

LB&I Transaction Unit Knowledge Base – International

Library Level	Number	Title
Shelf		Cross-Over
Book	16	Treaties
Chapter	7	Permanent Establishments and Business Profits
Section		

Unit Name	Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status	
Primary UIL Code	9450.07	Permanent Establishments and Business Profits

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Issue and Transaction Overview

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Background:

Under the Internal Revenue Code, a foreign company that carries on a trade or business in the United States is subject to tax at the same progressive rates as U.S. corporations, but only with respect to income effectively connected with its U.S. trade or business. However, if an eligible foreign company elects to apply a U.S. income tax treaty, it will be subject to U.S. tax on its profits attributable to a U.S. permanent establishment. In general, the nature and amount of activities that would lead to a foreign company being engaged in a U.S. trade or business are broader than those that would create a U.S. permanent establishment.

Permanent Establishment Concept in U.S. Income Tax Treaties:

In most cases, U.S. income tax treaties define a U.S. permanent establishment to include a fixed place of business in the United States through which the foreign enterprise carries on its business. However, a foreign enterprise will not be deemed to have a U.S. permanent establishment if its activities in the United States are limited to certain activities -- generally those of a preparatory or auxiliary nature. The following explains this exception as it is included in the U.S.-U.K. Income Tax Treaty.

Permanent Establishment Exception in U.S.-U.K. Income Tax Treaty:

The U.S.-U.K. Income Tax Treaty provides that a permanent establishment will not include a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

This Practice Unit will focus on whether an activity has a preparatory or auxiliary character for purposes of determining whether there is a permanent establishment.

Issue and Transaction Overview (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status (cont'd)

Caveats and Explanations:

Assumption of Fixed Place of Business

This Unit presumes that the foreign enterprise has a fixed place of business in the United States through which the business of the foreign enterprise is carried on. The focus of the Unit is to determine whether such business is of a preparatory and auxiliary character such that the foreign enterprise does not have a U.S. permanent establishment.

Eligibility for Treaty Benefits

This Unit assumes that the U.K. company qualifies for the benefits of the U.S.-U.K. Income Tax Treaty.

Appropriate U.S. Treaty

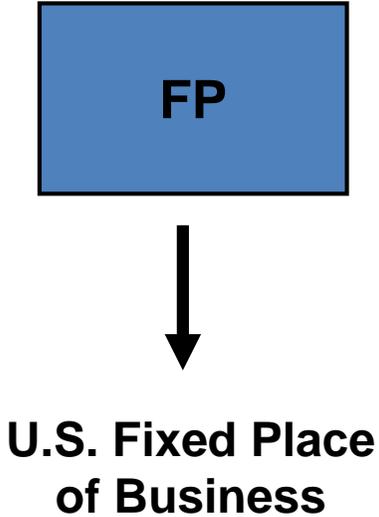
Remember that every U.S. income tax treaty is different. Although this practice unit addresses the meaning of permanent establishment found in the U.S.-U.K. Income Tax Treaty, the test in the treaty you are applying might differ. Therefore, in every case involving a tax treaty, you should carefully review the permanent establishment article and any other applicable articles in the treaty, and any contemporaneous or subsequent protocol(s), memoranda of understanding, or exchange(s) of notes between the treaty countries, to determine if treaty benefits should be granted. In addition, more interpretive guidance may be found in the Treasury Department's Technical Explanation of the treaty/protocol, as well as the Joint Committee on Taxation Report, the Senate Foreign Relations Committee Report, authoritative case law, and guidance issued by the IRS.

Technical Explanation and OECD Model

This Practice Unit refers to the Technical Explanation to the U.S.-U.K. Income Tax Treaty and the Commentaries on the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model).

Transaction and Fact Pattern

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Diagram of Transaction	Facts
 <p>The diagram consists of a blue rectangular box with the letters "FP" in black text. A thick black arrow points vertically downwards from the bottom center of this box to the text "U.S. Fixed Place of Business" which is centered below the arrow.</p>	<ul style="list-style-type: none">▪ Foreign Parent (FP) is a U.K. resident company engaged in multiple business ventures including advertising.▪ FP sends employees to conduct advertising and marketing in the United States.▪ FP has a fixed place of business in the United States.

Summary of Potential Issues

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Issue 1

Is the activity carried on solely of a preparatory or auxiliary character such that FP would not be considered to have a U.S. permanent establishment even though it conducts these activities from a fixed place of business?

All Issues, Step 1: Initial Factual Development

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Article 5(4) of the U.S.-U.K. Income Tax Treaty provides: Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

Fact Element	Resources
<p>Article 5(4) of the U.S.-U.K. Income Tax Treaty provides:</p> <p>Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:</p> <ul style="list-style-type: none">▪ The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;▪ The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;▪ The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;▪ The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;▪ The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;▪ The maintenance of a fixed place of business solely for any combination of the activities mentioned in sub-paragraphs above of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.	

All Issues, Step 1: Initial Factual Development (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Fact Element	Resources
<p>Under Article 5(1) of the U.S.-U.K. Income Tax Treaty, a U.S. permanent establishment includes a fixed place of business in the United States through which the foreign enterprise carries on its business.</p> <p>Please refer to “All Issues, Step 1: Initial Factual Development” in the practice unit entitled “Creation of a Permanent Establishment (PE) through the Activities of Seconded Employees in the United States” for guidance on identifying whether FP might have a U.S. permanent establishment under Article 5.</p>	<ul style="list-style-type: none"> ▪ FP’s Form 1120-F - <i>U.S. Income Tax Return of a Foreign Corporation</i> ▪ Practice Unit - <i>Creation of a Permanent Establishment (PE) through the Activities of Seconded Employees in the United States</i>, DCN: TRE/T/16_06-01
<p>After determining that FP conducts activities in the United States, make a preliminary determination of whether FP’s activities in the United States are limited to activities that are not considered to give rise to a U.S. permanent establishment as follows:</p> <ul style="list-style-type: none"> ▪ The financial statements may show that the FP’s activities are limited to certain preparatory and auxiliary activities and other activities specifically excluded under the treaty. ▪ Internet research may reveal that FP only performs certain preparatory and auxiliary activities in the United States or other activities specifically excluded under the treaty. For example, review taxpayer’s website to see how it describes its business in the United States. Companies often describe their capabilities to serve clients/customers in great detail and often list offices, projects/transactions and other useful information. 	<ul style="list-style-type: none"> ▪ FP’s Form 8833 - <i>Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)</i> (attached to FP’s Form 1120-F - <i>U.S. Income Tax Return of a Foreign Corporation</i>) ▪ Organizational charts ▪ Taxpayer financial statements ▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun & Bradstreet, EDGAR, search engines) ▪ Information Document Retrieval System (IDRS) to review FP’s Form 1120-F and Form 8833

All Issues, Step 1: Initial Factual Development (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Fact Element	Resources
<p> CONSULTATION: You might determine that FP does not have a permanent establishment and that FP does not carry on a fixed place of business in the United States. However, certain U.S. source income that FP receives may be subject to U.S. withholding tax under the Internal Revenue Code.</p> <p>Establish whether Form 1042-S was filed reporting payments to FP. Consult with the Repatriation/Withholding Practice Network (PN), reference and resource materials as necessary to determine whether it is more appropriate to pursue a case with respect to U.S. withholding instead of a permanent establishment case.</p>	<ul style="list-style-type: none"> ▪ Form 1042-S - <i>Foreign Person's U.S. Source Income Subject to Withholding</i> ▪ Practice Unit - <i>FDAP Income</i>, DCN: RPW/C/08_01-01(2016)
<p> CONSULTATION: Consult with the Income Shifting PN reference and resource materials as necessary and review other information such as transfer pricing documentation. Based on the amount of income reported on Form 5472, determine whether the matter is primarily related to the appropriate transfer price for transactions between related parties or is a permanent establishment issue.</p>	<ul style="list-style-type: none"> ▪ Transfer pricing documentation ▪ Form 5472 - <i>Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business</i>

Issue 1, Step 2: Review Potential Issues

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Issue 1

Is the activity carried on solely of a preparatory or auxiliary character such that FP would not be considered to have a U.S. permanent establishment even though it conducts these activities from a fixed place of business?

Explanation of Issue	Resources
<p>Article 5(4)(e) of the U.S.-U.K. Income Tax Treaty provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory and auxiliary character.</p> <p>It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.</p>	<ul style="list-style-type: none">▪ Commentary on Article 5(4) of the OECD Model Treaty (2014)▪ U.S.-UK Income Tax Treaty, Art. 5(4)(e)▪ TE to U.S.-UK Income Tax Treaty, Art. 5(4)(e)

Issue 1, Step 2: Review Potential Issues (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Issue 1

Explanation of Issue	Resources
<p>Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of Article 5(4)(e) of the U.S.-U.K. Income Tax Treaty.</p> <p>A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in Article 5(4) of the U.S.-U.K. Income Tax Treaty were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an enterprise maintains an advertising agency that also engages in advertising for other enterprises, the agency would be regarded as a permanent establishment of the enterprise by which it is maintained.</p> <p>If the nature of the business is marketing and not the eventual actual sale of products, advertisements would be integral and not preparatory.</p>	<ul style="list-style-type: none"> ▪ U.S.-UK Income Tax Treaty, Art. 5(4)(e) ▪ Commentary on Article 5(4) of the OECD Model Treaty (2014) ▪ <i>Rhoades & Langer – U.S. Intn'l Taxation & Treaties Treatise</i>

Issue 1, Step 3: Additional Factual Development

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine whether there is a permanent establishment as a result of the advertising/marketing activities of the FP employees.<ul style="list-style-type: none">– Review FP's financial statements, interview professionals, and research the internet to determine if FP's advertising department engages in advertising for enterprises other than FP.– Does FP earn a considerable profit in comparison to its other businesses such that the activities of the employees with respect to the advertising/marketing business may be considered more than preparatory and auxiliary? For example, do FP's financial statements include separate segment reporting for the advertising/marketing business? FP's U.S. business might need to be separated from any geographic or business line reporting in the financials to reflect FP's relevant financial information.	<ul style="list-style-type: none">▪ Interview professionals as needed to determine the scope of their activities▪ FP financial statements▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun & Bradstreet, EDGAR, search engines)

Issue 1, Step 3: Additional Factual Development (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Issue 1

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine whether there is a permanent establishment as a result of the advertising/marketing activities of the FP employees.<ul style="list-style-type: none">– Review FP's financial statements to determine if FP earns a profit from its advertising and marketing activities in the United States.– Review FP's financial statements and the internet to determine FP's core business(es). Is one of its core businesses marketing or does the marketing/advertising merely facilitate/increase its other businesses?– Based on financial statements, internet research and employee interviews, does FP conduct any other activities through the United States that in combination or alone (either through its employees carrying on business in the United States or through a dependent agent on behalf of FP) may cause FP to have a permanent establishment?	<ul style="list-style-type: none">▪ Interview professionals as needed to determine the scope of their activities▪ FP financial statements▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun & Bradstreet, EDGAR, search engines)

Issue 1, Step 3: Additional Factual Development (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

[Issue 1](#)

Fact Element	Resources
<p> CONSULTATION: Consider travel to interview relevant officers and employees of FP. Discuss with Exchange of Information (EOI) personnel whether government authorities will permit on-site interviews of FP employees and whether an invite letter is necessary. Obtain IRS approval using Official Travel Form 1321, an official government passport, and travel funds.</p> <p>Consult with the Information Gathering PN reference and resource materials as necessary to decide the appropriate procedures for conducting FP employee interviews and for requesting information. If necessary, customers may be interviewed. Consult with Counsel to determine appropriate summons procedures.</p>	<ul style="list-style-type: none">▪ IRM 4.10.3.2 - <i>Interviews: Authority and Purpose</i>▪ Form 1321 - <i>Authorization for Official Travel</i>▪ Practice Unit - <i>Using Alternative Means to Obtain Foreign Based Evidence</i>, DCN: IGI/9460.02_01(2013)▪ Practice Unit - <i>Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR</i>, DCN: IGA/9460.02_02(2013)

Issue 1, Step 4: Develop Arguments

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Issue 1

Explanation of Adjustment	Resources
<p> DECISION POINT: Using the information gathered in Steps 1 and 3, evaluate whether the advertising activities of FP’s employees in the United States are preparatory and auxiliary.</p> <p>Also, consider whether FP’s employees conduct any other activities through the United States that in combination or alone (either through its employees carrying on business in the United States or through a dependent agent on behalf of FP) may cause FP to have a permanent establishment.</p> <p>Keep in mind that certain U.S. source income received by FP might be subject to U.S. withholding tax.</p> <p>In addition, consider reviewing whether transactions between FP and U.S. are in accordance with the arm’s length principle.</p>	<ul style="list-style-type: none"> ▪ U.S.-UK Income Tax Treaty, Art. 5(4) ▪ TE to U.S.-UK Income Tax Treaty, Art. 5(4) ▪ Form 1042-S - <i>Foreign Person's U.S. Source Income Subject to Withholding</i> ▪ Practice Unit - <i>FDAP Income</i>, DCN: RPW/C/08_01-01(2016) ▪ Transfer pricing documentation ▪ Form 5472 - <i>Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business</i>

Issue 1, Step 4: Develop Arguments (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

[Issue 1](#)

Explanation of Adjustment	Resources
 CONSULTATION: If there are strong indicators of a permanent establishment but there is still incomplete information, please consult with the Information Gathering PN reference and resource materials, as necessary. Under Article 27 of the U.S.-U.K. Income Tax Treaty (Exchange of Information and Administrative Assistance), the U.S. may request information from the United Kingdom concerning the extent of FP's activities in the United States.	<ul style="list-style-type: none">▪ U.S.-UK Income Tax Treaty, Art. 27▪ IRM 4.60.1 - <i>Exchange of Information</i>▪ Practice Unit - <i>Using Alternative Means to Obtain Foreign Based Evidence</i>, DCN: IGI/9460.02_01(2013)

Index of Referenced Resources

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Form 1042-S - *Foreign Person's U.S. Source Income Subject to Withholding*

Form 1120-F - *U.S. Income Tax Return of a Foreign Corporation*

Form 1321 - *Authorization for Official Travel*

Form 5472 - *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

Form 8833 - *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*

IRM 4.10.3.2 - *Interviews: Authority and Purpose*

IRM 4.60.1 - *Exchange of Information*

Practice Unit - *Creation of a Permanent Establishment (PE) through the Activities of Seconded Employees in the United States*

Practice Unit - *FDAP Income*

Practice Unit - *Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR*

Practice Unit - *Using Alternative Means to Obtain Foreign Based Evidence*

U.S.-U.K. Income Tax Treaty, Art. 5(4)

U.S.-U.K. Income Tax Treaty, Art. 27

TE to U.S.-UK Income Tax Treaty, Art. 5(4)

Commentary to Article 5(4) of the OECD Model

Rhoades & Langer - U.S. Intn'l Taxation & Treaties Treatise

Index of Referenced Resources (cont'd)

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status

Organizational charts

Taxpayer financial statements

Transfer pricing documentation

FP financial statements

Interview professionals as needed to determine the scope of their activities

Information Document Retrieval System (IDRS)

Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun & Bradstreet, EDGAR, search engines)

Training and Additional Resources

Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status	
Type of Resource	Description(s)
Saba meeting sessions	<ul style="list-style-type: none">▪ <i>Intro to Treaties</i> - 2015 Centra▪ <i>IBC Aspects of Treaties</i> - 2014 Centra▪ <i>IBC 2011 CPE - Jurisdiction to Tax</i> - 2011 CPE Centra
Other Training	<ul style="list-style-type: none">▪ 2011 International Training Phase II Module F 3135-411 (Taxation of Foreign Corporations)
Reference Materials	<ul style="list-style-type: none">▪ International Bureau of Fiscal Documentation (IBFD) Tax Treaties Database (Westlaw)▪ <i>Anderson - Analysis of United States Treaties</i> Chapter 3 (Definition of "Permanent Establishment")▪ Pub. 901 - <i>U.S. Tax Treaties</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
EOI	Exchange of Information
FDAP	Fixed, Determinable, Annual, and Periodical
FP	Foreign Parent
IBC	International Business Compliance
IDR	Information Document Request
IRM	Internal Revenue Manual
JTT	Jurisdiction to Tax
OECD	Organization for Economic Cooperation and Development
OECD Model	OECD Model Tax Convention on Income and on Capital
PN	Practice Network

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
9450.07	<i>Creation of a Permanent Establishment (PE) through the Activities of Seconded Employees in the United States</i>	TRE/T/16_06-01
9450.07	<i>Creation of a Permanent Establishment (PE) through the Activities of a Dependent Agent in the United States</i>	TRE/T/16_07-02
9424.01	<i>FDAP Income</i>	RPW/C/08_01-01(2016)
9460.02	<i>Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR</i>	IGA/9460.02_02(2013)
9460.02	<i>Using Alternative Means to Obtain Foreign Based Evidence</i>	IGI/9460.02_01(2013)