aside and allows the parent's management to decide all matters of real importance;[71] however, if the subsidiary's board in fact meets and makes decisions, even though in doing so it may follow parent company proposals, central management and control will be considered to be located in the foreign jurisdiction.[72]

As in the United Kingdom, courts in Canada have had to struggle with the difficulties that arise when an integrated set of functions or activities is conducted by more than one related legal entity and where a legal determination (for example, liability to tax) depends on which of the entities is or are considered to carry on the relevant business activity. Like the OECD, our courts early admitted the possibility that, in exceptional circumstances, one company in a corporate group can carry on the business of a related, controlling group member. Although in these types of cases, in contrast to *Salomon*, the principle of separate legal personality is seldom sufficient, by itself, to provide a complete answer, the boundaries between related companies are not treated as being entirely permeable or vulnerable to ad hoc effacement; despite being integrated into the "productive unity" of the groupwide enterprise, a subsidiary will generally not be entirely merged with the controlling entity for Canadian tax purposes if its managerial organs duly perform their functions. Where a bilateral tax treaty applies, a similar analysis is required in order to determine whether a corporation has a permanent establishment in respect of an affiliate in another country. The result in the UK and Canadian cases reviewed above was often confusion, or at least contortion, of legal categories. Is the result any different in the treaty context?

AFFILIATED CORPORATION PE CASES—"REVENGE OF THE SOURCE COUNTRIES"[73]

The provisions of the permanent establishment article in income tax treaties do not have a static meaning but have shown that they are capable of flexibility and change over time.[74] Currently, at a very general level, the drivers for change seem to be

71 *Unit Construction Co. Ltd. v. Bullock*, [1960] AC 351 (HL).

72 *Wood v. Holden*, [2005] STC 789 (Ch. D.); aff'd. [2006] STC 443 (CA); leave to appeal refused (HL). This case was distinguished from *Unit Construction* on the basis that the controlling shareholders (or their advisers), rather than usurping the powers of the subsidiary's board of directors, proposed and advised that certain decisions be taken by the subsidiary's board. For a summary of the significance of *Wood v. Holden*, see Matias Milet and Joanna Barsky, "Corporate Residency in Multinational Groups and Realities of Multinational Group Activity: The U.K. High Court's Wood v. Holden Decision" (2005) vol. 13, no. 1 *International Tax Planning* 904-11. See also *Untelrab Ltd. v. McGregor*, [1996] STC (SCD) 1, at paragraph 72: "We accept that [a foreign subsidiary] was complaisant to do the will of [a UK resident parent corporation] but it did actually function in giving effect to its parent's wishes."

73 This phrase is borrowed from Lee A. Sheppard, "Revenge of the Source Countries?" (2005) vol. 37, no. 12 *Tax Notes International* 1362-75.

74 See Cockfield, supra note 7, at 400: "The permanent establishment principle has shown remarkable resiliency, forming an accepted international income tax law principle since its

source-country revenue authorities seeking to tax foreign corporate headquarters profits by imputing a local permanent establishment on the basis of an expansive notion of what constitutes a permanent establishment.[75] An MNE will often hold its most valuable intellectual property and house much of the groupwide expertise outside those foreign jurisdictions in which it has operating subsidiaries that generate relatively low-margin profits on intercompany or third-party sales or services. Profits of operating subsidiaries may be further diminished by converting entities from manufacturers or distributors to toll manufacturers or agents.[76] Under traditional transfer-pricing methods based on the arm's-length principle, the local tax authorities of one of those foreign jurisdictions will have a right to tax local operating subsidiaries on their relatively low-margin profits and to tax the parent company on its interest, dividends, royalties, and management or other fees received from the subsidiary (at tax rates often reduced by an income tax treaty). Those tax authorities will generally not otherwise be able to reach the richer profits of the parent company.

If the source country imputes a permanent establishment to the parent company in respect of a subsidiary's activities, does this alter the amount of profits that might be taxed in the source country? One view is that the assertion of an affiliated corporation PE adds nothing in this regard. A subsidiary that is resident in the source country is subject to tax by that country on its income, and transfer-pricing rules can see to it that the subsidiary's income reflects arm's-length compensation for its contribution to the two companies' combined activities. On this view, once the article 9 transfer-pricing exercise is completed vis-à-vis the subsidiary as an associated corporation, there are no further profits to allocate to the subsidiary as a permanent establishment under article 7. The assumption here seems to be that the subsidiary

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inception roughly 100 years ago. . . . The PE's success is surely related to the flexibility of the concept." Similar comments were made in a speech by the chair of the OECD's Committee on Fiscal Affairs, March 7, 2003, paragraphs 49-53, reproduced in 2003 *Worldwide Tax Daily* 50-10.

75 While net capital-importing countries typically seek to extend the boundaries of the permanent establishment concept, at times such countries and their advocates have gone further, calling for the wholesale elimination of the concept. See, for example, India, Ministry of Finance, "Executive Summary," in *Report of the High Powered Committee on E-Commerce and Taxation* (New Delhi: Ministry of Finance, 2001), 11-12: "The Committee is of the view that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept of PE should be abandoned and a serious attempt should be made within [the] OECD or the UN to find an alternative to the concept of PE."

76 See Le Gall, supra note 29. Also see generally Massimiliano Gazzo, "Permanent Establishment Through Related Corporations: New Case Law in Italy and Its Impact on Multinational Flows" (2003) vol. 57, no. 6 *Bulletin for International Fiscal Documentation* 257-64. Gazzo notes, ibid., at 257, "The current borderless environment allows MNEs to locate shared functions in countries with different cost profiles—e.g. production in a country with low labour costs, distribution in a low-tax country, and R&D in a country that grants subsidies."

as a legal entity and the permanent establishment of the non-resident parent are one and the same—that is, the affiliated corporation PE is not regarded as different than the subsidiary.

There is another way to view the matter, one that renders a finding of an affiliated corporation PE less inconsequential. In the recently finalized *Report on the Attribution of Profits to Permanent Establishments* and corresponding draft revisions to the commentary on article 7, the OECD implicitly takes the position—specifically in the case of agency permanent establishments as among associated corporations—that the affiliated corporation PE is different from *and exists alongside* the subsidiary.[77] While the agency PE is part of the non-resident enterprise as a legal entity, it may involve functions, personnel, assets, and risks of the non-resident enterprise as well as those of the local subsidiary.[78] On this view, the affiliated corporation PE might, depending on the circumstances, need to be allocated profits over and above those earned by the subsidiary, the notion being that the principal makes profits on the activities of the agent that are additional to the agent's profits. This position has been espoused by a court in India and by a handful of tax authorities.[79]

The OECD's comments regarding the attribution of profits to affiliated corporation PEs are not intended to expand the definition of a permanent establishment. However, if transfer pricing as an allocation mechanism is perceived to be in need of reinforcement by the allocation of profits to an affiliated corporation PE, then a source-country tax authority may well have an incentive to identify inadvertent or undisclosed permanent establishments alongside local subsidiaries. "Finding" such affiliated corporation PEs may require innovative interpretation of the traditional rules in article 5, or even the creation of permanent establishment fictions. It is these economic stakes, sometimes more or less evident, that form the backdrop to a current escalation of activity around the affiliated corporation PE concept.

77 Organisation for Economic Co-operation and Development, *Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks) and III (Global Trading)* (Paris: OECD, December 2006), paragraphs 266-81; and *Revised Commentary on Article 7 of the OECD Model Tax Convention* (public discussion draft) (Paris: OECD, April 10, 2007), paragraph 22.

78 On this view, the permanent establishment involves functions, personnel, assets, and risks of the non-resident enterprise that are intimately involved with the activities of the source-country subsidiary: "On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). On the other hand, *the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident*, together with sufficient 'free' capital to support those assets and risks." Ibid., at paragraph 268 (emphasis added).

79 See the decision of India's Income Tax Appellate Tribunal, *Dy Director of Income Tax v. SET Satellite (Singapore) Pte Ltd.*, ITA No. 535/Mum/04 (April 20, 2007). See also Australian Taxation Office, *Attributing Profits to a Dependent Agent Permanent Establishment* (September 2005) and the IFA Branch Reports from Denmark, Norway and Switzerland in International Fiscal Association, *The Attribution of Profits to Permanent Establishments*, Cahiers de droit fiscal international, vol. 91b (Rotterdam: International Fiscal Association, 2006).

In addition to a good deal of commentary on the issue of affiliated corporation PEs,[80] there have been a number of recent instances where non-resident taxpayers have disputed the assertion of an affiliated corporation PE by source-country tax administrators. I focus here on four foreign cases, each of which presents a different approach to the affiliated corporation PE, and the problems of legal form it raises within the economic and allocational context just outlined.

The first case examined, *Interhome*,[81] arose in France, a civil-law country. Nevertheless, it shows the ongoing relevance of determining, as in Anglo-Canadian case law, whether a subsidiary carries on its own business or that of its parent, and provides some markers for how that distinction can be made. In *Interhome*, France's highest appellate court in tax and administrative matters ruled that, in principle, a French subsidiary of a foreign company may constitute a permanent establishment, subject to strict conditions. The court's decision was based in part on the conclusions of the government commissioner, appended to the judgment, which explicitly recognize that the affiliated corporation PE concept cohabits uneasily with (1) the separate legal personality of the subsidiary,[82] and (2) the existence of another mechanism (transfer pricing) for adjusting profits arising in France.

The case dealt with a Swiss corporation, Interhome AG, which entered into agency agreements with owners of vacation homes in various European countries, including France, pursuant to which Interhome AG undertook to offer the homes for vacation rental. As part of an arrangement reminiscent of Canada's *Sudden Valley* case,[83] Interhome AG distributed brochures in France describing the rental properties and indicating its French subsidiary as a contact. The subsidiary, Interhome Gestion SARL ("Interhome France"), was a substantial operation with 30 offices in France; it maintained the rental properties, booked reservations, and signed lease agreements with tenants. In exchange for its services, Interhome France received a fee from Interhome AG, which apparently was generally insufficient for a profit to be earned in France. The parent company was the subsidiary's only client. In these

80 See, for example, Arnold, supra note 5, at 96-99; Le Gall, supra note 29; Gazzo, supra note 76; and Vann, supra note 12.

81 *Ministre de l'économie, des finances et de l'industrie v. Société Interhome AG*, June 20, 2003, appeal no. 224-407 (Conseil d'État). Reported, with an unofficial translation, as *Minister v. Interhome AG* (2003), 5 ITLR 1001. References here are to the unofficial translation.

82 For instance, the government commissioner expressed doubt as to whether a fixed place of business permanent establishment can arise in respect of a separate legal person: "The criterion of a fixed place of business is . . . based on a purely material approach to the notion of a permanent establishment, which in my opinion excludes a person legally distinct from the foreign company from being regarded as such a permanent establishment of the latter." Ibid., at 1030.

83 *Sudden Valley Inc. v. The Queen*, 76 DTC 6178 (FCTD). In this case, a US real estate promoter was found not to be "carrying on business in Canada" on the basis of the extended statutory meaning of this phrase, because the company's advertising in Canada consisted merely of inducements to visit the US property and not offers for sale.

circumstances, the French tax authorities assessed the Swiss parent company on the basis that it had a permanent establishment through Interhome France as its dependent agent.[84]

The court noted that even though Interhome France was a legally and economically dependent agent, it could be treated as a permanent establishment of Interhome AG only if it had authority to engage the latter in or commit it to commercial relations in respect of operations that constituted the business proper of Interhome AG. Robert Couzin has observed that the terms "engage" and "commercial relations" create a less determinate test than a strict legal conception of contracting in the name of the parent.[85] Despite being more fluid than the actual wording of article 5(5) of the OECD model and the related commentary,[86] the court's test was not met on the facts of the case, in particular because of how the "business proper" of the parent company was characterized. The court found that the business of Interhome AG consisted of entering into agency agreements with local homeowners pursuant to which Interhome AG undertook that it or its affiliates would find tenants for the homes. In contrast, it was the business of Interhome France to actually find the tenants, sign the leases, and maintain the homes. Although these two businesses were closely interconnected, they were held to be distinct. Thus, while Interhome France did have the authority to enter into contracts (namely, the lease agreements), these were not contracts, or even "commercial relations," that engaged Interhome AG in respect of its own business. The *Interhome* case demonstrates the importance of legal form (and therefore tax planning) to the outcome of affiliated corporation PE determinations, since the court characterized the respective businesses of the parent and the subsidiary by reference to the kinds of contracts that each company entered into.

The next case, from India, illustrates an alternative approach to deciding the affiliated corporation PE question, in which more emphasis is placed on a different aspect of legal form—namely, the separate legal personality of related companies. India's economy provides something of a laboratory for affiliated corporation PE arguments, since many MNEs have outsourced not only routine but also fairly sophisticated business functions to that country. A recent ruling, *Morgan Stanley*,[87] involved business process outsourcing (or offshoring), in this case the transfer by a financial

84 The tax authorities also argued that Interhome AG had a fixed place of business permanent establishment in respect of each French vacation home; however, Interhome AG had no right of entry in respect of the homes, and the court easily rejected that argument.

85 Robert Couzin, "Beyond Our Borders: Some Global Tax Developments," in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 3:1-26, at 3:20.

86 Compare the *Interhome* language with paragraph 33 of the commentary on article 5 of the OECD model: "The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise."

87 Indian Authority for Advance Rulings, AAR no. 661 of 2005, 2006 *Worldwide Tax Daily* 2006-12114.

services firm of certain non-critical firmwide processes and applications to a jurisdiction with lower labour costs.[88] The taxpayer, Morgan Stanley and Co., U.S. ("Morgan Stanley"), outsourced to an Indian captive service provider, Morgan Stanley Advantage Services Limited ("MS India"), both typical functions—information technology support, human resources, accounting, and payroll—and more sophisticated tasks, such as financial research, company and industry analyses, and the development of customized financial software, which are essential to Morgan Stanley's selection and monitoring of its own investments and those of its clients.

The extent of the services delegated to a remotely located party created for Morgan Stanley what economists call an agency problem: how to ensure that a person (the agent) who is given control over resources that are not its own with a contractual obligation to use those resources in the interests of some other person (the principal) actually will perform this obligation. In order to maintain the high standard of back-office intercompany services that (presumably) prevailed before the offshoring to MS India, Morgan Stanley proposed to send its own staff to India for stewardship (monitoring and instruction) activities. In addition, it was proposed that Morgan Stanley employees would be sent on deputation to MS India for up to two years to work under its supervision and control.

At issue in these circumstances was whether Morgan Stanley had a permanent establishment in India under the 1990 US-India tax treaty. The Indian tax authority argued that MS India was a fixed place of business for Morgan Stanley and/or that it was a dependent agent of Morgan Stanley. The tribunal—the Indian Authority for Advance Rulings (AAR)—rejected both grounds for asserting that Morgan Stanley had a permanent establishment in India. (On this and its other key holdings the AAR's ruling was recently upheld by the Supreme Court of India. The court released its judgment on July 9, 2007, a date too near the publication date of this article for the later decision to be discussed here.) While the AAR agreed that the plethora of services rendered by MS India were essential to the functioning and even the ultimate profitability of the Morgan Stanley group, this did not mean that MS India did not have its own business. The AAR invoked an analogy:

> In a case where an Indian subsidiary of a foreign automobile manufacturing company, should design, undertake research work, prepare software and supply the same to the foreign company which may, after due study, utilize the same; can it be said in such a situation that the business of manufacturing automobiles is carried on through [the] Indian subsidiary? We think "not."[89]

88 Financial services in particular lend themselves to this kind of outsourcing, owing to the relatively small proportion of face-to-face customer dealings in overall activities of the enterprise and the lack of geographic ties to factors of production. See Nick Cronkshaw and Martin Shah, "How To Outsource Financial Services Tax-Effectively" (2003) vol. 14 *International Tax Review* 12-16, at 12.

89 *Morgan Stanley*, supra note 86, at 13.

Similarly, the rendering of essential services by MS India to Morgan Stanley did not mean that the business of Morgan Stanley was carried on through the place of business of MS India. Although such terms as "back-office functions" and "front-office functions" may imply a single business in an economic sense, the AAR is saying that, for tax purposes, the rendering of back-office services solely to affiliated companies can be a separate business.

The finding that Morgan Stanley did not have a fixed place of business in respect of MS India illustrates the strong effect of legal entity boundaries on the characterization of lines of business. If an MNE that manufactures widgets consists of a single corporation that carries on its global operations entirely through branches, it is doubtful that anyone would characterize the rendering of payroll and human resources services by certain personnel of the firm to other personnel as a distinct business. However, when a multijurisdictional enterprise is subdivided into several legal entities, each carrying on a distinct subfunction of the group's overall activity, it begins to seem more plausible that there is more than one business. That plausibility is enhanced when a corporate group's intercompany transactions take place across national borders, such that the transfer-pricing demands of each jurisdiction require arm's-length compensation for such transactions. It is thus that by degrees one can arrive at the conclusion that a provider of even non-productive intercompany services conducts a business that, for income tax purposes at least, should be regarded as distinct from the wider business being serviced. It is perhaps going too far to hold (as the House of Lords did in *Salomon*) that if a company has been validly incorporated, the business necessarily belongs to the company and not to the shareholder(s); and yet the *Morgan Stanley* ruling suggests that the fact of incorporation creates a strong bias in favour of considering that a company carries on a separate business. This places a heavy burden on tax authorities seeking to argue for an affiliated corporation PE based on article 5(1) (fixed place of business).

In addition to rejecting the fixed place of business argument of the Indian tax authority, the AAR disagreed with the argument that MS India was a dependent agent. The tax authority had noted that MS India bore no business risk (it was compensated at cost plus a markup, regardless of results) and was subject to detailed supervision and control by Morgan Stanley. While the AAR agreed that these were indicia of agency, it found no evidence that MS India had, and habitually exercised, authority to enter into contracts in India with third parties on Morgan Stanley's behalf. Here, something of a consensus emerges from *Interhome*, the *Morgan Stanley* ruling, and the OECD commentaries. Although this article has stressed the continuities between older case law and treaty determinations of affiliated corporation PEs, on this point there is a significant difference. In many of the older cases where a corporation was found to be the "mere agent" of another corporation, the courts did not expressly ask whether the agent in question actually had (let alone whether it habitually exercised) contracting authority, or whether the contracts in question pertained to the business proper of the alleged principal. Thus, in the tax treaty context, legally imprecise findings of agency that might have prevailed in other areas of law will fail to give rise to a permanent establishment if they do not meet the specific requirements

of article 5(5). Again, this puts an emphasis on legal form and rewards careful tax planning.

Although there was no affiliated corporation PE in *Morgan Stanley* on the basis of the two grounds available under the OECD provisions, article 5 of the US-India tax treaty also had a special provision[90] based on the UN model that led to a different result. Under this provision (which appears in similar form in 27 of Canada's tax treaties,[91] including those with India and China), the performance of services within a country by a taxpayer over a certain period of time can give rise to a permanent establishment therein, even in the absence of other permanent establishment indicia related to a physical location or agency. The AAR held that under this rule, the US personnel's stewardship activities in India would give rise to a Morgan Stanley permanent establishment in India. This finding should be noted by MNE headquarters companies considering temporarily sending executives to certain treaty countries to supervise or manage local subsidiaries.

As recent as the 2006 *Morgan Stanley* ruling is, part of its analysis may already be considered by some to be outdated. Although the AAR found that Morgan Stanley had a permanent establishment in India under article 5, this proved to be a finding without consequence since the AAR also held under article 7 that no profits should be allocated to such permanent establishment. The AAR stated that where, as was the case with MS India, an Indian affiliate gives rise to a permanent establishment of a non-resident, the amount taxable in India should be only the amount attributable to the operations of the local affiliate. It called this a proposition that was "too well settled to admit of any elaboration" and accordingly reasoned that because the profit margin of the service provider (MS India) had been established on an arm's-length basis, there were no profits of the service recipient (Morgan Stanley) left to allocate to India. More recently, however, a case decided by India's Income Tax Appellate Tribunal refused to adopt the proposition found to be self-evident in *Morgan Stanley*.[92] Citing among other sources the recent OECD report on allocation of business profits to permanent establishments,[93] the tribunal in *SET Satellite (Singapore)* distinguished between the profits of the "dependent agent PE" and its (affiliated) Indian corporate agent. According to the tribunal, the taxable profits of the dependent agent are generally based on the arm's-length fee that the Indian corporation

90 Article 5(2)(l) of the Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at New Delhi on September 12, 1989.

91 See the permanent establishment article in Canada's tax treaties with Algeria, Argentina, Armenia, Azerbaijan, Cameroon, Chile, China, the Czech Republic, Ecuador, India, Indonesia, Kazakhstan, Kuwait, Lebanon (1998, not yet in force), Mexico, Mongolia, Oman, Pakistan, Papua New Guinea, Peru, Slovakia, South Africa, Tanzania, Thailand, Vietnam, Zambia, and Zimbabwe.

92 *SET Satellite (Singapore)*, supra note 79.

93 Supra note 77.

receives for providing services as agent. The profits of the dependent agent PE are different, being the profits of the non-resident enterprise in respect of the activities carried on in India through the permanent establishment, and such profits are net of the arm's-length fee earned by the agent. Thus, to hold, as in *Morgan Stanley*, that the dependent agent PE will generally have no profit after deduction of the arm's-length service fee paid to the agent is "patently erroneous" according to the tribunal in *SET Satellite (Singapore)*.

In order to arrive at a conception of profit allocation so opposed to that expressed in *Morgan Stanley*, the tribunal in *SET Satellite (Singapore)* had to elaborate on the nature of the dependent agent PE. It began by calling the dependent agent PE a legal fiction: because the agent is a legally separate person, the dependent agent PE is not really an "establishment" as such (permanent or otherwise) of the non-resident. The only physical source-country presence is that of the local agent; the non-resident enterprise is merely "deemed" (the term used in article 5(5)) to have a source-country presence, in respect of the agent's activities, through its legal relations with the agent. This leads to a view of the permanent establishment itself as a mental construct that exists alongside the local agent:

> The hypothetical PE, therefore, must be visualized on the basis of presence of the . . . [non-resident enterprise] as projected through the PE, which in turn depends on functions performed, assets used and risks assumed by the . . . [non-resident enterprise] in respect of the business carried on through the PE.[94]

A non-resident projects a presence of sorts in a source country through a hypothetical construct that exists on the basis of a business carried on through an agent in the source country. It is on the basis of this perspective that the tribunal concluded that the dependent agent PE and the dependent agent have to be treated as two distinct taxable units, each with its own potential profit.

Although *SET Satellite (Singapore)* and the OECD report from which it quotes at length deal primarily with profit allocation to a permanent establishment under article 7, they also clearly have implications for how one identifies the scope and nature of a permanent establishment under article 5. Clarifications and fresh insights on the nature of permanent establishments have thus at times come about indirectly or incidentally. A more frontal and radical reconceptualization of the affiliated corporation PE in particular has been undertaken by the courts in Italy.

In the 2002 *Philip Morris* case,[95] the Italian Supreme Court held that an international MNE group as a whole (not just one member of the group) can have an Italian permanent establishment on the basis of the strategic coordinating activities

94 *SET Satellite (Singapore)*, supra note 79, at paragraph 11.

95 *Ministry of Finance (Tax Office) v. Philip Morris (GmbH)*, May 25, 2002, no. 7682/02 (Supreme Court of Cassation). The description of the case and subsequent citations are based on the unofficial translation of the judgment: *Ministry of Finance v. Philip Morris* (2002), 4 ITLR 903.

conducted by a company that is resident in Italy. That decision has been widely commented upon and criticized,[96] with the OECD going so far as to modify its commentary on article 5 in order to register its disagreement.[97] Here, I will focus on the attempt in the case to effect a fundamental reorientation in the method of analyzing affiliated corporation PEs.

A layered, intricate cluster of relations between various members of the Philip Morris group structured the marketing of Philip Morris cigarettes in Italy. Certain European members of the Philip Morris corporate group (including the German taxpayer involved in the litigation, Philip Morris GmbH) marketed cigarettes in Italy by selling them, and licensing their trademarks, to the Italian state monopoly, AAMS, which undertook to sell Philip Morris brand cigarettes to Italian retailers. Entrusting a government body with these crucial business functions gave rise to a version of the agency problem faced by Morgan Stanley when it put a remotely located party in charge of certain back-office group functions. Intertaba SpA, an Italian Philip Morris group member, was thus entrusted with monitoring warehousing and distribution of Philip Morris products by AAMS. Intertaba personnel also participated in contract negotiations between the European companies and AAMS, although Intertaba did not execute contracts on anyone's behalf. Intertaba's activities also included the manufacture and sale of cigarette filters, from which it obtained the bulk of its revenue. There was some evidence that Intertaba had been endowed with this independent business as a tax-planning measure, in order to avoid giving rise to a permanent establishment in Italy through its activities on behalf of non-resident affiliates.

The Italian tax authorities asserted that Philip Morris GmbH had an undisclosed permanent establishment in respect of Intertaba, which they asserted was merely a domestic operating unit belonging to Philip Morris GmbH and other group members. If their view were upheld, the German company could not benefit from the reduced tax rate under the Germany-Italy tax treaty on the considerable royalties it received from AAMS. Two lower courts found in favour of the taxpayer, but in 2002 Italy's Supreme Court reversed and remanded the case for reconsideration in accordance with a set of five principles. One of these principles was that participation in contract negotiations can—using a substance-over-form approach—be found to be tantamount to an "authority to conclude contracts," such that a company (like

96 See, for example, Robert Goulder, "IFA Panelists Slam Italian High Court Ruling on Permanent Establishments" (2002) vol. 27, no. 10 *Tax Notes International* 1152; and Tax Executives Institute, letter to Jeffrey Owens, head of the OECD Centre for Tax Policy and Administration, October 17, 2003, available in "TEI Comments on PE Definition in OECD Model Treaty," 2003 *Worldwide Tax Daily* 203-12.

97 In April 2004, in reaction to *Philip Morris*, the OECD issued a management services discussion draft to clarify the permanent establishment definition in article 5 of the OECD model: Organisation for Economic Co-operation and Development, *Proposed Clarification of the Permanent Establishment Definition: Public Discussion Draft* (Paris: OECD, April 2004). The proposed changes were reflected in revisions made to the commentary on article 5 in 2005.

Intertaba) with no such legal authority might be a dependent agent. The revised OECD commentary on article 5 specifically rejects that notion, thereby reasserting the importance of legal form.[98]

Two other controversial principles in *Philip Morris* effect what might be termed a diffusion of the permanent establishment concept:

- a corporation resident in Italy may take on the role of a "multiple permanent establishment" of foreign companies belonging to the same group and pursuing a common strategy; and
- the entrusting of the management of business transactions to a "national structure" by a corporation that is not resident in Italy leads to that national structure becoming a permanent establishment of the non-resident corporation.

These principles are debatable, and each of them has been either rejected or qualified in the revised OECD commentary on article 5.[99] The point here is not to rehearse all the objections to *Philip Morris*, but to ask what led Italy's Supreme Court to open up new territory.

The court seemed to think that the sharing of functions and the complexity of organizational lines of command and supply within contemporary MNEs had evolved to the point where traditional permanent establishment analysis needed to be reformulated. According to the court, Intertaba in effect monitored and coordinated the sale (by AAMS) of Philip Morris cigarettes for the whole European Philip Morris group in Italy, even if, nominally, Intertaba was a local filter manufacturer. In part through executives who also held posts in other group companies, Intertaba performed important management functions of the group's business in Italy in the strategic/decision-making area. But lines of managerial command also went the other way, since the court noted the dominant position of foreign management in respect of local activities. After acknowledging the existence of article 5(7) (whereunder control of one company by another will not of itself give rise to a permanent establishment), the court warned that this article should not blind tax authorities or courts to "the phenomenon of undisclosed permanent establishments [which] finds more fertile ground for growth within multinational groups."[100] This is so, according to

98 See paragraph 33 of the commentary on article 5, as revised in 2005: "The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise." The Italian courts, however, remain undaunted. In 2006, while acknowledging that the revised OECD commentary expressed a contrary opinion, the Italian Supreme Court found that a Panamanian company had a permanent establishment in Italy in part as a result of its Italian affiliate's participation in contract negotiations held in Italy. See Marco Rossi, "Italy's Supreme Court Recharacterizes Company as Permanent Establishment," 2006 *Worldwide Tax Daily* 213-2.

99 See paragraphs 41.1 and 42 of the commentary on article 5 of the OECD model.

100 *Philip Morris* (unofficial translation), supra note 92, at 938.

the court, because of the integration of the activities of separately incorporated subsidiaries into a broader organizational structure:

> [T]he global strategy of a group can take on such penetrating forms of utilisation of the controlled companies as to cause the latter to actually become, *even if they are endowed with the status of independent entities*, management structures of the business carried on by other companies.[101]

At first blush, this is similar to what we saw the Canadian courts doing in cases like *Palmolive* and *Famous Players*, where the separate legal personality of subsidiaries was to some extent disregarded so that the tax consequences arising from subsidiary activities could be attributed to a parent company. However, note that the Italian court does not pierce the corporate veil or otherwise challenge the separate legal personality of subsidiaries. Its theory is not simply that the subsidiary itself is the permanent establishment of the parent, but rather that the subsidiary's activities and relations with group members give rise to a "management structure" or a "national structure," which is the permanent establishment.

Operating on the basis of this structural paradigm, the Supreme Court in *Philip Morris* chastised the lower court for a methodological inability to grasp the true nature of the relationships within an MNE. In this criticism one can read a kind of anti-formalism manifesto. The lower court had invoked article 5(7) to assert that it was irrelevant that Intertaba and Philip Morris GmbH belonged to the same corporate group. The Supreme Court disagreed: even though a group of corporations, as such, cannot have rights or liabilities (such as tax liability), a group of companies can carry on management activities through a "structure" operating in a source country as part of a wider synergistic plan controlled by the group. Conceptually, the court seemed to take its cue from the Italian tax authority, which spoke of the "inter-organic" relationship among the Philip Morris group members. In order to grasp such a phenomenon, the court said, one must look beyond the bilateral relationship between the non-resident taxpayer and the source-country affiliate, to the multilateral group relations. To do otherwise constitutes "an unwarranted subdivision of the phenomenon."[102]

Others have rightly criticized this holistic approach as being inconsistent with the prior international consensus in a number of ways. It is unsurprising that the OECD should disagree with the notion of a group of companies having a permanent establishment, since this goes directly against the foundational thinking of Carroll on the issue of whether the "undertaking" or "enterprise" that is to be analyzed under article 5 (as having or not having a permanent establishment) could be a commonly controlled group rather than a single entity. The revised commentary on article 5 now states that the determination of the existence of a permanent establishment

101 Ibid. (emphasis added).

102 Ibid.

must be made separately for each company in the group, and that the existence in a country of a permanent establishment of one company "will not have any relevance as to whether another company of the group has itself a permanent establishment in that State."[103]

What is less often noted is that, regardless of the soundness of its conclusions, the *Philip Morris* decision represented a conceptually systematic and fundamental shift in thinking about permanent establishments (and the non-residents that are charged with having them), a reconceptualization in which permanent establishment rules attempted to "let in" aspects of the reality of contemporary business arrangements that might be obscured under a more traditional method. I suggest that one way of understanding the interorganic approach of the Italian court is to note its affinities with the ideas of the influential 20th-century thinker Martin Heidegger, who believed that one obtained an, in some respects, impoverished knowledge of an object by considering it in bare isolation. A favourite example in this regard was a hammer: the hammer permits us to engage in the practice of driving nails, which is useful for joining pieces of wood together, an activity that is used in building a structure, which in turn is useful for constructing dwellings to provide shelter from the elements, etc. The significance of the hammer cannot be grasped without taking into account its function within a larger context of human projects.

The hammer in *Philip Morris* was the Italian subsidiary. Its activity of monitoring AAMS's storage and distribution of Philip Morris cigarettes in Italy would have been relatively meaningless without reference to the cigarette production and marketing activities of the European Philip Morris licensors of AAMS and their links to the parent company. Contrast this with the more orthodox conception of the relationship of MNE group activities followed in *Interhome*, according to which entering into agency agreements with homeowners for purposes of being able to rent out their houses is a different business from that of subsequently renting out the houses. Judged purely for its descriptive qualities, the *Philip Morris* interorganic approach is more faithful to the relations between related corporate entities, particularly in the context of contemporary MNE structures.

Legal rules, however, are not judged by how well they describe or conform to business realities. Indeed, the reconceptualization of affiliated corporation PEs along interorganic lines risks eliminating any principled basis on which to make decisions as to tax nexus. If ultimately the activities of a local subsidiary are always connected in ever-expanding concentric circles to broader coordinated group foreign activities, the danger is a limitless network of reciprocal affiliated corporation PEs.[104] The international allocation of taxing jurisdiction, however, does not work

103 Paragraph 41.1 of the commentary on article 5.

104 Some, however, have suggested that amending existing treaty rules so as to achieve this very outcome could enable source countries to obtain a greater share of MNE worldwide profits. See, for example, Arnold, supra note 5, at 98 and 107, recommending that a subsidiary be "deemed" to be a permanent establishment of its non-resident parent and any related entities;

that way. Within the current framework, while courts and tax authorities can and should adequately take into consideration the real business and legal connections between affiliates across borders, they have to be able to do so while respecting determinate markers of tax nexus so as to have an administrable international tax system. The traditional approach generally exhibited in the case law—of presuming a subsidiary to carry on its own business in the absence of extraordinary circumstances (for example, undue parent interference in board decisions)—provides greater certainty as a tool for drawing boundaries in attempting to establish taxable presence. This may be a case of gaining in conceptual efficacy what is lost in descriptive accuracy.

CONCLUSION

In 1991, Skaar concluded his historical study of the permanent establishment article by suggesting that "the future is likely to prove that the PE principle has lost its force for new and mobile industries."[105] However, he noted at least one exception, predicting that countries would, through "creative interpretation," increasingly attempt to assert the existence of affiliated corporation PEs as a way of counteracting tax planning through the use of captive companies.[106] The latter prediction has proved the more accurate. More than a decade later, another observer commented on the recent revitalization of the permanent establishment concept in certain jurisdictions:

> The complexity and, more importantly, the statelessness . . . of the new organizational form of MNEs revitalize the traditional international tax concepts, such as "tax residence" and "permanent establishment" (PE). These concepts, generally designed to source income and to distribute taxing rights among different countries, today seem to be used by the tax authorities to challenge group tax planning.[107]

This last passage points to economic organizational factors underlying the resurgence of the affiliated corporation PE at a time when interaffiliate dealings have grown ever more complex. This article, in contrast, has primarily identified the conceptual and legal conditions of possibility for the adaptation of the protean permanent establishment concept to such complexity. One such enabling condition has been the toolkit of concepts borrowed from domestic law for attributing activities of one company to a controlling, related company; these range from agency to various ways of conceiving of the controlled company's business as lacking any separateness from the business of the related company.

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and Vann, supra note 12, at 381, suggesting the creation of a presumption that associated enterprises are permanent establishments of each other unless it is established that they are legally and economically independent of one another.

105 Skaar, supra note 9, at 573.

106 Ibid., at 554.

107 Gazzo, supra note 76, at 257.

However, it is also because permanent establishment arguments seem to be breaking away from their traditional conceptual moorings that it has been possible to advance them with some traction in the context of MNEs. One sees this in the *Philip Morris* notion that a local subsidiary's activities constitute a "national structure" of non-resident group members, so that the affiliated corporation PE is a structure rather than a company. One also sees it, surprisingly enough, in the consensus views of the OECD itself, when it concludes that where there is a dependent agent PE as a result of a local subsidiary's activities, that permanent establishment is not identical with the subsidiary, since it may involve risks, assets, or capital attributable to the parent company and not to the subsidiary. One implication of the OECD view, as elucidated by the Income Tax Tribunal of India, is that a dependent agent PE is a legal fiction, a heuristic construct rendering conceptually intelligible the non-physical projection of the non-resident in the source country as its business is carried on therein by the local agent, but more importantly serving the purpose of creating a notional independent business to which to attribute local profits of a non-resident enterprise. In each of these examples, there is a subtle yet significant shift away from simple identification of the permanent establishment with the local legal entity, an identification that had early proved to be a stumbling block in admitting the affiliated corporation PE as a possibility. In these new ways of thinking about a permanent establishment under article 5, the *Salomon* principle and legal form generally are not so much compromised, as in the domestic-law cases examined here, but simply circumvented.