

**CENTRE FOR TAX POLICY AND ADMINISTRATION  
COMMITTEE ON FISCAL AFFAIRS****CTPA/CFA/WP1/NOE2(2013)4/CONF  
Confidential****Working Party No. 1 on Tax Conventions and Related Questions****INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT)****Comments received on the discussion draft****19-22 February 2013**

*This note includes the comments received on the revised discussion draft on the interpretation and application of Article 5 (Permanent establishment) of the OECD Model Tax Convention as well as the discussion draft itself. It is presented FOR DISCUSSION at the February 2013 meeting of the Working Party.*

*Please bring a copy of this document to the meeting as no additional copies will be available in the meeting room.*

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**SUMMARY / ACTION REQUIRED**

**This note includes the comments received on the revised discussion draft on the Interpretation and application of Article 5 (Permanent establishment). The discussion draft itself is included in the Annex.**

**The Working Party is invited to discuss these comments at its February 2013 meeting.**

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**INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT)****INTRODUCTION**

1. This note includes the comments received on the revised discussion draft on the interpretation and application of Article 5 (Permanent establishment) of the OECD Model Tax Convention, which was released on 12 October 2012<sup>1</sup> and is reproduced in the Annex. Part 1 includes the comments that were received from the Delegate for Belgium whilst Part 2 includes comments received from the private sector (except for the comments that were not submitted in a format allowing their inclusion in this note, which are indicated by an asterisk [\*] in the list below and which will be made available separately). These comments were received from the following organisations and individuals (all these comments are available on the OECD web site):

- 1) Asea Brown Boveri Ltd (ABB)
- 2) BIAC
- 3) British Private Equity and Venture Capital Association (BVCA)
- 4) Chartered Institute of Taxation CIOT)
- 5) Confederation of British Industry (CBI)
- 6) Confederation of Swedish Enterprise
- 7) Deloitte LLP (United Kingdom)
- 8) Ernst & Young Global Services Ltd.\*
- 9) European Business Initiative on Taxation (EBIT)
- 10) German Association of the Automotive Industry (VDA)
- 11) German Electrical and Electronical Manufacturers' Association (ZVEI)\*
- 12) German Engineering Federation (VDMA)
- 13) German Federation of Tax Advisers
- 14) A. Greenbank & M. Zetter (Macfarlanes LLP)
- 15) ICON Wirtschaftstreuhand GmbH\*
- 16) Institute of Chartered Accountants in England and Wales (ICAEW) Tax Faculty
- 17) International Air Transport Association (IATA)
- 18) International Bar Association (IBA)\*
- 19) International Chamber of Commerce (ICC)
- 20) Japan Foreign Trade Council (JFTC)
- 21) M.E. Mancilla Rendon & M. Astudillo Moya
- 22) PwC (Richard Collier)
- 23) Repsol
- 24) Tax Executives Institute (TEI)
- 25) S. Towers (Deloitte & Touche LLP Singapore)
- 26) Treaty Policy Working Group
- 27) True Partners Consulting International Network
- 28) Volkswagen AG
- 29) WTS GmbH

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1 See <http://www.oecd.org/ctp/taxtreaties/PermanentEstablishment.pdf>

2. At its February 2013 meeting, the Working Party is invited to discuss these comments and those that will be circulated separately.

## PART 1 — COMMENTS FROM BELGIUM

### *Definition of “permanent establishment” - Minor proposed changes*

#### *Home office as a PE*

3. When discussing the wording of the new paragraph 4.2 of the commentary, a number of delegates indicated that the combination of the words “regular” and “continuous” sounded weird and it was decided to replace “on a continuous and regular basis” by “on a continuous basis”. We think that a similar change should be made in paragraph 4.8. However, talking about a home office, it seems to us that it would be more appropriate to keep “regular” and delete “continuous” since an individual would generally not perform all his work at home but would carry on part of his activities in the enterprise’s offices, visit customers,...

4. We also suggest moving the end of paragraph 4.9 to a new paragraph 4.10. This way, paragraph 4.9 would contain examples illustrating the principles defined in paragraph 4.8 and paragraph 4.10 would explain why the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a crucial issue. In this respect, we have added the case of the dependent agent working from home whose activities as such constitute a PE irrespective of whether his home office can be considered as being at the disposal of the enterprise.

4.8 Even though part of the business of an enterprise may be carried on at a location such as an *individual’s home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual (e.g. an employee) who works for the enterprise. Whether or not a home office constitutes a location at the disposal of the enterprise will depend on the facts and circumstances of each case. In many cases, the carrying on of business activities at the home of an individual (e.g. an employee) will be so intermittent or incidental that the home will not be considered to be a location at the disposal of the enterprise (see paragraph 4.2 above). Where, however, a home office is used on a regular **and continuous** basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on the enterprise’s business (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise.*

4.9 *A clear example is that of a non-resident consultant who is present for an extended period in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise. Where, however, a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities.*

**4.10** *It should be noted, however, that since the vast majority of employees reside in a State where their employer has at its disposal one or more places of business with which the activities of these employees are effectively connected (e.g. to which these employees report), the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue. Also, activities will often be carried on at home by an agent to whom paragraph 5 applies and whose activities create as such a permanent establishment. Also-Finally, the activities carried*

*on at a home office will often be merely auxiliary and will therefore often fall within the exception of subparagraph e) of paragraph 4.*

#### ***Main contractor who subcontracts all aspects of a contract***

5. The term “possession” is used in many construction contracts to describe the contractor’s right to occupy the construction site. If the contract would contain no specification with respect to this possession it is held that such possession is implied. We propose to clarify the meaning of “legal possession” in this area (see the footnote on paragraph 19).

10.1 An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met. In the context of paragraph 1, that will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise. Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 4.2; in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. Paragraph 19.1 illustrates such a situation in the case of a construction site; this could also happen in other situations. An example would be where an enterprise that owns a small hotel and rents out the hotel’s rooms through the Internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis.

19. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. [the six subsequent sentences have been moved to new paragraph 19.1] If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts all or parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has legal possession<sup>1</sup> of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period. The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.

**1. A construction contract generally requires, expressly or implicitly, the owner to give the contractor such possession, occupation or use of the construction site as is necessary to enable him to carry out his obligations under the contract. Where work is subcontracted, the general contractor will generally have legal possession of the site and the work of the subcontractors will need to be carried out under the general contractor’s site regulations in particular with respect to the conditions of access to the site.**

#### ***Additional work on a construction site***

6. In September 2012, during a parallel session of the 17<sup>th</sup> Annual Tax Treaty Meeting, it appeared that the panelists and the participants had diverging views with respect to training performed on a construction site after its delivery as well as with respect to the example relating to additional construction

work undertaken on a construction site under a separate contract after the delivery of the initial construction. We propose to clarify these situations in a footnote.

19.1 In general, a site continues to exist until the work is completed or permanently abandoned. The period during which the building or its facilities are being tested by the contractor or subcontractor should therefore generally be included in the period during which the construction site exists. In practice, the delivery of the building or facilities by the client will usually represent the end of the period of work, provided that the contractor and subcontractors no longer work on the site after its delivery for the purposes of completing its construction.<sup>1</sup>...

1. For example, where after delivery of a technologically advanced construction project, employees of the contractor or subcontractor remain for four weeks on the construction site to train the owner's employees without any additional payment being due, that training work shall not be considered as completing the construction.

For example, where, during testing of a facility, it would appear that enhancements could improve that facility and the contractor would, under a separate contract, undertake additional work on the construction site after the facility was delivered, such additional work could be considered as completing the construction. In such case, the construction and the additional work could be regarded as a single project forming a coherent whole commercially and geographically (see paragraph 18).

*Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature ? - Scientific research.*

7. In September 2012, it was stressed by some participant that paragraph 23 refers to "scientific research" and that scientific research (as opposed to R&D) is very likely to be a preparatory activity. However, if one looks for a definition of "scientific research" it appears that the meaning of these terms is far from clear and that these terms are often considered as covering basic research, applied research and development. Therefore, we propose to clarify this issue in a footnote to paragraph 23.

23. Subparagraph e) 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. ... forms of business organisations which, although they are carried on through a fixed place of business, and may well contribute to the productivity of the enterprise, involve activities which are so remote from the actual realisation of profits by the enterprise that they should not be treated as permanent establishments. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research<sup>1</sup> or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

1. In determining whether scientific research has a preparatory or auxiliary character, a distinction should be made between, on the one hand, basic research (work undertaken for the advancement of scientific knowledge without a specific practical application in view) which is likely to be so remote from the actual realisation of profits that it may have a preparatory or auxiliary character and, on the other hand, applied research (work undertaken for the advancement of scientific knowledge with a specific practical application in view) and experimental development (work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements

***thereto) which are connected to the actual realisation of profits and which are less likely to have a preparatory or auxiliary character.***

## PART 2 — COMMENTS RECEIVED FROM THE PRIVATE SECTOR

### 1. ASEA BROWN BOVERI LTD (ABB)

8. We thank you for the opportunity to comment on the revised public discussion draft “Interpretation and Application of Article 5 (Permanent Establishments) of the OECD Model Tax Convention”. We are strongly convinced that the efforts taken by the Working Party mean a step in the right direction and will considerably improve the day-to-day tax work of ABB and other multinationals which almost daily face tax treaty interpretation issues in many jurisdictions globally.

9. In the following commentary, we limit our remarks to the changes in the revised discussion draft dated October 19, 2012, concentrating on the issues which from our point of view are most controversial.

#### 2. *Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)*

10. In the last years we observed the tendency of many tax administrations worldwide to categorize pure service activities under Art. 5 para.1 of the OECD Model Convention. They have concentrated on the time spent in the candidate PE country and often not considered the other requirements under the “place of business” concept, particularly ignoring whether or not a fixed place of business exists.

11. Contrary to sentence 1 of paragraph 4.2, we claim that the “at the disposal” concept should mainly cover cases where an enterprise carries out its business activity in a fixed place based on a formal legal right. Adapting this approach tremendously increases the degree of legal certainty (required for proper tax compliance) leading to a huge advantage for all multinational companies acting in an international environment. Having said that, we believe that the number of cases in which “disposal” is created without formal legal right is very limited.

12. We theoretically concur that the outcome in some cases based on the underlying facts and circumstances may be comparable to operating based on a factual legal right (e.g. by having legal possession) and therefore require an equal treatment but we doubt that the “having the effective power to use that location” in addition to the temporary element is clear enough to cover all relevant events.

13. In practice the term “effective power” is hard to define and it is unclear which degree of power will be sufficient to cross the line. We fear that this leaves too much space for interpretation with the tax authorities in the source countries and reduces the level of legal certainty for the taxpayer and finally leads to double taxation.

14. We therefore recommend at least considering the criteria defined by the German Federal Tax Court in various decisions which states that “disposal” includes the right to exclude others from the fixed place of business and therewith from its usage.

15. Following this principle, we come to the conclusion that neither the painter which spends three days per week over a period of two years carrying on his business in the premises of his customer nor the example in paragraph 13 (i. e. Peter who provides training services to CLIENTCO’s staff while using the office space of the client), create a PE. Both simply render their services at the clients’ premises but are not allowed to dispose over such premises (e. g. by conducting other business there while having the effective power to exclude others – including their own clients - from its usage).

16. For the sake of legal certainty the pure provision of services should never create a PE unless the respective tax treaty provides for a Service PE definition following the UN or OECD model. In case the treaty partners intend to include the provision of services under the permanent establishment principle they could therefore simply do so (vide paragraph 42.23 OECD Model Commentary).

17. We fear that based on the current (rather unclear) commentary wording a lot of source countries claim “disposal” is given although the enterprise solely renders its services at the location of its customer and not through it and therefore highly appreciate further – and more practical – clarifications being implemented in future commentaries.

**6. *Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

18. We strongly support a commentary insertion which clearly suggests a minimum consecutive period of time as a general rule under Art. 5 paragraph 1 OECD Model Convention (e. g. the 12 months period as provided by Article 5 paragraph 3 OECD Model Convention) which would considerably increase legal certainty.

19. Although we see the necessity to define certain exemptions to this general approach, we doubt that the examples implemented in the discussion draft will mean a great help for our daily work as they represent isolated cases which will hardly replicate in practice.

20. We appreciate the deletion of the fair example (5 weeks a year over 15 consecutive years which clearly does not qualify as being permanent). However, the newly implemented example (drilling operations at a remote arctic location) leaves some uncertainties. Is it decisive for the conclusion that duration of activity (i. e. expected to take 5 years) as well as the seasonal breaks has been clear right from the start of the undertaking? Will projects exceeding the initially planned duration lead to the same results? Is the fact that it is impossible to operate during the strong arctic winter (due to the permanently frozen ground) decisive for also counting the seasonal breaks? Would the solution be different in case of breaks caused by other reasons (e. g. delay caused by the customer)?

21. Due to the described uncertainties, we are of the opinion that the practical applicability of this specific example is limited and appreciate further clarification.

22. We strongly support a concept clearly defining a minimum consecutive period of presence in line with Germany’s observation listed in paragraph 45.8 to Article 5 OECD Model Convention according to which “the necessary degree of permanency requires a certain minimum period of presence during the year concerned, irrespective of the recurrent or other nature of an activity”. We therefore propose to amend the example in a way that the presence per term exceeds 6 months together with a clear statement that this is the minimum period required for creating “permanence”.

23. Though limited to sole proprietors the example mentioned under 6.2 remains critical both from a justification and a practical handling point of view.

**8. *Main contractor who subcontracts all aspects of a contract (paragraph 10 and 19 of the Commentary)***

24. As a general principle, the source country should be allocated the right to tax the profits of a foreign enterprise only under the condition that a business activity within its territory meets a certain degree of permanence (“rootedness”) which justifies source taxation. Based on that, we doubt that a foreign enterprise is able to carry out a business activity which creates a tax liability in another country without being present there.

25. In a construction business it is not uncommon to run the local portion of a construction project without (own) on-site personnel. We are therefore afraid that the newly established total delegation principle in paragraph 19 (“period spent by subcontractor = time spent by general contractor”) opens the door for source countries to tax the foreign enterprise without considering the other requirements defined therein, namely that the main contractor needs to have disposal over the site. It is our strong conviction that disposal cannot be created without a local presence of either own personnel or at least persons who receive instructions, supervision and guidance from the enterprise. For sure this is not given in case of an independent third party subcontractor.

26. We'd like to highlight that the newly defined examples explaining under which circumstances disposal over the site is given (i. e. legal possession of the site, control of access to and use of the site and overall responsibility of what happens at that location) are limited to a low number of cases. In practice it is mostly and solely the so-called general contractor which has the mentioned powers/ obligations. However, the setup of a construction project in the 21<sup>st</sup> century regularly foresees that this general contractor often involves a multitude of subcontractors which in turn engage their own subcontractors and so forth and it is usually not the case that the subcontractor controls access to or even has legal possession of the site. Due to the lack of “legal possession” (including the power to exclude others from usage) of that fixed place (i. e. site) those examples would most likely not qualify as permanent establishment for the first and any subsequent subcontractor. Moreover, it may even be concluded that a general contractor subcontracting the responsibility for the site (e. g. access control procedures) does not create a permanent establishment, even if the subcontractor exceeds the PE threshold as provided by the applicable Double Tax Convention.

27. Finally, it is unclear which result would have to be attributed to a permanent establishment deemed to exist without any physical presence in the source country following the principles of the (functionally) separate legal entity approach in Article 7 of the OECD Model Convention according to which the significant people functions represent a key factor.

28. We respectfully disagree to the widening of the permanent establishment definition in terms of Art. 5 paragraph 1 of the OECD Model Convention. An independent subcontractor – from our point of view – can never carry on a business activity of his customer. It is always the case that the subcontractor carries on its own business activity whereas – in the absence of own personnel in the source country – the main contractor simply does not have a business activity there.

29. Looking at the example under paragraph 10.1 it is not clear what the term “other factors” includes in practice although – compared to the previous discussion draft- the insertion of the reference to paragraph 4.2. is a step in the right direction. We however assume that a lot of source countries will interpret this general term in an extensive way finally leading to an increased number of PEs, partly for activities which do not involve a presence of the main contractor in the source country at all.

30. We therefore highlight that the only correct solution in this respect is to clearly define in the commentary that under Art. 5 paragraph 1 OECD Model Convention a subcontractor can never create a permanent establishment for the main contractor.

## 2. BIAC

### ***INTRODUCTION***

31. We note that you have requested comments that focus on the drafting of the recommendations rather than on their substance. In this regard, we have attempted to offer drafting suggestions on specific

issues but we also note that such drafting suggestions often relate to substantive concerns. We hope to have the opportunity to work with WP1 to further improve the guidance.

32. Before commenting on specific issues, we have set out below a number of general concerns that BIAC members have identified during their review that relate to several issues considered in the Discussion Draft.

### ***Widening interpretations***

33. As we understand it, the fundamental purpose of this project is to clarify issues of interpretation of the Commentary on Article 5; changes to the Article itself are not within scope. BIAC is concerned that some of these interpretative changes, however, will have the effect of fundamentally changing the operation of Article 5. If such changes are desired, they ought to be made to the Article itself rather than through reinterpreting long-standing principles. Renegotiating bilateral treaties is difficult and time consuming, but the alternative of changing the meaning of the treaty through shifting the interpretation of the existing provisions undermines long-standing international practice, and will increase uncertainty for both governments and businesses in the application of those treaties.

34. Business is concerned that a lack of clear language, definitions, or ‘bright line’ tests will not assist in reducing double taxation and will discourage the cross border trade and investment that is part of the OECD’s core mission. Guidance also ought to facilitate the resolution of disputes under the Mutual Agreement Procedures in addition to determining taxing rights. A lack of clarity and an openness to multiple interpretations do not contribute to this goal.

35. We are concerned that – without this being clearly articulated – the OECD and some of its member governments are suspicious of the way in which business considers taxation in relation to investment decisions. It appears from previous discussions and public consultations that WP1 is concerned that businesses will always seek to go right up to but not beyond any ‘bright line’. In our experience, business is not generally done in this way, and avoiding clear definitions due to these concerns, which likely relate to a minority of business practices, may be damaging to cross border trade. For example, business may want to put a ‘toe in the water’ in a country in order to determine whether opportunities justify an investment. If the PE standard is not clear, then business may be reluctant to do this because of the significant accounting and regulatory burdens associated with establishing a PE in a jurisdiction. Thus, lack of clarity over the PE standard may discourage foreign direct investment.

36. Further, the lack of clarity puts business in a difficult position with respect to its tax filing obligations and the possible imposition of interest and penalties. Generally, if no tax return is filed (because the taxpayer believes there is no PE), then the statute of limitations does not run and the tax authorities could assert a tax liability with interest and penalties at any time. All of this leads to caution on the part of business in deciding whether to make an initial investment or commence initial commercial activities in a jurisdiction. Therefore, the deliberate avoidance of ‘bright lines’ is not in the interest of countries or business.

### ***Response to Comments at Consultations***

37. BIAC would also like to express its concern at what it perceives as the lack of response from WP1 on suggestions that have previously been made by business.

38. BIAC submitted a significant number of comments in response to the OECD’s October 2011 Discussion Draft. These suggestions were made based on our members’ experience of PE discussions and disagreements with and between OECD member and non-member governments.

39. Business fully understands and appreciates the value of clarity and the true cost of ambiguity when considering taxation and investment decisions. BIAC's comments are always offered bearing this in mind.

40. Business understands that WP1 may have legitimate concerns about the use of PEs in certain circumstances – although it would prefer for those concerns to be more clearly articulated. However, changing a general rule to catch a minority of specific problems seems neither sensible nor proportionate. It would be much better to come up with specific rules for specific circumstances. Some of these concerns arising from new ways of doing business might be better dealt with under the BEPS project.

41. We have re-visited our previous suggestions and are concerned with the lack of response, particularly on key issues. We stand by our previous comments and encourage the OECD to revisit them. Where we feel the issues are most critical, we have provided additional input in this letter to better explain our material concerns and suggestions.

42. Guidance will be most effective, and will promote certainty and cross-border trade and investment if the opinions of business and governments are articulated, understood and debated before guidance is adopted.

#### ***A lack of consensus***

43. As noted above, several comments made in this document relate to the ambiguity of the proposed guidance. This should be of concern not just to business but also to governments, considering that improving clarity is the fundamental objective of this project.

44. BIAC understands that the Discussion Draft is not clear on several issues because there is a lack of consensus among WP1 representatives. As we have stated in previous comments on earlier Discussion Drafts, reservations from WP1 representatives can cause problems in Competent Authority contexts, as one country or the other may take the position that it is not bound by the provisions of a treaty to which it has made a reservation. As a policy, BIAC recommends to the OECD that in principle, reservations should be resisted, as they do not facilitate dispute resolution nor provide principles which non OECD countries can apply in a consistent manner.

45. However, if WP1 cannot reach consensus on certain issues, we believe it would be helpful to state clearly which representatives have expressed dissenting views and what those views are. Such an approach, although not ideal, would be preferable to new vague guidance with the resulting increased risk of dispute. This should be helpful to countries entering into treaty negotiations as well as taxpayers since the dissenters' observations will allow countries with different views to identify and potentially resolve those differences in the context of negotiations rather than leaving the issues to be identified and resolved (or not) through the competent authority process.

46. BIAC would be pleased to engage openly with WP1 on these most difficult of issues in the hope of achieving greater clarity.

#### ***KEY COMMENTS***

##### ***Issue 2: Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)***

###### ***“Meaning of Effective Power to Use”***

47. The revised Discussion Draft adds that whether a location may be considered to be at the disposal of a foreign enterprise depends in part on the foreign enterprise “having the effective power to use that

location.” It appears that WP1 intended to respond to commenters’ requests that the Commentary be revised to require a foreign enterprise to have more than a mere presence (or a presumed ability to be present) at the location. We are concerned, however, that the proposed “effective power to use” standard does not adequately communicate this intent. If a foreign enterprise is in fact present at a particular location, it seems that it is thereby “effective” in being there. Accordingly, we ask WP1 to consider the following alternatives. Per our comments on the October 2011 Discussion Draft, we continue to believe that the concept of “control” would provide the clearest guidance to taxpayers. Thus, the language in paragraph 4.2 would read “having control over that location.” Alternatively, WP1 may consider using other formulations that require more than mere physical presence at a particular location, such as “having the effective power to determine how and when the location will be used by the enterprise in the conduct of its business” or “having command over.” Indeed, the formulation should be consistent with the other standards set forth in the existing Commentary (e.g., paragraph 4 refers to a foreign enterprise having certain premises “at its constant disposal”). Whatever the appropriate formulation, it is important to distinguish the test for a fixed place of business PE under Article 5(1) from the optional deemed services PE standard that applies by its terms only if included in the applicable treaty (Commentary paragraph 42.21).

*Mere Presence (or Presumed Ability to be Present)*

48. The “effective power to use” is one factor, among others (e.g., “the extent of the presence” of a foreign enterprise’s employees at a location), in determining whether a place is at the disposal of a foreign enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on.”

49. However, the various factors used in revised paragraph 4.2 unfortunately lack the clarity necessary to provide taxpayers the guidance they need, especially on an issue as fundamental as the existence of a PE. For example, revised paragraph 4.2 explains that whether a PE exists depends on, among other factors, “the extent of the presence of the enterprise,” and if an enterprise performs its business activities at a particular location “on a continuous basis during an extended period of time.” The “extent of the presence” formulation suffers from a lack of clarity. Does “the extent of the presence” refer to the length of time that an enterprise is present at a particular location, or to the number of employees it has there at any given time, or to other considerations, or to a combination of factors? Likewise, does “extended period of time” refer to the six-month or greater period set forth in paragraph 6 of the Commentary (explaining that “experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried out in a country through a place of business that was maintained for less than six months”). If so, then we suggest that a cross-reference to paragraph 6 be inserted in paragraph 4.2. As discussed above, BIAC is concerned that the lack of guidance with ‘bright lines’ has the unfortunate consequence of discouraging investment, resulting in protracted and needless expensive controversies.

50. Along similar lines, we remain very concerned that the proposed standards could be read as coming close to erasing the distinction between the existence of a fixed place of business PE under Article 5(1) and the alternative provision for a services PE, especially if, as appears to be the case under the proposed standards, presence combined with the passage of time without more is all that is required to constitute a PE under Article 5(1). Courts have required a more demanding standard for finding that a taxpayer has a fixed place of business at a third party’s premises under treaties. For example, Canada’s Federal Court of Appeal in *The Queen v. William A. Dudney* (2000) held, under facts very similar to the example involving Peter in paragraph 13 of the Revised Discussion Draft, that a “fixed base” (analogous to a fixed place of business PE) did not exist, despite the presence of the taxpayer at the client’s location for a total of 340 days over two years. The Dudney Court noted that the taxpayer’s access to the client’s premises was determined exclusively by the client, that the taxpayer could not do work there for anyone

other than that client, that the taxpayer had no space in the premises that was exclusively his, and that the taxpayer was not identified to other clients as working at the client's location and could not be found by them there. When Canada and the United States subsequently amended their income tax convention to include a services PE provision, the U.S. Senate Foreign Relations Committee said that amounted to a reversal of the result of the Dudney decision. The Oxford English Dictionary defines "at one's disposal" to mean "available for one to use whenever or however one wishes". If the Commentary is amended in such a way as to deprive the concept of "disposal" of any of that notion of freedom to determine the time and manner of use, that will subvert the common meaning of the existing Commentary language and potentially amount to a stealth introduction of the services PE alternative into Article 5(1) itself.

#### *Contract Manufacturing Arrangements*

51. The revised Discussion Draft helpfully retains language from the original Discussion Draft confirming that "it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant."

52. As explained in paragraph 18 of the revised Discussion Draft, WP1 intended the conclusion that no PE exists under the CARCO example set forth in paragraph 17 to "be reflected in the changes to paragraph 4.2 (relating to the meaning of "at the disposal of"). The CARCO example clearly involves a consignment or toll manufacturing arrangement pursuant to which the foreign enterprise maintains ownership of the raw materials, work-in-process, and final product through the manufacturing process.

53. Thus, in order to more clearly reflect the WP1 conclusion, paragraph 4.2 should be revised by adding "or a consignment or toll manufacturer" after "supplier or contract-manufacturer" to clarify that the same conclusion applies equally to a consignment or toll manufacturing arrangement.

#### ***Issue 6: Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

54. We are disappointed that the Working Group has not accepted BIAC's repeated recommendation for the adoption of a more definite minimum time threshold for the establishment of a PE. It appears that the lack of a more definitive statement in this regard is due to an inability to achieve consensus among the delegates. BIAC believes that this inability to achieve consensus or the deliberate avoidance of 'bright lines' is not in the interest of countries. BIAC is aware that some countries are concerned that drawing 'bright lines' with respect to the minimum time required to have a PE will encourage taxpayers to go right up to that line and then leave in order to avoid being subject to tax. Business is not generally conducted in that way. It is far more likely that a company will avoid engaging in a country when it is unclear when the company will become subject to tax. This lack of clarity is therefore likely to discourage and delay foreign direct investment. We urge WP1, when it reviews the Discussion Draft, to continue to work on this issue. It would be helpful if the wording with respect to the 6 month minimum time period could be made more definitive. We suggest that a new last sentence be added to paragraph 6 of the Commentary as follows (proposed new text italicised in bold and underlined):

***Based on these member country practices, generally, a place of business that does not exist for more than 6 months will not be considered fixed and therefore will not constitute a permanent establishment except in the case of the two limited exceptions described in paragraphs 6.1 and 6.2.***

55. It is our understanding based on the public discussion that the examples in paragraphs 6.1 and 6.2 are intended to be read narrowly and therefore it would be useful to make that clear in the Commentary. A sentence along the lines suggested above would be helpful in that regard.

56. We reiterate our previous comments as to the problems experienced by the business community with respect to the PE concept when dealing with business activities of a short duration. As mentioned before, we object strongly to the assertion that a PE could be found based on either of the exceptions proposed in the Discussion Draft. However, given that our suggestions have been rejected, we appreciate that the Working Group has attempted to limit the application of the PE concept to short-term activities by way of the addition of more specific examples to the Commentary.

*Recurrent activities*

57. BIAC appreciates the narrowing of this exception that seems evident from the inclusion of a new more limited example, statements at the public consultation, and the deletion of the example pertaining to selling at a commercial fair. We are concerned, however, that the substantive language of paragraph 6.1 has not been narrowed. Therefore, some countries might take the position that it is still possible to conclude there is a PE based on the recurrent short-term presence at a location, without regard to the reason for which the presence is short-term. There are a couple of ways this ambiguity could be eliminated. One way would be to revise the first sentence along the lines of the following (proposed revisions italicised in bold and underlined):

One exception to this general practice has been where the activities were of a recurrent nature; in such cases, ***if the reason the activities are recurrent rather than continuous relates to the nature of the location at which the activities are performed***, then each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years).

58. BIAC believes this formulation makes clear that the nature of the location, rather than the nature of the business, is the reason for the application of this exception. That is, the enterprise would be carrying on drilling operations in country S year round except that the seasonal conditions prevent them from engaging in that activity. Including the suggested language would also clarify the application of the exception to other common, situations. For instance, in the case of an MNE, marketing personnel may meet every year at a company headquarters. Although this is a recurrent activity, the nature of the location has no effect on the way the business is conducted and therefore these activities should not be captured by this test. Further, in our view these more common examples would not trigger a PE because the headquarters are not at the disposal of the marketing personnel and the activities performed at the headquarters should be considered preparatory and auxiliary. - Nevertheless, clarifying the language in paragraph 6.1 would eliminate any doubt on this issue.

59. Another way of reducing the ambiguity would be to include examples of cases in which recurrent activities do not result in the creation of a PE. These examples could include the example from the prior Discussion Draft, the example of marketing personnel meeting at headquarters discussed above, and an example of a consultant who travels annually to meet with a client for two weeks at the client's place of business and to review the client's activities and provide advice.

60. If the recurrent activities exception does apply and a PE is deemed to exist, it is unclear at what point in time the recurrent activity will constitute a PE. It seems logical that that point would be when the total amount of time spent by the enterprise of State R in State S exceeds the six month general threshold (or whichever general time threshold is in place in State S). BIAC strongly supports this interpretation because of the difficulties associated with retrospective PEs. The facts of the example in the revised Discussion Draft provide that the enterprise expects the operations to continue for a period of five years. In such a case, where the taxpayer expects from the outset to be in State S for such a period, treating the taxpayer as having a PE from the outset is less troubling. In the absence of evidence of such an intention (e.g., a contract signed by the enterprise that indicates the duration of the activities), a PE based on

recurrent activities should be constituted on a prospective basis from the date when the relevant time threshold is passed to avoid difficult compliance issues. BIAC understands that the Commentary is not clear because there is no consensus among the countries concerning this issue. However, it is unfair to taxpayers to find a PE retrospectively and then impose penalties, if the standard is not clear. At a minimum the Commentary should urge countries to clearly set forth their positions in their bilateral agreements, so that taxpayers can understand their tax filing obligations.

*One Shot Projects*

61. BIAC reiterates its previous comments concerning the inappropriateness of treating any short-term business as a PE. We believe it is crucial that the exception be limited to its stated purpose: to permit source country taxation where activities constituting that business are carried on exclusively in the source country. In order to make that clear, the portion of the example illustrating when a PE would not be found to exist should be revised as follows (proposed revisions italicised in bold and underlined):

This would not be the situation, however, where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four ***month production of a documentary week international sports event.*** In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S.

62. If this exception is not limited to the unique and self-contained business, then it would dramatically undercut the general PE rule. We agree that non-resident caterers that operate their business in a state during a sporting event of limited duration (such as the Olympics) or other short term event should not have PEs in that state, assuming that they operate their business outside that state as well. Because of the importance of this distinction, it is important to maintain both the parts of the example illustrating both the unique and self-contained nature of the business and the business that is part of a larger multinational enterprise. The absence of any kind of minimum time limit, even in the case of a unique, self-contained business, continues to be of concern to the business community.

***Issue 7: Presence of foreign enterprise's personnel in the host country (paragraph 10 of the Commentary)***

63. It is disappointing that none of BIAC's proposed amendments/clarifications appear to have been included within the revised text. Specifically the use of the term "secondment" without definition may lead to an inconsistent application of the term.

64. In addition, BIAC strongly believes that paragraph 10 of the Commentary should be revised to include a new last sentence concerning cross border reporting lines (proposed new text italicised in bold and underlined):

***It should be noted that cross border reporting lines will not, in and of themselves, create a secondment of the reporting employee to the company to which the employee reports.***

65. BIAC assumes that this is in fact the intention of the current draft and therefore such an amendment should be quite straightforward, however, should this not be the intention this should be clearly articulated along with the reasons as to why.

66. The examples intended to illustrate the application of paragraphs 8.13 to 8.15 of the Commentary to Article 15 and their application to the determination of whether a PE exists are not detailed enough. In particular, the second example, discussed in paragraphs 41 and 42 of the Discussion Draft, does not indicate how the issue of whether RCO is considered to be the employer of the hotel managers ought to be resolved. One approach to providing more clarity on this issue would be to expand the second example to

include additional facts concerning the employment relationship that are enumerated in paragraph 8.14 of Article 15 Commentary. Perhaps there could be two examples, one in which RCO is considered to be the employer and one in which RCO is not considered to be the employer. At a minimum, the Commentary should encourage treaty partners to be clear on this point in their bilateral negotiations.

***Issue 8: Main contractor who subcontracts all aspects of a contract (proposed paragraph 10.1 of the Commentary)***

67. We remain of the view that the proposed paragraph 10.1 is deeply troubling as a matter of principle. In providing that the business of an enterprise can be carried on by a third party, without limitation as to whether the third party is in any sense dependent on the enterprise, the paragraph represents a material extension of the PE rule. There is, however, no guidance or commentary on why it has been necessary to extend the fixed place of business rule in this way, nor is there any clarity on the intended scope and operation of the rule. Further, the general statement in the first sentence of proposed paragraph 10.1 "An enterprise may also carry on its business through sub-contractors, acting alone or together with employees of the enterprise" seems evidently at odds with other statements made in the Commentary. For example, in existing paragraph 42 there is the statement "Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location...". Even in relation to the services PE discussion (and notwithstanding the lower threshold test that applies for a services PE) the same conflict emerges. In paragraph 42.23, for example, the comments in the last sentence of the paragraph indicate that, absent circumstances involving specific direction and control, services performed by an individual on behalf of an enterprise are not to be regarded as performed by the enterprise. We assume it cannot have been the intention of the OECD to create a conflict with this existing guidance.

68. In the absence of any principled explanation of the proposed paragraph, we cannot support its inclusion in the amendments to the Commentary to Article 5. If the OECD does wish to pursue the change it would seem necessary, as a minimum, to provide some guidance on the circumstances in which the business of a third party may be considered to represent the business of another company and also to address any inconsistencies with existing statements in the Commentary. The WP1 should also clarify how to apply the concept of premises being "at the disposal" of an enterprise when WP1 considers that the business of the enterprise is being conducted by a third party (especially, for example, an independent third party) at the third party's premises. Finally, if WP1 wishes to retain the current language in the Discussion Draft without further clarification, the OECD should, as a matter of urgency, clarify how the Authorised OECD Approach to the attribution of profits to permanent establishments applies to situations where a permanent establishment is found to exist under Article 5(1) because of activities carried on by a third party for the benefit of a foreign enterprise.

***Issue 19: Meaning of "to conclude contracts in the name of the enterprise" (paragraph 32.1 of the Commentary)***

69. Issue 19 clearly posed the question for which guidance was sought under Article 5(5), namely whether the phrase "to conclude contracts in the name of the enterprise" refers only to cases where the principal is legally bound vis-à-vis the third party, under agency law, by reason of the contract concluded by the agent, or whether it is sufficient that the foreign principal is economically bound by the contracts concluded by the person acting for it in order for a PE to exist. We were, of course, quite disappointed to hear during the public consultation that the WP1 delegates were unable to reach a consensus on that question, particularly in light of the history of Article 5(5) and its Commentary and the well-reasoned opinions issued by various countries' Supreme Courts in recent years which have concluded the standard requires the principal to be legally bound. We continue to believe that the OECD, by making no improvement to the Discussion Draft, would be squandering a precious opportunity to provide valuable

guidance through the Commentary on an issue that cries out for resolution, especially when one considers the number of controversies that continue to fester now, and are likely to arise in the future, on this question. We are particularly disappointed by the apparent truth that consensus was so far from being attainable that the OECD could not even express a preferred view on this question, allowing dissenting members to record their disagreements through observations. While not ideal, that approach would have been preferable to a complete lack of consensus on the issue raised.

70. We were nevertheless heartened to hear at the public consultation that the language which was proposed to be added to paragraph 32.1 of the Commentary was simply intended to shed light on the historic basis for the sentence, now present as the first sentence of paragraph 32.1 but originally added to paragraph 32 of the Commentary in 1994, which reads: “Also, the phrase authority to conclude contracts in the name of the enterprise’ does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.” The history of the introduction of that sentence in 1994 is irrefutable – the sentence was intended to address a concern raised by the United Kingdom, a common law country, concerning the possibility that a literal application of the Article 5(5) words “contracting in the name of” would cause a UK agent who did not reveal his principal but did enter into a contract which legally bound the principal not to be recognized as creating a PE.<sup>1</sup>

71. Thus, the sentence added in 1994 was specifically intended to confirm that an agent acting on behalf of an undisclosed principal who legally bound that principal would create a PE under Article 5(5); it had no connection with situations involving agents contracting in their own names where those agents did not legally bind their principals.<sup>2</sup> This history was fully noted and understood by the Rapporteur Public in the Conseil d’Etat’s Zimmer case in France and contributed to the decision in that case which held that a commissionnaire would not create an Article 5(5) PE where it did not legally bind the party it represented. The same history was cited and understood by the Supreme Court of Norway in its Dell decision, which similarly held that a commissionnaire acting for an undisclosed principal would not create an Article 5(5) PE without legally binding the principal.

72. We were likewise heartened to hear from the Secretariat at the public consultation that there was surprise that the language proposed to be added to paragraph 32.1 of the Commentary under the October 2011 Discussion Draft – “For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract” -- could be interpreted as applicable to situations where an agent may have bound its undisclosed principal economically but not legally.

73. Given the acknowledgement that the new sentence, as drafted, had apparently been misunderstood by some readers to support the “economically bound” approach, we were especially disappointed that WP1 did not take the opportunity presented by the revised Discussion Draft to improve on the ambiguous drafting to more clearly reflect the intention underlying the new language, namely to provide an illustration which would better explain the historic basis for the language in the first sentence of paragraph 32.1 regarding contracts “which are binding on the enterprise”.

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1 This concern was described in the May 1993 article by John Avery-Jones et al., “Agents as Permanent Establishments under the OECD Model Tax Convention”, *European Taxation*, page 161, as having been the source of an observation entered by the UK on the Commentary on Article 5 in 1992.

2 The introduction of the sentence resulted in the UK’s withdrawal of its observation on the Article 5 Commentary in 1994.

74. The history of the first sentence of Article 32.1, and its origins in the OECD's desire in 1994 to confirm the potential creation of an Article 5(5) PE in the case of an undisclosed agent who legally binds his principal, are objective facts which cannot be denied. It would be contrary to known fact and regrettably productive of unjustified new confusion to introduce into the Commentary language which incorrectly left the impression with some readers that the first sentence of Article 32.1 was intended to address anything other than situations where an undisclosed agent legally bound his principal.

75. For this reason, we strongly recommend that the new language proposed for inclusion in paragraph 32.1 be redrafted to eliminate any possible interpretation that the first sentence of paragraph 32.1 was intended to address situations involving agents who did not legally bind their principals. The simplest and most straightforward way of doing that would be to add the word "legally" before "bound" in the proposed new language. Alternatively, the new sentence could be redrafted to refer more clearly to the historic concern which led to the introduction of the first sentence of Article 32.1. For example, the new sentence could be redrafted along the following lines: "This clarification confirms that a person acting on behalf of an enterprise may create a PE for that enterprise under paragraph 5, where the person concludes contracts with third parties which under applicable law bind the enterprise vis-à-vis the third parties, even if the person does not formally disclose that it is acting for the enterprise and the name of the enterprise is not referred to in the contracts."

76. If WP1 cannot agree to improve the drafting of the proposed addition in accordance with either of the recommendations above, we respectfully urge WP1 to omit the proposed addition from the final package of changes to the Commentary. We believe that the proposed addition, as currently drafted, has the risk of creating greater confusion than if no change were made to paragraph 32.1. The fact that the acknowledged misinterpretation of the proposed addition was identified in the course of the public consultation and was not addressed in the revised Discussion Draft exacerbates the potential confusion.

77. The purpose of this project is to clarify issues of interpretation under Article 5 that were identified. If the resulting changes fail to bring greater clarity and actually create greater confusion, they undermine the very objective the OECD set out to achieve and bring discredit to the Commentary itself. That would indeed be a lamentable outcome, particularly when WP1 resigned itself to the fairly unambitious task of illustrating the historic genesis of existing Commentary language.

78. We are also disappointed that WP1 has declined to provide guidance on three additional scenarios raised by BIAC (involving multiple approvals or nonexistent or highly circumscribed negotiating authority) on the grounds that the cases are factual and that the Commentary ostensibly already provides adequate guidance to deal with them. We respectfully disagree with the latter conclusion and submit that it is untenable in the face of the business views expressed in the public consultation on that point.

79. We suggest that WP1 could better fulfil its mandate on this project by attempting to address these issues through proposed enhancements to the Commentary. BIAC would be glad to engage in a dialogue with the OECD on these issues. If WP1 decides not to pursue that route, we strongly urge that its final report omit the third through sixth sentences of paragraph 112 of the Discussion Draft. Those sentences include some loose commentary on the scenarios raised without any indication of whether that commentary reflects a consensus view of WP1, nor any opportunity for countries to make their individual views known through observations or otherwise. If there are consensus conclusions which can be formalized into Commentary on Article 5, then the OECD should consider adopting such enhancements to the Commentary; otherwise, loose remarks on scenarios which are not being addressed in actual Commentary language should not be included in the final report.

**OTHER COMMENTS*****Issue 3: Can the premises of a (converted) local entity constitute a permanent establishment of a foreign enterprise under paragraph 1? (paragraph 4.2 of the Commentary)***

80. The earlier Discussion Draft provided that “no distinction should be made based in the application and interpretation of Article 5 based on whether or not the facts and arrangements relevant to the determination of a PE resulted from a business restructuring.” (Paragraph 19 of the first Discussion Draft.) BIAC suggested that Commentary itself should be clear on this point. The OECD proposes to include an entirely new paragraph 3.1 that would make this clear. We appreciate the OECD proposing to clarify this point and support inclusion of this new paragraph.

81. Paragraph 17 of both versions of the Discussion Draft provides as follows:

*Two relevant questions are whether these premises are at the disposal of the foreign enterprise and whether it is the business of the foreign enterprise (and not only the business of the local entity) that is wholly or partly carried on in these premises.*

82. BIAC continues to believe that whether the premises of the premises of SUBCAR are actually at the disposal of CARCO would be made clearer by actually including the entire example (which paragraph 18 indicates WP1 agrees does not constitute a PE) and not just the abbreviated version that is contained in paragraph 4.2. The additional detail in the longer example helps flesh out the level of involvement that CARCO is permitted to have without having a PE and therefore would be helpful to include.

***Issue 10: Meaning of Place of Management (paragraph 12 of the Commentary)***

83. BIAC supports the proposed changes to the Commentary on this issue. The new Discussion Draft (copied below) makes minor clarifying changes we believe constitute improvements. The background material contains an example (paragraph 58) and an explanation (paragraph 60) that make clear that centralizing administrative functions does not create a PE because the place where these functions are performed is not “at the disposal” of the entity on whose behalf they are performed. We believe it would be useful to make a minor change to paragraph 12 of the Commentary that would clarify this issue further (proposed new text italicised in bold and underlined).

This paragraph contains a list, by no means exhaustive, of examples of places of business, each of which can be regarded as constituting a permanent establishment under paragraph 1 provided that it meets the requirements of that paragraph. As these examples are to be read in the context of the general definition given in paragraph 1, the terms listed, “a place of management”, “a branch”, “an office”, etc. must be interpreted in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1 (**e.g., the premises are at the disposal of the entity on whose behalf the services are provided**) and are not places of business to which paragraph 4 applies.

***Issue 11: Additional work on a construction site (proposed new paragraph 19.1 of the Commentary)***

84. BIAC supports the proposed changes to this paragraph of the Commentary. For the many reasons discussed during the public consultation, we appreciate that the OECD has not proposed to adopt the standard of “delivery and the acceptance by the client”.

***Issue 12: Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)***

85. BIAC commends the OECD for making clear the listed activities constitute “automatic exceptions” to the fixed place of business PE described in Article 5(1). The revised version of paragraphs 21 and 23 of the Commentary makes clarifying changes that we believe represent improvements to the earlier draft.

***Issue 13: Relationship between delivery and the sale of goods in subparagraph 4a) (paragraphs 22 and 27.1 of the Commentary)***

86. BIAC agrees with the proposed changes on this issue and believes the minor clarifying changes to paragraph 27.1 are improvements to the draft language.

***Issue 17: Negotiation of import contracts as an activity of a preparatory or auxiliary nature (paragraphs 24 and 25 of the Commentary)***

87. BIAC supports the clarification provided by paragraph 24.2 of the draft Commentary. However, we propose that a new sentence should be added at the end of this paragraph to confirm that it relates to the application of the paragraph 1 rules, rather than being an extension of the deemed PE rules contained within paragraph 5 (proposed new text italicised in bold and underlined):

24.2 Similarly, where an enterprise that sells goods worldwide establishes an office in one State, and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State (e.g. by participating in decisions related to the type, quality or quantity of products covered by these contracts) even if they do not exercise an authority to conclude contracts in the name of their employer, such activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment. **However, an enterprise will not be taken to have established an office in one State where the enterprise's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise.**

***Issue 20: Is paragraph 5 restricted to situations where sales are concluded? (paragraph 33 of the Commentary)***

88. BIAC suggests adding language to paragraph 33 to clarify that a toll manufacturer that purchases materials on behalf of a foreign enterprise/principal (e.g., by accepting a purchase order) is not the type of contract referred to in paragraph 5 because such purchases do not relate to the “business proper” of the principal. An enterprise that engaged in purchasing activities directly would not be considered to have a PE under paragraph 4(d) of Article 5. Thus, purchasing activities of a toll manufacturer should not cause the enterprise to have a PE. Accordingly, BIAC requests that WP1 add the following language at the end of revised paragraph 33 of the Commentary (proposed new text italicised in bold and underlined):

***Similarly, a toll manufacturer that concludes contracts for materials that are needed to manufacture the goods for a principal enterprise in another country is not the type of contract to which paragraph 5 applies because such contracts do not relate to the business proper of the principal (see paragraph 4(d) of Article 5).***

89. Again, we thank you for the opportunity to comment on this draft. We would reiterate again, however, the importance for both taxpayers and governments of providing clarity in this area to reduce the

potential for uncertainty and dispute. If it would be useful, BIAC representatives would be pleased to meet with representatives of the WP1 to assist in furthering the attempt to clarify the concept of "Permanent Establishment" in treaty situations based on the experience of business.

### **3. BRITISH PRIVATE EQUITY AND VENTURE CAPITAL ASSOCIATION (BVCA)**

#### *[...]/3. Comments*

90. We refer to our letter dated 9 February 2012 commenting on the OECD's previous public discussion draft on this subject (a copy is enclosed for ease of reference) and to the comments made by our representative at the public consultation meeting held by the OECD on 7 September 2012. As previously stated, we also endorse the comments made in section VI. of the Report of the Venture Capital Tax Expert Group on "Removing Tax Obstacles to Cross-Border Venture Capital Investments" published on 30 April 2010 (the "Expert Report").

91. We would respectfully ask the Working Group to reconsider the request in the Expert Report for published guidance that Fund Managers and their personnel will generally be regarded, in relation to VC Funds and their investors, as agents of independent status acting in the ordinary course of their business. As previously stated, we believe that Fund Managers and their personnel should generally be viewed as independent agents, given that:

- (a) Fund Managers normally provide their services to VC Funds in which a disparate group of investors have invested, including a significant number of third party investors who otherwise have no economic or legal connection to the Fund Manager;
- (b) Fund Managers are normally paid an arm's length fee for their services;
- (c) Fund Managers are not normally subject to detailed instructions or day-to-day control by the investors in the VC Fund; and
- (d) Fund Managers normally bear the risk of their business activities, in the sense that any poor performance is likely to result in reduced future fee income.

92. We acknowledge that the facts and circumstances of arrangements may vary. However, we believe that it should be possible to identify the normal, arm's length categories of case in which Fund Managers will generally be regarded as acting as independent agents. We attach some proposed language for inclusion in the proposed guidance set out in Paragraph 125 of the Discussion Draft (our changes are marked in bold and italics).

93. We would, of course, be happy to discuss this proposal with the Working Group.

#### *Changes to proposed guidance in Paragraph 125 of the Discussion Draft*

The definition of "enterprise of a Contracting State" in Article 3(1) refers to "an enterprise carried on by a resident of a Contracting State".

The term "enterprise" itself is not defined, even though subparagraph d) of Article 3(1) clarifies that "it applies to the carrying on of any business". The first part of paragraph 4 of the Commentary on Article 3 reflects different views as to whether the term refers to the organisation that carries on a business activity or to the activity itself:

The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the

Contracting States. No exhaustive definition of the term “enterprise” has therefore been attempted in this Article.

This ambivalence between the view that an enterprise is a business organisation and the view that it is a business activity appears in different parts of the Convention. In the context of Article 5(1), which refers to “the business of an enterprise”, it seems difficult, however, to refer to an enterprise as an activity and the term therefore seems to correspond to a business organisation. On that basis, the term would cover any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form.

In the particular case of an enterprise taking the form of a fiscally transparent partnership, that enterprise should be viewed as a distinct enterprise carried on by the partners who share the profits of that joint enterprise. Paragraph 19.1 of the Commentary on Article 5 confirms that position (see also the third example in paragraph 42.38); that paragraph deals with the situation of a transparent partnership and concludes that:

In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve month[s], the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.

Applying this analysis to a venture capital fund set up as a transparent limited liability partnership, one would therefore consider that the fund forms a distinct enterprise carried on jointly by the limited partners and the general partner, who all share in the profits of that joint separate enterprise (i.e. separate from the partners’ respective enterprises). This enterprise being carried on by each partner, it constitutes an enterprise of each Contracting State of which a partner is a resident as regards the share of that particular partner.

It follows from the above analysis that the reference, in Article 5(5), to a person acting on behalf of an enterprise and having the authority to conclude contracts in the name of that enterprise must therefore be applied with respect to the partnership, which is the relevant enterprise in whose name the fund’s investment contracts could be concluded. If the conditions of paragraph 5 are met, it is that enterprise that will be considered to have a permanent establishment, and the result will be that an enterprise of each Contracting State in which a partner is a resident (in proportion to the share of the profits of that partner) will be considered to have a permanent establishment.

The analysis should be the same for the purposes of Article 5(6) and the independent status of a local fund manager should therefore be determined in relation to the limited partnership itself rather than by reference to each investor in that partnership. *However, this analysis (treating the local fund manager as acting on behalf of one enterprise, rather than a number of enterprises) will not of itself make it less likely that a local fund manager will be an agent of independent status. Although the position will depend on the facts, a local fund manager of a venture capital fund (or a similar investment fund) established as a limited partnership will normally be acting as an agent of independent status, provided that:*

- (a) *the local fund manager provides its services of identifying, making, managing and selling investments in the ordinary course of its business;*

- (b) *the fund is widely held (meaning that no majority interest in the assets or income of the fund is held, directly or indirectly, by five or fewer persons, taken together with persons connected with them);*
- (c) *any investors in the fund who control, or are under common control with, the local fund manager do not have an interest in the assets or income of the fund which in aggregate exceeds 50 per cent; and*
- (d) *the fund manager receives an arm's length fee for its services.*

#### 4. CHARTERED INSTITUTE OF TAXATION (CIOT)

94. We refer to the revised proposals on the interpretation and application of Article 5 (Permanent Establishment) published on 19 October 2012. This contains some modifications to the earlier public discussion draft published on 12 October 2011 as a result of comments received on the earlier draft, including during the discussions at the public meeting held in Paris on 7 September 2012.

95. We would like to take this opportunity to reiterate some of the comments made in our response to the earlier public discussion draft and to comment on some aspects of the proposed drafting.

##### 1. *Home office as a PE (proposed new paragraphs 4.8 and 4.9)*

96. Although the revised new paragraph 4.8 is broadly reasonable, a possible conclusion that could be drawn is that where an enterprise decides to establish a new business in a territory, and hires staff to work in that territory prior to establishing an office, it may have created a PE at that point if the new staff work from home and their activities are part of the wider commercial activity. This may well be earlier than many enterprises anticipate, although profit attribution at that stage is likely to be small. It would be helpful to clarify this.

97. Also, we queried in relation to the proposed new paragraph 4.2 set out on page 9 of the October 2011 discussion document what was meant by the phrase '*continuous and regular basis during an extended period of time*'. It was not clear whether this phrase is intended to mean an extended continuous period or regular significant lengths of time over an extended period. Helpfully the revised draft paragraph 4.2 has deleted the words "*and regular*" from the proposed commentary which we think clarifies matters.

98. However, the phrase '*regular and continuous*' is also used here. This gives rise to similar questions as what is meant by the phrase '*continuous and regular*'. We suggest that the same changes should be made here as have been made to paragraph 4.2 to ensure that the same phrase is used throughout the commentary.

##### 2. *Presence of foreign enterprise's personnel in the host country (paragraph 10 of the Commentary)*

99. We remain of the view that whilst the proposed changes to paragraph 10 regarding secondees are helpful, the comments in paragraph 44 of the discussion document are of concern. These relate to the situation where a secondee remains on their home country payroll (often for HR/benefits/compensation/currency reasons) and the host company is charged on a cost-plus basis. Paragraph 44 mentions the possibility that this cost-plus indicates that what the secondee is doing in the host country is not part of the host company's activity but rather part of the home company's activity, hence there is PE exposure. Reference is then made to the criteria in paragraphs 8.13-8.15 of the Model commentary regarding the host state company being the 'economic employer' for Article 15 183 day protection purposes to avoid a home state company PE in the host country.

100. Whilst the changes are designed to be helpful, given the multiplicity of criteria in paragraphs 8.13-8.15 and the subjectivity sometimes involved (for example who instructs the individual (matrix management)), the outcome may not always be certain. In the worst case, this might leave multinational companies with the choice of accepting a local 'economic employer' and so host country taxation of secondees, even where they are present for no more than 183 days in the host country, or accepting a PE of the non-resident company in the host state. Further clarification would be welcome.

**3. *Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)***

101. We continue to have concerns about the proposals made in relation to this issue. Although some changes from the earlier draft have been made, in our view, the new provisions still leave open the issue relating to the overall responsibility of the contractor on the on-site operation by the sub-contractor. We remain of the view that this should be dealt with under the dependent agency type PE rule rather than deeming the subcontractor(s) to be a PE of the non-resident main contractor. As drafted, although discussed in the context of the construction industry, there is a real danger that this principle of deeming a third party subcontractor to be a new type of PE of the main contractor could be extended to other industries – for example financial services in the context of brokers acting for non-resident principals. We suggest that further changes are required to ensure that this paragraph does not set a dangerous precedent.

**4. *Does a development property constitute a PE (paragraph 22 of the Commentary)***

102. We remain of the view that the analysis at paragraph 86 of the discussion document is incorrect in terms of interaction of treaty and domestic law. A domestic charge under the Business Profits Article 7 cannot be justified by reference to the host state being permitted to charge under the Capital Gains Article 13. We refer to the Malaysian High Court case of *DIGR v Euromedical Industries Ltd* [1983] Part 1 Case 14 [FCM], where, in the absence of a PE, Malaysia's domestic withholding tax on technical assistance fees paid to a UK parent was blocked (the fees being business profits for treaty purposes rather than royalties, but there being no Malaysian PE).

**5. *Meaning of 'to conclude contracts in the name of the enterprise' (paragraph 32.1 of the Commentary)***

103. As previously stated, the proposed addition to paragraph 32.1 of the Commentary will expressly provide that a principal enterprise bound by a contract concluded by another person with a third party would not be protected from having a PE in the country of that other person merely by virtue of that other person not disclosing that it was acting for the principal enterprise in its dealings with the third party. This would in particular appear to be targeted at principals in commissionaire arrangements, but as worded goes much wider than this. As it stands this is an unwelcome clarification, because the analysis is incomplete. The existence or otherwise of a PE should be with regard to all the facts and, in particular, the conduct of the parties. It would be preferable if the revised commentary reflected this.

**5. CONFEDERATION OF BRITISH INDUSTRY (CBI)**

***General comment***

104. The CBI is aware of a general concern that the input of commentators has not been adequately addressed in the WP1 recommendations in the revised proposals. The CBI is particularly concerned that there is now more ambiguity and lack of clarity of intent in the identification of when a permanent establishment (PE) has come into existence than previously.

105. The CBI is also aware of the comments from BIAC, and generally endorses the observations made in that document. A point of particular concern to our members has been set out below.

***General comment on "Time requirement for the existence of a permanent establishment (paragraph 6 of the commentary)***

106. Although the Committee on Fiscal Affairs requested comments on the drafting of the Revised Proposals, the CBI would still like to raise its strong concerns regarding lowering of the timing threshold for a PE from six months to effectively four weeks.

107. A number of commentators raised their concerns at the OECD Paris meeting on 7 September 2012 regarding lowering of the six months threshold to four months. It is disappointing to see that the OECD further lowered the threshold to three months (paragraph 6.1 of the Revised Proposals) and, furthermore, added that the threshold could be as low as four weeks (paragraph 6.2 of the Revised Proposals).

108. The CBI is concerned that this will give encouragement to countries – whether they are or not OECD Members – to tax on the basis of a few weeks' presence. This could lead to increased double taxation, as well as tax revenue reduction for many OECD Members. The CBI would strongly recommend that rather than changing the general PE rule – especially through the Commentary – that has worked so well for so many years, the specific issues that concern the Working Party are dealt with in the Base Erosion and Profit Shifting Project instead. That would allow the general rule to remain intact while effectively dealing with specific problems through targeted measures.

***Drafting comment on "Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

109. Based on the above, the CBI suggests below wording changes to be included in the Revised Proposals.

110. The CBI believes that "very short period" referred to in paragraph 6 on page 14 will only be an issue in exceptional cases. Hence, the following sentence in paragraph 6 on page 14 should be removed:

~~"A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time."~~

111. In addition, in the first sentence of paragraph 6.1 on page 14, the phrase "has been" should be replaced with "might be", as follows:

~~"One exception to this general practice has been might be where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years)".~~

112. Similarly, in the first sentence of paragraph 6.2 on page 14, the phrase "has been" should also be replaced with "might be", as follows:

~~"Another exception to this general practice has been might be where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger."~~

113. The CBI also proposes that a sentence is inserted at the end of paragraph 6.1 on page 14 underlining the exceptional circumstances being illustrated:

*"In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any continuous presence lasts less than 6 months; the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business. However, these illustrations define exceptional circumstances only and should not be regarded as a general practice."*

114. Similarly, a sentence should be inserted at the end of paragraph 6.2 on page 14 underlining the exceptional circumstances being illustrated:

*"In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S. However, these illustrations define exceptional circumstances only and should not be regarded as a general practice."*

## 6. CONFEDERATION OF SWEDISH ENTERPRISE

115. As mentioned in our previous comments, we welcome the initiative by the OECD to provide further guidance and clarification in relation to the concept of Permanent Establishment. We do however regret that our comments to the proposed amendments in the previous proposal have not been sufficiently addressed. There are still some proposals that raise concern and warrant further consideration. In order to facilitate the reading for WP1 we have revised our previous paper. We apologize for the fact that there will be some repetition of previous comments.

### ***Issue 2. Meaning of "at the disposal of" (paragraph 4.2 of the Commentary)***

116. The concept "at the disposal of" is no doubt an important and critical element in determining when a "place of business" is at hand. The current guidance in the Commentary to Article 5 provides little guidance in this respect, leaving business with legal uncertainty in investment decisions. Physical presence at a fixed place as opposed to legal responsibility for what occurs at a fixed place or some sort of more theoretical right to be present at a fixed place does give rise to uncertainty.

117. Consequently, we fully support the efforts made by the OECD to provide further clarification regarding the meaning of the phrase "at the disposal of".

118. The Discussion Draft proposes two new examples to the Commentary in paragraph 4.2 to determine whether an enterprise has premises at its disposal in such a way that it may constitute a "place of business through which the business of that enterprise is wholly or partly carried on".

119. The first example in paragraph 4.2 refers to a situation where "an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities (e.g. where it has legal possession of that location)". This situation seems quite straight forward since the language indicates that the enterprise owns or leases the property. That in turn would mean that the enterprise has control of the premises and thus is able to exclude others from those premises. Consequently, it is reasonable to conclude that such a situation would constitute a location to be at the disposal of the enterprise.

120. The second example in paragraph 4.2 of the Commentary for determining when an enterprise also would be considered to have premises at its disposal deals with a situation where the enterprise "is allowed to use a specific location that belongs to another enterprise or that is used by a number of

enterprises and performs its business activities at that location on a continuous basis during an extended period of time.”

121. This example cause greater concern than the first one, since the question of whether the enterprise has control of the premises does not seem to be sufficiently addressed.

122. As we see it, the definition of “at the disposal of” should include some degree of control over a physical “fixed place”. The Discussion Draft states that an enterprise must have *effective power* to use the location. This would clearly not seem to be the case in the example discussed by the Working Party (“Consultant working at the client’s premises”), as the consultant (Peter) neither has legal power of disposition nor effective authority to dispose the rooms or exclude others from the rooms. Should the interpretation be that the independent consultant in the example is considered to have a PE, it would certainly be a step towards a more general application of the so called “Service-PE” principle, than what is the case under the current Commentary. That would mean that many cases that currently fall outside the scope of Article 5 of the MTC (cases where there is no ”place of business” as the enterprise does not have any place at its disposal) suddenly would constitute a PE in accordance with Article 5.1.

123. Given the general wording in the second example in paragraph 4.2 in combination with the fact that the question of control is not sufficiently addressed, there is an obvious risk that any independent consultant providing services, in a case similar to the consultant example above, would be considered to have a PE even in cases where the facts clearly indicate that the person does not have any premises at his disposal.

124. Alternative provisions of services are dealt with in paragraphs 42.11- 42.48 of the Commentary. The conclusion to be drawn from paragraph 42.24 must be that unless a specific Service-PE provision is included in a tax treaty, then the normal standards of Article 5 shall apply.

125. Consequently, a service PE provisions should be dealt with between States on a bilateral basis through explicit provisions in a tax treaty and not incorporated through a back door into the OECD Commentaries.

126. Furthermore, the proposed language in the second example is problematic and may open up for interpretations that were not initially intended. When read in conjunction with the proposed new provision in paragraph 10.1, stating that an enterprise may carry on its business through subcontractors, it implies that an enterprise that carries on its business through a subcontractor is considered to have premises at its disposal on the mere fact that the business activities have been performed on a continuous basis during an extended period of time.

127. In our view, such a general statement seems incorrect. As a general rule, a subcontractor, being a separate legal entity, should be considered to perform its own business under a contract with the general contractor. Whether or not premises used by the subcontractor would be at the disposal of the general contractor would have to be determined based upon the facts and circumstances of each separate case.

#### ***Issue 6. Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

128. The current guidance on when short duration business and recurrent activities could constitute a PE is not very clear. This is also explicitly acknowledged in paragraph 6 of the Commentary which basically states that it is sometimes difficult to determine when the nature of a business is such that a very short period of time may constitute a PE. From a business perspective this is very unsatisfactory.

129. To suggest that a business activity which exists only for a short period of time is to be considered permanent is in itself in fact a contradiction in terms. All the more reason to be clear on the time frame required. The examples in the proposed paragraph 6.1 and 6.2 unfortunately provide little guidance beyond the specific situations in the examples themselves and may in fact be causing more concern than they are adding value. Both examples deal with situations where it clearly can be questioned whether the activities carried out could be considered to have any degree of permanency.

130. In relation to the example on *recurrent activities*, the question arises whether a PE would exist on a retrospective basis or in the year in which the cumulative presence exceeds the PE threshold. Creating a retrospective PE would, for obvious reasons, cause tremendous compliance difficulties. Furthermore, what if the expected 5 years drilling operations are shut down after 2 or 3 years? Is the *intention* to operate a business for a certain period of time enough to create a PE? If so, that would certainly be in contradiction with the provision in Article 5.3 of the MTC, according to which a building site or construction or installation project, irrespectively of the intention, only would constitute a PE if it actually lasts more than twelve months. Another question that can be posed is what would happen if there is a 2 or 3 year interruption in the recurrent activity.

131. As for the second example regarding a *short duration business*, this exception is somewhat clearer than the one on recurrent activities since it deals with a unique and self-contained business activity carried on for a short time exclusively in a specific State. It also clarifies that a PE does not exist if the activity conducted only is part of a larger multinational enterprise.

132. The time requirement is undoubtedly crucial for the assessment of whether a PE is at hand. The current Commentary leaves business with poor guidance in this respect. Although the OECD has taken some of the business comments on the 2011 Discussion Draft on-board, there are still a number of question marks concerning the time requirement for the existence of a PE. It is regrettable that a prescribed time frame is not considered instead of the elaboration with problematic distinctions. It is generally difficult to see why a prescribed time frame would cause such concern among administrations. The certainty a prescribed time frame would provide should definitely outweigh any negative consequences that could possibly be presented.

***Issue 8. Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)***

*The proposed new paragraph 10.1*

133. In the suggested paragraph 10.1, the Discussion Draft seems to be moving into dangerous territory by concluding that a subcontractor may constitute a PE for an enterprise if the enterprise carries on its business through the subcontractor (other than in cases where such subcontractor is a dependent agent to the enterprise in accordance with Article 5.5). It is important to make the distinction between the business of an enterprise and the business of subcontractors. The assessment of whether any particular enterprise has a PE under Article 5.1 should be determined on a strict entity-by-entity basis. There is a risk to the suggestion in paragraph 10.1, as it may undermine this fundamental entity-by-entity basis.

134. In the revised version of the Discussion Draft, the OECD has made some amendments. It now states that “in absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site.”

135. The fact that an enterprise has *effective* power to use a site does not necessarily mean that it *exercises* its power to use the same site. As can be concluded from paragraph 4.2, physical presence at a site is a requirement for having a location “at its disposal”. The existence of a PE should depend on the enterprise’s actual presence within the State, not only the responsibility or the theoretical availability over the premises.

136. Furthermore, the view expressed in the proposed paragraph 10.1 would have odd implications, as the same business (with the same personnel, location, equipment etc.) potentially could constitute a permanent establishment for more than one enterprise.

*The proposed wording of paragraph 19*

137. The Discussion Draft also suggests a change in paragraph 19 stating that the time spent by the subcontractor must be regarded as time spent by the general contractor not only when the general contractor subcontracts part of such a project, but also when the general contractor subcontracts the whole project. This is odd in two respects. *First*, it is difficult to understand how a main contractor has “a fixed place of business” and conducts his business “through” that place when he subcontracts all of the work at a particular site.

138. *Second*, in cases where a main contractor subcontracts parts of a project, the main contractor would normally have to have some physical presence at the location in order to perform the activities which have not been subcontracted. In cases where a main contractor subcontracts all parts of a contract, no such presence is required. To our understanding, the current wording of paragraph 19 (i.e. “[...] subcontracts parts of [...]” primarily aims at preventing schemes where a main contractor carries out as much of a project as possible within the 12 month period and subcontracts the remaining parts of the project, in order to avoid having a PE under Article 5.3. Paragraph 19 makes clear that in such cases the period spent on the project by the subcontractors shall be considered to be time spent on the project by the main contractor. As we see it, the aim to prevent schemes in order to avoid having a PE is therefore not needed when the whole project is subcontracted.

139. Furthermore, the current wording of paragraph 19 only refers to the period spent on a project by a subcontractor. The proposed new paragraph 10.1 would change the current interpretation of Article 5 as it would not only allocate to the general contractor the period spent by a subcontractor on a project, but also the business activities performed by such subcontractors. In our view, that would mean a clear extension of the PE concept since such a wider interpretation would not only be relevant in relation to Article 5.3 but also in relation to Article 5.1.

140. To say the least, we find the proposals in the Discussion Draft regarding subcontractors to be very troublesome for business. It elaborates on language developed specifically for building sites or construction or installation projects (where there is a time frame). As the proposals appear to widen the PE scope not only in relation to building sites etc., but also in relation to other activities, the consequences could be far reaching and are likely to result in a dramatic increase of PEs.

141. As we see it, the current paragraph 10 of the Commentary offers no support for the conclusion that an independent subcontractor could constitute a PE for the main contractor merely by performing his own business activities. Creating the suggested link between paragraph 10 and paragraph 19 will mean that what is now a well-defined and limited exception for building sites, construction- or installation projects will become a general rule.

142. There is also the question of the rationale behind these amendments. Considering the possible implication for business with additional uncertainty and the risk of double taxation, is there a need for

expanding the PE concept to cover these situations? The subcontractors in question will most likely be taxed either as residents or because they themselves will have a PE. What is the rationale behind identifying a PE for the general contractor? With these amendments it will be extremely important to ensure that this new subcontractor PE in Article 5 is compatible with the guidance for attributing profits to PEs under Article 7.

143. Should these proposals be adopted, corresponding guidance under Article 7 would be necessary in order to avoid numerous cases of double taxation. The profits to be allocated to such a PE cannot be the profits taxed with the subcontractor and it cannot be the profits realized by the general contractor unless the general contractor is allowed to deduct all costs relevant to the income. Such costs would for example include the compensation provided to the subcontractor for his services.

144. It is difficult to foresee the full consequences of the proposed amendments. However, it is not difficult to foresee that the impact these changes would have on business would not be positive. Should these proposal be incorporated into the Commentaries we fear that there will be a dramatic increase in the cases of double taxation.

145. Consequently, we urge the OECD to reconsider its proposal in this respect.

## 7. DELOITTE LLP (United Kingdom)

146. We welcome the opportunity to contribute further to the OECD's revised proposals concerning the Commentary to Article 5 of the Model Tax Convention.

147. We appreciate the efforts taken by Working Party 1 to clarify the guidance on Article 5 and recognise the difficulty in reaching a consensus amongst OECD Members. This is a complex topic with potential for double taxation, and businesses want as much certainty as possible. At the same time, tax authorities are concerned about potential erosion of their country's tax base. It is also an area where, as was evident at the Public Meeting in September 2012, OECD Members are not all in agreement on some of the matters of principle.

148. The consultation and this response focus on the Commentary to the current Article 5 of the OECD Model Tax Convention. Although questions of permanent establishment are not mentioned in the OECD's Base Erosion and Profit Shifting (BEPS) background brief issued in November 2012, many commentators have suggested that this an area of the international tax system for multinational companies that warrants review, particularly for today's internet-based businesses and practices. We look forward to contributing further to this debate and development of the international tax system as the BEPS project progresses.

149. As a general comment, the revised proposals in the consultation document do not go far enough to remove ambiguity, provide a sufficient number of relevant examples (particularly where subtle issues are concerned) nor seek to address concepts which remain undefined within the Commentary. We have, wherever possible, confined our comments on this draft to the wording of the proposed amendments to the Commentary rather than on points of principle, as requested. However, there are occasions when a lack of clarity stems from a lack of statement of points of principle.

150. Our key observations are as follows:

- The revised drafting of Paragraph 32.1 of the Commentary does not make it clear that for a permanent establishment to exist the principal is required to be legally bound to third parties by the contract entered into by the agent, as discussed at length at the Public Meeting. The revised Commentary may be interpreted by some States such that an agent

may be considered to economically bind the principal even if there is no legal binding of the principal to its customers. If it were correct, this would represent a significant change to the historical interpretation of Article 5 provided by earlier versions of the OECD Commentary (on which the negotiation of tax treaties was based) and in addition is not in accordance with Supreme Court decisions such as that in *Zimmer* in France, *Dell* in Norway and *Boston Scientific* in Italy.

- A minimum time requirement for the creation of a fixed place of business permanent establishment would be of great benefit to business. The current lack of consensus and clarity from Member States on this point (as set out in paragraph 6) raises the risk of potential double taxation and hinders compliance with tax compliance obligations.
- The example proposed in paragraph 6.2 introduces additional complexity and, appears to be more ‘artificial’ than many of the other examples in order to make the distinction that this is the sole business of the non-resident and therefore considered permanent. We question whether this example adds useful guidance to the Commentary.
- Paragraph 19.1 of the Commentary addresses the issue of the period during which a construction site exists, and considers also guarantee periods. There is a question of how to deal with situations where there is, at the date of delivery of the building or facilities to the client, a known defect that will need to be remedied under the terms of the original contract. Where under normal accounting principles this would give rise to recognition of a provision for future costs it would be helpful to clarify that this provision relates to the permanent establishment in the State of construction or installation, and not to the State of residence. We acknowledge that this is a question of attribution of business profits rather than one of determination of taxing rights, but it is an example of where the interaction of Articles 5 and 7 are essential to understanding the taxation consequences for business of everyday commercial activities.

151. Further detailed comments are provided in the attached appendix.

### *Appendix*

#### *Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)*

152. It is not clear to us the meaning of the phrases “continuous”, “effective power” or “extended period of time”.

153. The term “effective power” has been illustrated by examples but we would suggest a definition of this term and other further examples to illustrate this point.

154. The meaning of the phrase “during an extended period of time” seems to introduce a new concept. If this is the intention of the OECD, then the new concept should be defined. Rather than introduce a new concept, we suggest that instead this phrase is updated to “a certain degree of permanency” and specifically cross-referenced to paragraph 6 of the Commentary.

***Can the premises of a (converted) local entity constitute a permanent establishment of a foreign enterprise under paragraph 1? (paragraph 4.2 of the Commentary)***

155. We welcome the inclusion of paragraph 3.1 which provides clear guidance that a permanent establishment depends on the facts and circumstances applicable at one point in time.

***Home office as a PE (proposed new paragraphs 4.8 and 4.9)***

156. We agree that the removal of “at the disposal of” in the revised Commentary provides more clarity because the home office would only be at the disposal of one employee of the enterprise and not any employee of the enterprise or the enterprise itself.

157. It is not clear to us the meaning of the phrase “regular and continuous” which has been removed in the proposed revision of section 4.2 but not here. We recommend that the term “regular” be removed to aid clarity and to be consistent with Paragraph 4.2.

***Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

158. It would be extremely beneficial to have a clear agreement among OECD Members as to the minimum time requirement for an establishment to be considered ‘permanent’ as a practical means of establishing tax liabilities and compliance requirements. The issue for business is that without a degree of certainty in this area they are at risk of challenge from individual tax authorities, often without protection of a statute of limitations, where other countries would not consider source taxation. This uncertainty gives rise to the risk of double taxation, and also penalties and interest if compliance obligations have inadvertently not been met.

159. The new example in paragraph 6.1 provides a commercially realistic situation where work may be recurrent in nature but still create a permanent establishment. It is clear from this example that it is the location that requires intermittent activity, and that from the outset this is expected by the business to continue for many months spread over a number of years.

160. We agree with the principles set out in paragraph 6.2. However, the example proposed in paragraph 6.2 relating to the catering services for the television documentary production introduces additional complexity and, appears to be more ‘artificial’ than many of the other examples in order to make the distinction that this is the sole business of the non-resident and therefore considered permanent. We question whether this example adds useful guidance to the Commentary.

161. In addition, the example at the end of paragraph 6.2 which considers a cafeteria at an international sports event of four weeks’ duration, which we agree would not create a permanent establishment, may create some confusion. It would be helpful to clarify that this is due to the general principles for determining ‘permanent’ as set out in paragraph 6 (and see comments above) rather than because of the extremely short four-week period of the example.

162. We have concerns that the term “business” could be interpreted differently in different States leading to potential double taxation. It would be helpful to further amend the Commentary to prevent elements or distinct functions of an enterprise being defined as a “business” for the purpose of the exception to the general rule in paragraph 6.2.

***Additional work on a construction site (proposed new paragraph 19.1 of the Commentary)***

163. We agree that the general principles set out in paragraph 19.1 are helpful.

164. There is an additional question of how to deal with situations where there is, at the date of delivery of the building or facilities to the client, a known defect that will need to be remedied under the terms of the original contract. Where under normal accounting principles this would give rise to recognition of a provision for future costs it would be helpful to clarify that this provision relates to the permanent establishment in the State of construction or installation, and not to the State of residence. We acknowledge that this is a question of attribution of business profits rather than one of determination of taxing rights, but it is an example of where the interaction of Articles 5 and 7 are essential to understanding the taxation consequences for business of everyday commercial activities.

165. Our comments regarding the term “extended period of time” as discussed above are also applicable here. We suggest that in this example this phrase could be replaced by “during a period that exceeds twelve months” given that this is referring to a building site, construction or installation project. An example to illustrate this point of principle would also be helpful.

***Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)***

166. We welcome the updates to paragraphs 21 and 23 as these serve to remove uncertainty as to the application of paragraph 4 a)-d).

167. It can be inferred from part f) that the combination, for example, of having goods processed, stored and delivered must be capable of being preparatory or auxiliary. However, depending on the circumstances of a manufacturing business, e.g. of consumer goods or industrial products, it may be reasonable that these activities are not preparatory or auxiliary. This combination of activities occurs in some modern businesses involving contract or toll manufacturing of goods and centralised management of inventory and distribution. We consider that an example would aid the interpretation of this paragraph and we would propose the inclusion of the following example:

*“An enterprise resident in State A has goods manufactured for them by a contract manufacturer in State B which are then stored in the enterprise’s warehouse in State B for onward delivery. The enterprise manages the inventory in its warehouse located in State B centrally before goods are distributed to customers. In this example, the combination of activities conducted by the enterprise would not constitute a permanent establishment of the enterprise in State B.”*

168. Paragraph 4 of Article 5 may sometimes be misinterpreted when determining whether a permanent establishment exists at a location which undertakes two or more of the activities in paragraph 4 a)-d) where these combined activities are not preparatory or auxiliary. The misinterpretation is that this location would constitute a permanent establishment of the enterprise regardless of the factors in paragraph 1. We consider that it would be helpful to point out in the Commentary that, for instance, if goods were stored and processed by another enterprise in a third party warehouse, this would not constitute a permanent establishment as there is no fixed place of business at the disposal of the enterprise. As one may deem activities of a preparatory or auxiliary nature to not be a permanent establishment, it must have been a permanent establishment without the exception.

***Meaning of “to conclude contracts in the name of the enterprise” (paragraph 32.1 of the Commentary)***

169. The update to paragraph 32.1 is intended to provide that an enterprise is not excluded from having a permanent establishment in a country where it is legally bound to third parties by contracts entered into by agents merely by virtue of the fact that the agent did not disclose it was acting for the principal enterprise (as is the case in some common law countries).

170. However, the update to the Commentary is not clear on the important point of principle as to whether the principal is required to be legally or only economically bound by the contract. We consider that the intention of the update should be to clarify that whenever an enterprise is bound commercially to the customer, which means *legally* bound to the customer, that the undisclosed agent would be concluding contracts in the name of the enterprise. The Supreme Court decisions in, for example, the *Dell* and *Zimmer* cases in Norway and France respectively found that only legal binding is relevant in determining whether a permanent establishment is created when the business of the enterprise is conducted through a commissionaire. The point was also clearly analysed and concluded on by the Italian Supreme Court in the case of *Boston Scientific*. We propose that the updated Commentary reflects this interpretation and provides clarity by changing “bound” to the phrase “legally bound in the sense that the ultimate customer is able to look through the agent and take legal action against the principal, if necessary” in paragraph 32.1

171. The Commentary may be interpreted such that the agent may be considered to bind the enterprise even if there is no legal binding. This would represent a significant extension to the current and historical interpretation of the Model Tax Convention. As such, we would suggest that the wording of the Commentary be updated as follows:

32.1 Also, the phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. *For example, in some countries an enterprise would be legally bound in the sense that the ultimate customer is able to look through the agent and take legal action against the principal, if necessary, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract. In this case, should the ultimate customer be dissatisfied with performance under the contract they have legal redress against the Principal directly and would not be limited to seek redress only from the undisclosed Agent with whom they have contracted.*

**8. ERNST & YOUNG**

172. [These comments were submitted in PDF format only. They will be made available separately]

**9. EUROPEAN BUSINESS INITIATIVE ON TAXATION (EBIT)*****Issue 6: Time requirement for the existence of a PE (paragraph 6 of the Commentary)***

173. At the OECD Paris meeting on 7 September 2012 and again in the present revised discussion draft, the Committee on Fiscal Affairs is proposing to replace the two earlier originally proposed exceptions to the general practice of Contracting States, that, unless a place of business is maintained for six months or more, it does not constitute a PE.

174. EBIT wishes to reiterate that, as we have stated before, the carving out of exceptions from the current norm that places of business operated for less than six months, and especially as is proposed now, to bring this further down to three and four months, respectively, and, in some circumstances even to effectively four weeks, to constitute a PE is clearly a seriously unwelcome development as far as EBIT is concerned. To EBIT this proposed change appears to be hostage to fortune to source tax based countries.

175. In terms of drafting changes, EBIT therefore suggests that both the paragraph 6.1 and 6.2 examples be qualified by the following additional wording "This illustration should nonetheless be considered to be very much the exception to the general rule that a permanent establishment does not exist unless it has subsisted for 6 months or more.", probably best added at the end of each of these paragraphs.

***Issue 7: Presence of foreign enterprise's personnel in the host country (paragraph 10 of the Commentary)***

176. EBIT continues to be of the opinion that whilst the proposed changes to paragraph 10 regarding secondees are helpful, the comments in paragraph 44 are of concern. These relate to the situation where a secondee remains on their home country payroll (often for HR / benefits / compensation / currency reasons) and the host company is charged on a cost plus basis. Paragraph 44 mentions the possibility that this cost plus indicates that what the secondee is doing in the host country is not part of the host company's activity but rather part of the home company's activity, hence there is PE exposure. Reference is then made to the criteria in paragraphs 8.13-8.15 of the Model Commentary regarding the host state company being the "economic employer" for Article 15 183 day protection purposes to avoid a home state company PE in the host country.

177. Whilst the changes are designed to be helpful, given the multiplicity of criteria in paragraphs 8.13-8.15, and the subjectivity sometimes involved e.g. who instructs the individual (matrix management), the outcome may not always be certain. In the worst case, this might leave MNCs with the choice of accepting a local "economic employer" and so host country taxation of secondees even where present for no more than 183 days in the host country or accepting a PE of the non-resident company in the host state. EBIT asks the Committee on Fiscal Affairs for further clarification.

***Issue 8: Main contractor subcontracting all aspects of a contract (paragraphs 10 and 19 of the Commentary)***

178. Despite the fact that some changes are proposed in the revised discussion draft, the issue relating to the overall responsibility of the contractor on the on-site operation by the sub-contractor has not been solved.

179. As previously stated, Issue 8 should surely be dealt with under the dependent agency type PE rule rather than deeming the subcontractor(s) to be a PE of the non-resident main contractor. Also, this "principle" of deeming a third party subcontractor to be a new type of PE of the main contractor could be extended to other industries e.g. financial services regarding brokers acting for non-resident principals. EBIT believes this to be a very unhelpful proposal from the perspective of business.

180. EBIT therefore strongly recommends that the wording change in paragraph 19 ie the addition of the words "all or" is not proceeded with and the necessary consequential changes are made.

181. Equivalently, the "acting alone or" wording in paragraph 10.1 should be deleted and the necessary consequential changes should be made.

***Issue 14: Does a development property constitute a PE? (paragraph 22 of the Commentary)***

182. EBIT remains of the view that the OECD's analysis in paragraph 86 is incorrect in terms of interaction of treaty and domestic law. A domestic charge under the Business Profits Article 7 cannot be justified with respect to the host state being permitted to charge under the Capital Gains Article 13. EBIT would like to refer to the Malaysian High Court case of *DIGR v Euromedical Industries Ltd* [1983] Part 1 Case 14 [FCM], in this respect, where in the absence of a PE, Malaysia's domestic withholding tax on technical assistance fees paid to a UK parent was blocked (the fees being business profits for treaty purposes rather than royalties, but there being no Malaysian PE).

183. As to drafting changes, at the very least the second sentence of paragraph 85 and note 9 on page 29 should be deleted.

***Issue 19: Meaning of "to conclude contracts in the name of the enterprise" (paragraph 32.1 of the Commentary)***

184. The proposed addition to paragraph 32.1 will expressly provide that a principal enterprise bound by a contract concluded by another person with a third party would not be protected from having a PE in the country of that other person merely by virtue of that other person not disclosing that it was acting for the principal enterprise in its dealings with the third party. This would in particular appear to be targeted at principals in commissionaire arrangements, but as it is worded it goes much wider than this, so the proposed clarification is not helpful according to EBIT, as the analysis is incomplete. The existence or otherwise of a PE should be with regard to all the facts and in particular the conduct of the parties, and it would be preferable if the revised commentary expressly stated this.

185. EBIT trusts that the above comments are helpful and will be taken into account in finalising your Commentary on: "OECD Model Tax Convention: Revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment)".

**10. GERMAN ASSOCIATION OF THE AUTOMOTIVE INDUSTRY (VDA)**

186. We would like to take this opportunity to comment on the OECD discussion draft regarding the "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention" published on 19 October 2012 (Revised public discussion draft).

187. The German Association of the Automotive Industry (VDA) consists of about 600 member companies (manufacturers and suppliers) with production sites and license holders in about 2,000 locations around the world. Therefore, the definition of the permanent establishment (PE) and the resulting taxation are very important topics for the automotive industry.

188. In some points the OECD draft is not clearly defined. This could lead to problems of interpretation and with that to a double taxation. Such wide interpretations for PE definition could also lead to the difficult situation that a Company is accused by tax authorities of not having registered a PE, even though the Company was more than willing to comply with the rules. Furthermore, a wide interpretation will likely increase the number of PEs and in this respect increase the administrative burden for the Company: Especially the preparation of separate financial statements for the PE requires often a significant change in the IT landscape.

189. In the following we are commenting on some problematic issues of the revised proposal, which should be changed.

***Paragraph 4.2: "at the disposal of" - "having the effective power to use"***

190. It would be helpful to add an additional sentence that a place "at the disposal of" or respectively a location with the "effective power to use" it only forms a PE for the enterprise if the enterprise actually makes use of its disposal right/power and is physically present at this location. From our point of view an enterprise does not make use of the location/place if the activities conducted there are solely performed by subcontractors. This would be in line with the sentence in 4.2 of the draft commentary '*...it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise...*'

***Paragraph 6.1: Time requirement for the existence of PE - recurrent activities***

191. While it may be quite certain in the case of a drilling station that such an activity is recurrent, it is hard to determine in practice: In many cases the enterprise does not know from the beginning if a regular presence in one country is necessary because a project develops step by step. In order to avoid uncertainty, a clear definition of a PE is important: It would be helpful to add a fixed minimum time requirement, e.g. a PE is constituted for the future (no retroactive PE) when the activity takes place yearly with a minimum of x months and only if the accumulated time over the years of physical presence exceeds 6 months altogether (e.g. each year the physical presence is three months; the 6 months period is exceeded in year 3, i.e. a PE is registered in year 3 for the activities in the future).

***Paragraph 10.1: Main contractor who subcontracts all aspects of a contract***

192. In connection with our comment on 4.2 we suggest to change the following: An enterprise may also carry on its business through subcontractors. However a PE of the enterprise is only created in case the place, where the activity is performed is at the disposal of the enterprise, the enterprise's employees are physically present at that place and the other requirements for a PE (e.g. a certain time period of physical presence) are fulfilled. If all work is subcontracted and the enterprise is not physically present no PE exists for the enterprise.

193. In case the work is completely subcontracted no PE should be constituted by an enterprise: By owning a site (legal possession) or controlling the access and using it from outside that country, the enterprise does not add value on the territory of the relevant country; no profit or loss is created by just having the "effective power to use" a place. If a PE was assumed, the PE income could only be zero: From our point of view it would not be appropriate to allocate profits related to subcontractor's work or related to enterprise's "entrepreneurial" profit to the PE. This could happen if the commentary is changed in such a way. Unfortunately the commentary does not address the point of income allocation to such type of PE. Furthermore, we see this point to be in contradiction to the "Authorized OECD Approach" and its "significant people's function" concept.

194. From our perspective, it is important to differentiate between the business of the enterprise and the business of its subcontractors. The subcontractor as the one adding value on the territory of that country should be held tax liable in the country for his part of the project but not the enterprise in the role of a main contractor.

195. Furthermore, in case of physical presence of an enterprise together with its subcontractor a similar view should be taken: The PE of the enterprise should only include the activities related to the time period of the enterprise's physical presence and not also the subcontractor's activities. A clear separation between the enterprise's business and subcontractor's business is needed to avoid double-taxation.

***Paragraph 24.2: Negotiation of import contracts as an activity of a preparatory or auxiliary nature***

196. The proposed change addresses an enterprise that establishes an office in one State, with the employees working in that office taking an active part in the negotiation of important parts of contracts for the sale of goods in that State. In such a case, a PE will be assumed even if the employees do not have the authority to conclude contracts in the name of their employer.

197. This leads to an expansion of the PE definition similar to the above discussed changes referring to the term "fixed place of business".

198. From our point of view the requirement for an agent PE should be triggered only by an existing authority to conclude contracts in the name of the enterprise, but not just by an "active involvement" in the negotiations. Negotiations within the boundaries clearly set by the enterprise and without authority to conclude contracts should be treated as preparatory or auxiliary functions and, therefore, should not constitute a PE. Furthermore, "active involvement" is a broad expression missing clarity. It will be hardly possible to comply with the OECD rules because it is impossible for an enterprise to define a clear borderline between preparatory/auxiliary function on the one side and agent function on the other.

***Paragraph 32.1: "conclude contracts in the name of the enterprise"***

199. A clear definition of "conclude contracts in the name of the enterprise" is needed. If this clear definition is missing, the taxpayer is exposed to the risk of not having registered an agent PE. Concluding contracts should have the meaning of a person being able to legally bind the enterprise. Therefore the wording of the draft commentary should be changed as follows: "...***the paragraph applies equally to an agent who concludes contracts which are legally binding on the enterprise even if those contracts are actually not in the name of the enterprise.***"

200. To increase legal certainty the commentary should add one additional point: No PE is created in case an enterprise being part of an international group acts as central coordinator for a global customer contract involving the enterprise directly alongside other enterprises of the group as far as the enterprise can show that its function is really only of a coordinative nature. The coordinative nature is given if the enterprise receives the negotiation positions of all other enterprises being part of that potential future customer project prior to negotiation with the customer and only communicates these approved negotiation positions to the customer and if all binding correspondence is signed by all involved enterprises. In a global acting Corporation the customer needs one central contact person (Key Account Manager) to discuss the whole business relationship and expects only one global contract valid for all group companies.

***General remark to agent permanent establishment:***

201. In a global group of companies an agent function for the enterprise could be performed by enterprise's related party Company in another country. We would appreciate it if the commentary could add that in such a case the PE registration is obsolete on the condition that the transfer price for the agent function is at arm's length. Due to the concept of "significant people's function" the agent PE's income would also only consist of a third party acceptable agent commission, i.e. the taxable income would be the same compared to the Situation without a PE registration. To avoid the high administrative effort for a PE we would like to suggest to "copy" into the commentary this already successfully implemented concept in the treaty between Germany and Austria (see protocol to article 5 of the German-Austrian-treaty).

**11. GERMAN ELECTRICAL AND ELECTRONICAL MANUFACTURES' ASSOCIATION (ZVEI)\***

[These comments were submitted in PDF format only. They will be made available separately]

## 12. GERMAN ENGINEERING FEDERATION (VDMA)

202. The German Engineering Federation VDMA (Verband Deutscher Maschinen- und Anlagenbau e.V.) represents more than 3000 companies in the engineering industry, making it one of the largest and most important industrial associations in Europe. Accounting for sales of 208 bn. Euro and nearly 980.000 employees (2012) engineering and plant construction is one of the largest industrial sectors and an important employer in Germany. Three fourths of those companies' business is considered export. In this kind of business, permanent establishments (PE) are a very important issue. Therefore, VDMA maintains a working group specialized on taxation of large scale construction projects whose members are very experienced in international taxation in general and, in particular, with respect to construction PEs. The working group thoroughly monitors OECD's activities concerning the interpretation and application of Art. 5 of the OECD-Model Tax Convention (OECD-MTC). VDMA already commented the first version of the discussion draft released on 12 October 2011 which has been posted on the OECD website (dated 27 January 2012) and Dr. Stefan Bendlinger represented VDMA in the public consultation meeting held in Paris on 7 September 2012.

203. The revised version of the public discussion draft released by the OECD on 19 October 2012 reflects some (not all) of the comments presented by the business community, which we very much appreciate. But there are still some issues left which we again ask the OECD/CTPA to give attention from a practical point of view. Our remarks concentrate on the amendments of the revised version of paragraphs 1 to 42.10 of the Commentary to Art. 5 OECD-MTC, which are of utmost importance for the German engineering and plant construction industry.

### ***General remarks***

204. We are aware of the difficulties to cover all forms of international businesses, which have developed over the years, under Art. 5 OECD-MTC considering that the wording has been unchanged since more than 50 years. One reason for maintaining the wording of Art. 5 OECD-MTC seems to be the fact that a new version of Art. 5 OECD would require many decades to be installed into the worldwide network of bilateral tax treaties. Therefore, the OECD/CFA obviously decided, rather than changing Art. 5 OECD-MA, to change the Commentary on the PE-definition so that states wishing to do so could apply the new interpretations to existing tax treaties. We noticed, however, that starting with the (famous) "painter example" in paragraphs 4.5. and 5.3. of the Commentary to Art. 5 OECD-MTC the Commentary continuously has broadened the application of the PE-concept and goes beyond the wording of the PE-definition in Art. 5 OECD-MTC. Well established interpretation principles have been undermined and more taxation rights given to the source states.

205. A further concern is that the Commentary tries to give guidance by **examples** that sometimes look artificial and the practical relevance is not always obvious. Instead, we would prefer if the guidance would be more principle driven and so giving clear answers that could be applied to more than one case.

### ***OECD-MTC-Commentary, Paragraph 4.2.***

206. Paragraph 4.2. 5<sup>th</sup> sentence considers a PE to exist where an enterprise "...is allowed to use a specific location...and performs its business activities at that location on a continuous basis during an extended period of time". **Observation:** In the revised draft, the word "regular" has been replaced by "continuous". To us the difference in the meaning of this change is unclear. The Commentary does not define the term "extended period of time" which in practice would be very helpful. The same goes for the expression "intermittent" and "incidental" in paragraph 4.2. 6<sup>th</sup> sentence. Is a one week's disposal sufficient, is it one month, or four months?

207. The example of a contract- manufacturer in the 7<sup>th</sup> sentence suggests that no PE is established for the principal due to the fact that the principal provides all of the goods to be processed by the contract-manufacturer. **Observation:** We agree with this particular example as described. However, we propose that the example be complemented by an additional version, where the principal not only provides the goods to be processed but also special tooling and machines and/or technical recipes and formulas or drawings. We believe it would be helpful to provide further guidance by modification of one and the same example in order to better understand where the line for a PE is drawn.

***OECD-MTC-Commentary, Paragraph 4.8. and 4.9***

208. Paragraph 4.8. 4<sup>th</sup> sentence considers an employee's home office to be at the disposal of the enterprise if "...the enterprise has required the individual to use that location to carry on the enterprise's business (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office...)": **Observation:** The question whether or not the enterprise rents office facilities is not decisive for determining, whether the employee's home is at the disposal at the enterprise. In general the employee's home never is at the disposal of the enterprise as described in paragraph 4.2 because it is not given control over or access to the employee's home. A different view could be taken only, if the employer would compensate the employee for providing the home office. Therefore, the facts and circumstances described in paragraph 4.9 do not, in our opinion, give reason to consider them as a clear example of a PE. In addition, the criterion of a request by the enterprise is in many cases not relevant as to our experience in most cases the employee request to work from home while the enterprise would prefer to have him/she work in the office but accepts the employee's wish.

***OECD-MTC-Commentary, Paragraph 6.1.***

209. Paragraph 6 4<sup>th</sup> sentence expresses the view of OECD's member states that a PE "normally" has not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for **less than six months**. Recurring activities are an exemption to this general principle. According to paragraph 6.1 1<sup>st</sup> sentence, in such cases each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used. The revised discussion draft fortunately has eliminated the example of an individual renting a stand at a fair for 15 consecutive years to sell sculptures and replaced it by the example of a **drilling enterprise** carrying on drilling operations at a remote arctic location for **three months per year** for an **expected period of 5 years**. **Observation:** We expressly welcome that the original example of a market stand has been eliminated. Unfortunately, the newly included example **does not give guidance on PEs in case of recurrent activities** for several reasons. Firstly it can be assumed that a drilling station requires some installation and/or equipment that will stay onsite also through the periods where no activity is performed. Therefore, to us it seems to be an example to illustrate the interruption of business activities as dealt with in paragraph 11 5<sup>th</sup> sentence rather than a recurrent activity. Secondly, assuming that all equipment will be removed from the drilling site when the activity is closed down for 9 months, based on this example one could assume that recurrent activities require a consecutive presence in the source state of at least three months. This assumption however is cut down by the last sentence of paragraph 6.1. of the Commentary saying that "*...the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business.*"

210. Business practice requires a more definitive time limit when dealing with business activities of a short duration. It is still unclear at what point recurrent activities constitute a PE. Determining a time test to be applied to the amount of time that the enterprise must spend in the source state in each year would be helpful. A practical solution could be to consider the **183-days test** as used in Art. 15 para 2 a) OECD-MTC as a measure for the time requirement to consider an establishment to be "fixed". If the delegates do not achieve consensus even a shorter period (at least 90 days) would be acceptable as it would provide

legal certainty. A yearly time minimum could avoid many of the compliance problems which have been discussed in the public consultation meeting on 7 September 2012 with respect to the retrospective construction of PEs. Another test could take the intention of an activity an indication of a permanent engagement. If e.g. the enterprise has based its activities in the source country on a long term agreement and the term of this agreement multiplied with the expected annually recurrent time spent exceeds 183 days then a PE may be assumed.

***OECD-MTC-Commentary, Paragraph 6.2.***

211. Similar objections apply to the example presented in para 6.2. 2<sup>nd</sup> sentence of the Commentary to Art. 5 OECD-MTC considering a restaurant operating during a period **of four months** to constitute a PE in the source state, if the restaurant is **the only business activity** carried out by the individual ("one-shot project"). As already mentioned in our comments on the October 2011 discussion draft, we doubt whether it should make a difference if the entrepreneur is doing business in one state only or in the residence state as well. Although the example uses a four months period it is unclear whether this time limit standard can be used as a general standard. In addition, the example as described is confusing with respect to the relevant time periods. While the first example of an exclusive local business suggests a time period of 4 months, in the variation of that example (sentence 7) only a time period of 4 weeks is referred to. So it is unclear to us whether even a 4 weeks period would be sufficient to establish a PE if it was the sole business activity, and whether a 4 months period would not be considered a PE in the case where the local activity did not represent the entire business activity of the enterprise.

212. Rather than introducing specific rules for short term activities we would prefer to stick to the general time limit of 6 months for the following reason: The exclusive short term activities as described in the cafeteria example does, in our opinion, well compare with a service PE as described in para. 42.23. Should this not be acceptable to the working party, a provision in the Commentary that clearly defines the minimum time period that is required, which, however, in no case be less than three or four months in case of activities done exclusively in the source country would be a better guideline.

***OECD-MTC-Commentary, Paragraph 10.1.***

213. In the **absence of employees** of the enterprise paragraph 10.1., 4<sup>th</sup> sentence of the Commentary considers a place of business to be at the disposal of the enterprise, if the enterprise has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. This is supported both by reference to paragraph 19 OECD-MTC (construction sites) and an example where an enterprise owns a small hotel and subcontracts the on-site operation of the hotel to a service provider remunerated on cost-plus basis. **Observation:** The Commentary assumes that for Art. 5 para 1 OECD-MTC purposes **the subcontractor's activity is assigned to the business activity of the general contractor** and consequently the subcontractor's premises are deemed to be at the main contractor's disposal. **Observation:** We reiterate our concerns regards this fictitious PE. If the general contractor of a construction or installation project is at no time during that project physically present onsite but it is only the subcontractors who carry out activities in the source state, the general contractor should not be considered to have a PE just by virtue of the subcontractors' activities. As clearly stated in para. 4.2, there are two requirements to be met in order to consider a PE: "*the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there.*" Pure legal responsibilities cannot be decisive for deeming a general contractor's PE to exist. In fact, the responsibility as a general contractor does not necessarily include the fact that he may have access to or physical control over the location as he may have assigned those functions to a service provider.

***OECD-MTC-Commentary, paragraph 19***

214. Paragraph 19 2<sup>nd</sup> sentence adds that if an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts all or parts of such a project to other enterprises (subcontractors) the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project In other words a general contractor could constitute a PE without being present in the source state. Paragraph 19 3<sup>rd</sup> sentence justifies this interpretation based on the general contractor's **legal responsibilities**. **Observation:** As explained above, the theoretical availability of the site is not sufficient but needs to be supplemented by activities at the location that usually require physical presence.

215. The draft of the new version allocates the subcontractor's activities not just for time test purposes, but requires that the subcontractor's **functions** are allocated to the general contractor. According to the opinion of some of the CFA-delegates this means that a portion of the general contractor's profits could be taxed by the source **state without any “people functions” executed by the general contractor at site**. Assuming that the “people functions” pertaining to the appointment of subcontractors are done by the headquarters staff in the residence state (which is common practice in construction business), **the profit allocation to the PE would be nil**. This view is supported by the fact that a construction PE starts to exist from the date on which the contractor begins his work at site. Appointing subcontractors is a function done right before the PE in the source state comes into existence. Considering further that some countries tax the profits of a construction PE on a deemed profits basis without allowing subcontractor's costs as a deduction, profits would be taxed at least twice. First in the hands of the general contractor and once more again in the hands of the subcontractor. The extension of the PE definition to this set of facts could end in taxation of business profits that never have been generated. Therefore we strongly support not to amend the paragraph 10 2<sup>nd</sup> sentence of the Commentary.

***OECD-MTC-Commentary, paragraph 19.1.***

216. We support the language of paragraph 19.1. 2<sup>nd</sup> sentence that the “..*delivery of the building or facilities...*” represents the end of the period of work, provided that the contractor and subcontractors no longer work on the site after its delivery for the purpose of completing its construction. But we believe that paragraph 19.1. 2<sup>nd</sup> sentence should read as follows: “*In practice, the delivery of the building or facilities by the contractor (alternative: “...to the client”)... will usually represent the end...*” rather than referring to “*...the delivery of the building or facilities by the client...*”.

***OECD-MTC Commentary, paragraph 19.2.***

217. We agree with the conclusions drawn by the example in paragraph 19.2. that in the case of a **fiscally transparent partnership** the twelve months test is applied at the level of the partnership but the question whether or not the partners (who may be resident in different states) have a PE is to be determined according to the tax treaty concluded between the individual partner's residence state and the source state. **Observation:** In this respect however we emphasize, that the cooperation between two or more partners for executing a particular construction project regularly does not constitute a “partnership” according to the tax law of many States. In particular this is true if the partners act as “**consortium members**”. In this case, the twelve months test has to be applied at the level of the individual partners. Paragraph 19.2. of the Commentary should make reference to this fact as well.

***OECD-MTC Commentary paragraph 32.1.***

218. Whether or not an agent is a “dependent agent” acting on behalf of an enterprise and having and habitually exercising in a Contracting State an authority to conclude contracts in the name of the enterprise

is treated very differently in **common law** countries (“undisclosed agents”) and **civil law** countries (“commissionnaire arrangements”). High courts decided in different ways. The **French** High Court considered a commissionnaire not to constitute the enterprises PE (Conseil d’Etat, 31 March 2010, No 304715, “*Zimmer*”). The same did the **Norwegian** Supreme Court (Noregs Hogsterett, 2 February 2011, HR-2011-2245-A, “*Dell*”). The **Spanish** High Court (Sentencia de 12 enero 2012, JUR/2012/41054, “*Roche*” however considered a Swiss company’s sales subsidiary to constitute a PE as per Art. 5 para 5 OECD-MTC. The same did the **Indian** Authority for Advanced Rulings in the “*Seagate*”-case. (New Delhi, 25 October 2010). The example inserted in paragraph 32.1. 2<sup>nd</sup> sentence OECD-MC expresses OECD’s view, that “...in some countries...” an agent may be found to have an authority to conclude contracts in the name of the enterprise even if the latter is **not legally** but **economically bound**. **Observation:** What countries are implicated by the term “some countries” remains unclear. If the example just refers to countries where the agency law allows an undisclosed agent to bind the principal, this should be made explicit. The insertion of the example in paragraph 32.1. OECD-MTC increases uncertainty and does not allow taxpayers to predict the tax implications of their sales arrangements.

219. Paragraph 32.2 1<sup>st</sup> sentence of the OECD-MTC explains, that “*lack of active involvement by an enterprise in transaction may be indicative of a grant of authority to an agent.*” **Observation:** Language should be added to this paragraph that an agent is not deemed to be dependent if he is allowed **to negotiate within narrow fixed parameters only** and under conditions established by the enterprise. It should also be noted that no profit would be left for a deemed agency PE, if the agent is paid on an arm’s lengths basis. Such a concept already has been incorporated into No. 2 of the protocol to Art. 5 of the Tax Treaty between Austria and Germany. Austria and Germany agreed that in case of related enterprises no enterprise should be considered to be a PE of the other enterprise, if the functions performed which might constitute a PE are remunerated by reasonable transfer pricing. Such a concept should be introduced into the Commentary on Art. 5 para 5 OECD-MTC as well to reduce administrative burdens both for taxpayers and tax authorities.

220. We would be grateful if our comments would be considered when finalizing the forthcoming Update to the Commentary on Art. 5 OECD-MTC. We expressly agree that our comments in response to the subject public discussion draft is posted on the OECD website.

### **13. GERMAN FEDERAL CHAMBER OF TAX ADVISERS (BUNDESSTEUERBERATERKAMMER KDÖR)**

*[Note by the Secretariat: Two different sets of comments were sent by that organisation]*

*[First set of comments]*

221. The Federal Chamber of Tax Advisers represents the interests of more than 88.000 tax advisers in Germany vis-à-vis the Bundestag, the Bundesrat, the federal ministries, the top echelons of the civil service, the courts and the “institutions of the EU and OECD”.

222. The Federal Chamber of Tax Advisers supports every measure to prevent double taxation and a just distribution of profits between the different countries.

223. Our tax experts, professor Lüdicke and professor Schmidt, took part in the public consultation meeting which was held on 7 September 2012 in Paris.

224. In addition to our former comments we wish to add some general remarks.

1. We support every measure to modernize the definition of “Permanent Establishment” in order to match the necessities of modern economy, for instance in the IT environment.

2. As already mentioned in our statements before, we'd like to strengthen the following point:

The German Federal Chamber of Certified Tax Advisers as well as German industry appreciates every effort restricting the expansion of the PE, because for businesses and their advisers it is of utmost importance to know in advance of whether or not a specific activity in another state constitutes a Permanent Establishment. This is true not only in respect of administrative obligations regarding the taxation of the Permanent Establishment itself, but also- and sometimes more importantly – with respect to administrative obligations regarding the enterprise's employees as well as their material tax position.

3. Referring to our letter from 25. September 2012 and as already mentioned by our delegate professor Lüdicke during the meeting in Paris, it would be very helpful to clarify of whether or not the presence of the painter in his clients' office building where he spends, for two years, three days a week constitutes a Permanent Establishment only because "he is performing the most important functions of his business (i.e. painting)". The referral to the relatively most important functions of the painter's business suggests that this criterion is decisive for the assertion of a Permanent Establishment. Hence, the example should be of no importance to larger enterprises with many clients at the same time; even if one of the employed painters would spend more than half of his working time, over two years, in the building of one client that would not represent the most important functions of the business of the enterprise.

Therefore we'd like to repeat our question: Does this mean, may be in accordance with the example in Paragraph 6.2. ("catering"), that the Painter example would be applicable only for sole proprietors?

4. Some differentiations/examples may be a little bit confusing, for instance regarding "Recurring activities" in Paragraph 6.1.

While the decision if a PE does exist or not is very important for the businesses and their tax advisers, it is still unclear at which point recurrent activities constitute a PE, thus may lead to double taxation.

*[Second set of comments]*

225. In the context of this statement only points are mentioned, which are changed compared to the preliminary draft or which are highlighted.

226. ***The qualification of a farm as a permanent establishment.*** It is pointed out that the existence of a permanent establishment is assumed , notwithstanding which rules are applied for the achieved income.. These clarifications are welcome. Regarding a farm, the characteristics of a permanent establishment are fixed, even if it is irrelevant for the allocation of income from immovable property. The question remains relevant to the application of Articles 11, 15 and 24

227. ***The importance of the power of disposal ("at the disposal")***. The Working Group clarifies that the power of disposal requires the own authority of the entrepreneur, to use a place and decide independently the expansion of time using a place. Examples of this authority are legal ownership, the right or permission to use a particular place or the simple use of a particular place over a long period of time (for example Peter at CLIENTCO). That is not the case when such a use is only temporarily or occasionally by some employees having access to the offices of related companies they often claim for using for own purposes but not working there over a longer period of time. If this legal or actual opportunity doesn't exist, there is no power. Therefore, the facility of a contract-manufacturing venture is

therefore not in the power of disposal of the principal, as this principal uses the products made by the contractor for purposes of his own company. Thus, the relatively vague criterion ("at the disposal") is concrete and is restricted. It is assumed that the company has a "real (legal) right of use" and that this right must relate to a specific place. Although the exact form is not fully described, the examples explain however, that neither the mere presence nor the activity "under the direction" (at the direction) of the company (for example, in the context of construction contracts) constitute a permanent establishment.

228. In exceptional cases, the home office of an employee can be a permanent establishment, too. This exception applies when the home office is used regularly and constantly for working purposes. A further condition is that the company requests that the home office is used by its employee for business purposes (for example, because no office space for an activity that requires an office, is available). This clarification of the further requirement is to be welcomed, because it requires a statement (and thus the participation) for the creation of a permanent establishment. One may have different views on whether this additional requirement inherently has the effect that the home office is a fixed place of business "which is in under the power of disposal".

229. ***Time requirements for the existence of a permanent establishment.*** Addressed is the uncertainty, resulting from the commentary of the OECD regarding operational activities which are by their nature of short duration. In this context it is very helpful that the OECD has removed its controversial fair example and replaced it by an example of multi-year exploration activities. The now replaced fair example raised more questions (for example, regarding the necessary arrangements, the time of the initial reasoning of a permanent establishment, or the question of the retroactive correction) than settling questions. In this example, the activity is existing a number of years and can not be operated continuously for six or twelve months, because of the external conditions. The second example refers to a company in one country and a person, who is resident in another country. In addition, the company terminates after a short operation. This example is convincing, only because every company has to have at least one permanent establishment.

#### ***Personnel of a foreign company in the state of activity (state in which the work is carried out).***

230. The discussion refers to the difference between the employee in the legal and the economic sense. Besides the OECD draws a parallel to the corresponding provision in the commentary in Article 15. In the parallel to Article 15 the OECD explains, that the activity of an employee in the seat state does not constitute a permanent establishment in the state of activity of a subsidiary if the employee works in the area of responsibility of the subsidiary. A similar rule should apply to employees of a foreign company (temporary workers), working in the area of responsibility for the subsidiary. The indication of Article 15, to which the comment contains a manageable list of criteria for determining the economic employer, is helpful and brings a consistent application of these principles in the context of outsourced activities.

231. ***Total delegation to a subcontractor.*** The draft stipulates that the economic activity of subcontractors is attributed even if the company itself does not have any employee in the state of economic activity. A condition is that the company has the power of disposition the business establishment, as it has the power for legal reasons for example (ownership or usufructuary rights) to use the business facilities and legally binding the subcontractor for the creation of a permanent establishment during the necessary period of time. In general, it is difficult to reconcile the total delegation with the definition of permanent establishment, because this activity of the enterprise requires a fixed place of business and an activity in order (no establishment) becomes a permanent establishment, if the usufruct concerning the business facility does exist. To clarify the boundaries, the effective utilization of the employees of the subcontractor has to be clearly defined. Regardless of this (as with the permanent establishment constituted by representatives) problems of the allocation of profits between contractors and subcontractors arise.

232. **Joint ventures.** The OECD draft underlines that the term of the joint venture does not have to refer to a separate company. It can also include the case that two different companies, each performing parts of a project, decides to fulfill parts of the project and share its profit. Having the legal form of a transparent taxable entity, it may occur that to each partner of the company an own permanent establishment is attributed.. In this case the conditions of the permanent establishment (for example, the time threshold) have to be examined separately. These, compared to the first draft, more differentiated considerations, are convincing.

233. **Place of management.** The OECD makes clear that a place of management (a branch or an office) only meets the requirements of a permanent establishment, when the general conditions are met, which require the existence of a business facility. This clarification seems to be helpful.

234. **Additional work on a construction site.** For construction and assembly permanent establishments the time factor is of central importance. In this context, the revised draft regulates the end of construction and installation activities. The proposal clarifies that the test runs carried out by the staff of the construction, before approving the plant, belong to construction and assembly activities. The warranty work, which is provided after the acceptance of the work, is not included (but latter works have to be considered whether continuing works constitute a permanent establishment). As a rule, the work ends with the acceptance and transition of the construction site. In case of continuing the work seamlessly in order to eliminate cases of warranty, the economic activity goes on; it can not be terminated by its formal acceptance. These differentiations should be manageable in practice and are countenanced..

235. **Ancillary activities.** Associated with ancillary activities it was examined, whether the data listed activities in paragraph 4 generally are exceptions or don't constitute permanent establishments under the condition, that they are not preparatory or supportive. The revised draft emphasizes that activities, covered by the a to d, are not a permanent establishment, while regarding point e the activities are decisive.. The exceptions in a to d are applicable notwithstanding the storage or delivery was made before or after the contract.. This clarification seems helpful in the case that the legal title regarding goods passes to the customer after delivery.. A condition is, that the goods belong to the company, as long as they are stored at the site, issued or prepared for delivery. The commentary underlines that a permanent establishment can not be avoided due to fragmentation of the activities. In comparison it is not possible to reject a permanent establishment by representatives with the argument that various activities are preparatory activities. Associated with ancillary activities the supplementing of the commentary concerning the active involvement of employees of offices in negotiating important contractual components in sales contracts should be possible. They should constitute a permanent establishment, if the condition of the fixed place of business is satisfied, even though they have no final authority. With this addition a caveat of the Czech and Slovak Republics is also remedied. Even when there are good reasons for this expansion, it seems more clear for legal purposes , to keep the feature "competence to conclude contracts." Should the need arise. it has to be examined if to focus on a "contractual competence in a material sense" when contracts are only contracted pro forma in the country of the legal seat.

236. **Authority to contract.** In connection with the authority to conclude contracts the question is raised in the review whether paragraph 5 is limited to operations related to sales. The revision denies this question clearly and reveals that it is also an deputizing when for example a person has the authority to conclude leases for the company and exercises this power. The condition is, that the contracts refer to company assets (but not, for example, the recruitment of staff). Even though the latter differentiation is difficult to bring in tune with the wording of the provision in paragraph 6, it meets the intent and purpose of this paragraph. Not justified by the wording is the interpretation of the draft, saying that a permanent establishment is justified even if the contract is not concluded in the name of the company (indirect representation). Similar considerations of the OECD draft should be reconsidered again.

**14. A. GREENBANK & M. ZETTER (MACFARLANES LLP)**

237. We write in response to your request for comments on the Discussion Draft of 19 October 2012: "OECD Model Tax Convention: Revised Proposals Concerning The Interpretation And Application Of Article 5 (Permanent Establishment)". Our comments are in the attached Word document.

238. In general, we welcome the revisions presented in the Discussion Draft as providing more detailed guidance in applying Article 5. However, as you will see, we believe that the concept of premises being "at the disposal" of an enterprise resident in the other contracting state needs greater clarification and precision.

***Section 2: Meaning of "at the disposal of" (paragraph 4.2 of the Commentary)***

239. In our view, the concept of "at the disposal of" in para 4 of the Commentary suffers from the defect that it is treated as being determinative or at least highly persuasive in relation to all three aspects of the definition of a permanent establishment, whereas in fact it is only limited assistance in relation to two of those aspects.

***Place of business***

240. As regards the first aspect of the definition of a permanent establishment, namely whether the business is carried on through a "place of business", it is clear that premises which are not owned by the enterprise but are merely at its disposal can constitute a place of business through which the enterprise carries on business. The concept of premises being "at the disposal of" an enterprise merely means that the enterprise has the formal or informal right to use the premises (not necessarily exclusively) for the purpose of carrying on its business. As a place of business cannot constitute a permanent establishment unless the enterprise carries on its business there, it is implicit that the enterprise must be able to use the premises for that purpose. Accordingly, the concept of "at the disposal" adds very little to what is in any case implicit. However, the concept of "at the disposal" does make clear that the enterprise does not need to own the premises. All that is needed is a formal or informal right to use the premises for business purposes.

***Fixed***

241. Where the Commentary falls into error is in regarding the concept of "at the disposal" as having some function to perform in relation to a second aspect of the definition of a permanent establishment, namely whether the place of business is "fixed" (dealt with at paras 5 and 6 of the Commentary). This requires that the business be established at a distinct place with a certain degree of permanence (para 2 of the Commentary). As premises will be at the disposal of an enterprise even though its formal or informal right to use them is on a wholly temporary basis, the concept "at the disposal" is of no assistance in determining whether an enterprise's use of premises has the necessary degree of permanence to make them a "fixed" place of business.

***Through which the business is wholly or partly carried on***

242. As regards the third aspect of the definition of a permanent establishment, namely whether the business is carried on "through" a place of business, the concept of "at the disposal" is of assistance in distinguishing premises which are merely "where" a business is carried on from premises "through which" a business is carried on. Only the latter premises can constitute a permanent establishment. An enterprise which fits new or replacement windows to its customers' premises does not carry on its business "through" those premises, because it has no right to "use" the premises. The premises are merely "where" the business is carried on. It might be different if an individual whose job was to fit windows had a single

customer with premises of such magnitude that he was constantly employed in those premises fitting windows (though he might then be categorised as an employee of the customer).

*Need to expand the concept of “at the disposal”*

243. The concept “at the disposal of” could only perform the function of being of assistance in relation to all three aspects of the definition of a permanent establishment if it was split into three concepts as follows:

- premises not at the disposal of the enterprise, because the enterprise does not have any formal or informal right to use the premises for its business purposes and does not, therefore, carry on its business “through” those premises;
- premises at the disposal of the enterprise for business purposes on a sufficiently constant, stable, secure or continuous basis and for a sufficiently extended period of time to give a degree of permanence to the enterprise’s use of the premises and, therefore, to make them a “fixed” place of business “through which” the enterprise carries on its business (“at the fixed and regular disposal of”); and
- premises at the disposal of the enterprise for business purposes on too casual, insecure or intermittent a basis for the premises to be regarded as a “fixed” place of business (“at the precarious or temporary disposal of”).

244. Premises not at the disposal of the enterprise would not constitute a permanent establishment. Premises at the “fixed and regular disposal” of the enterprise would constitute a fixed place of business, whereas premises at the “precarious or temporary disposal” of the enterprise would not.

245. These distinctions could then be applied to the various examples discussed in the Commentary.

### ***Examples***

#### *Premises not at the disposal of the enterprise*

246. Where a salesman regularly visits a major customer to take orders and meets the purchasing director in his office to do so, the customer’s premises would not in our view be at the disposal of the enterprise employing him, because it does not have any right to “use” the premises to carry on its business. It merely has the right to visit the premises.

247. Where an enterprise is engaged in paving a road, the road would not in our view be at the disposal of the enterprise, because it does not have any right to “use” the road to carry on its business. The road is “where” the business is carried on but is not a place “through which” it is carried on. It might be different in the case of a road improvement project lasting more than 12 months (having regard to Article 5(3)).

248. Where a painter paints a customer’s premises, the premises would not in our view be at the disposal of the enterprise employing the painter, because the enterprise has no right to “use” the premises to carry on its business. The premises are “where” the business is carried on but are not a place “through which” it is carried on.

249. Where CarCo manufactures and sells automobiles and sets up SubCar to assemble cars from parts owned and supplied by CarCo, SubCar’s premises would not in our view be at CarCo’s disposal for the

purposes of its (CarCo's) business, because CarCo does not use SubCar's premises to carry on its business. The only business carried on in SubCar's premises is SubCar's business (of contract manufacturing).

***Premises at the “precarious or temporary disposal” of the enterprise***

250. Where a salesman regularly visits a major customer to take orders and is allocated a spare room in which he can be consulted by different members of the purchasing team, the room would in our view be at the “precarious or temporary disposal” of the enterprise employing him for the purposes of its business. The room is at the disposal of the enterprise on too casual and insecure a basis for the premises to be regarded as a “fixed” place of business. We assume, in this example, that the room allocated to the salesman changes from visit to visit, that the room is used for other purposes when he is not there and that, where no spare room is available, his visit is cancelled.

251. It follows that we do not agree with BIAC that unutilized capacity of a host operation made available to an enterprise should be regarded as not satisfying the requirement of being “at the disposal of” the enterprise. However, we regard premises which the enterprise has the right to use only if and when they are unutilized by the host operation (being at that time surplus to its requirements) as an example of premises at the “precarious or temporary disposal” of the enterprise.

252. Where a manager of a company is allowed for a period not exceeding 6 months to use a room in the offices of another company (eg a newly acquired subsidiary) for up to 3 days a week, in order to ensure that the subsidiary complies with its obligations under contracts concluded with its new parent, the room allocated to the manager changes from day to day, the room is used for other purposes when he is not there and, where no spare room is available, he is not able to visit, the rooms would in our view be at the “precarious or temporary disposal” of the parent.

253. Where a road transportation enterprise is allowed on a non-exclusive basis to use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer, the dock would in our view be at the “precarious or temporary disposal” of the enterprise for the purposes of its business. The dock would be at the disposal of the enterprise on too casual, insecure or intermittent a basis for it to be regarded as a “fixed” place of business.

254. Where a market trader regularly sets up his stand in an outdoor market, space at the market is allocated on a first come first served basis and the space allocated to the trader changes from market day to market day, the market would in our view be at the “precarious or temporary disposal” of the trader. Although the trader is a regular attender at the market (arriving early to avoid disappointment), space at the market is at his disposal on too casual, insecure or intermittent a basis for it to be regarded as a “fixed” place of business.

***Premises at the “fixed and regular disposal” of the enterprise***

255. Where Peter provides training to ClientCo's staff over a 20 month period at ClientCo's headquarters and 10 training rooms are made available to him to prepare and deliver the training sessions, the training rooms would in our view be at his “fixed and regular disposal” for the purposes of his business. The training rooms are at Peter's disposal on a sufficiently constant, stable, secure and continuous basis and for a sufficiently extended period of time to give a degree of permanence to his use of the premises and, therefore, to make them a “fixed” place of business “through which” he carries on his business.

256. Where a salesman regularly visits a major customer to take orders, is allocated a room (generally the same one) in which he can be consulted by different members of the purchasing team, the room is rarely used for other purposes when he is not there and the availability of a room to the salesman does not

depend on there being spare capacity (such that his visits are never cancelled), the room would in our view be at the “fixed and regular disposal” of the enterprise employing him for the purposes of its business. The room or rooms are at the enterprise’s disposal on a sufficiently constant, stable, secure and continuous basis to give a degree of permanence to its use of them and, therefore, to make them a “fixed” place of business “through which” it carries on its business.

257. Where a manager of a company is allowed for a 2 year period to use a room (generally the same one) in the offices of another company (eg a newly acquired subsidiary) in order to ensure that the subsidiary complies with its obligations under contracts concluded with its new parent, the room is rarely used for other purposes when he is not there and the availability of a room to the manager does not depend on there being spare capacity (such that his ability to carry out his work is never interrupted), the room would in our view be at the “fixed and regular disposal” of the enterprise employing him for the purposes of its business.

258. Where a painter paints and decorates a customer’s premises, the premises are of such magnitude that the painter is constantly employed in those premises painting and decorating them and a small area is made available to him in a shared storage room for him to store his equipment, the premises would in our view be at the “fixed and regular disposal” of the enterprise employing him for the purposes of its business. The same would apply if a self-employed painter had a single customer with premises of such magnitude that he was constantly employed in those premises painting and decorating them (though he might then be categorised as an employee of the customer, rather than as being self-employed).

259. Where a market trader regularly sets up his stand in an outdoor market, space at the market can be pre-booked for many months at a time and the space allocated to the trader rarely changes from market day to market day, the market would in our view be at the trader’s “fixed and regular disposal” for the purposes of his business.

***Section 3: Can the premises of a (converted) local entity constitute a permanent establishment of a foreign enterprise under paragraph 1? (paragraph 4.2 of the Commentary)***

260. We recommend that the following words be added at the end of new paragraph 3.1:

“and without evaluating those circumstances by reference to their derivation or history”.

***Section 4: Home office as a PE (proposed new paragraphs 4.8 and 4.9 of the Commentary)***

261. We do not agree that the question whether the employer *requires* an employee to work at home is the most appropriate criterion for distinguishing a home which is a PE from one which is not. We would draw the distinction as follows.

262. Where an employee’s home is used by him for business purposes on a casual, insecure or intermittent basis, the terms of employment do not specifically contemplate the employee working from home and the job can be properly performed without the employee working at home, the employee’s home would in our view be at the “precarious or temporary disposal” of the enterprise employing him and would not, therefore, be regarded as a “fixed” place of business through which the enterprise carries on its business.

263. Where an employee’s home is used by him for business purposes on a constant, stable, secure or continuous basis and for an extended period of time and either the terms of employment specifically contemplate the employee working from home or the job cannot be properly performed without the employee working at home, the employee’s home would in our view be at the “fixed and regular disposal” of the enterprise employing him and, accordingly, his use of his home for business purposes would have a

sufficient degree of permanence to make it a “fixed” place of business “through which” the enterprise carries on its business. A common feature of this kind of arrangement is that a significant amount of equipment (particularly, IT equipment) is made available by the enterprise to the employee for home use. Where the terms of employment include a rental payment for the business use of the home, those terms clearly contemplate the employee working from home. However, home working may be still contemplated by the terms of the employment notwithstanding that the indications are rather less clear than that.

264. The fact that the employee does not permit visits to his home for business purposes is a factor pointing against a PE but we do not regard it as a particularly strong factor.

***Section 6: Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

265. On the need for a time requirement, we agree with the concerns raised by BIAC and do not support the recommendations of the Working Party. We, therefore, agree that a fixed place of business should only be regarded as existing if the enterprise’s business is conducted there for a minimum period of time. BIAC recommended 12 months. We would accept a minimum period of 6 months (the period currently mentioned in para 6).

266. In our view, the approach of the Working Party (reflected in the current para 6) that a PE can exist for a very short period of time (just a few weeks in the case of a catering enterprise which hires premises to provide catering services to its country’s athletes during the Olympic Games) where the nature of the business is such that it will only be carried on for that short period of time is wholly inconsistent with the fundamental concept of a “permanent establishment”.

267. Furthermore, we do not accept that the fact that the activities carried on by the enterprise for a short duration in the host country constitute a business that is carried on exclusively in that country has any bearing on the question whether the premises in which the activities are carried on is a fixed place of business. It is a factor which is simply not relevant to the question of permanence.

***Section 7: Presence of foreign enterprise’s personnel in the host country (paragraph 10 of the Commentary)***

268. In our view, the revised para 10 should explain the three different scenarios which may arise where the personnel of one enterprise work at the premises of another enterprise. Using the hotel management example, they are as follows.

269. In the first scenario, a hotel management company provides a hotel management service to an hotel owning company. This service obviously requires personnel employed by the hotel management company to be physically present in the hotel. The question whether the hotel constitutes a PE of the hotel management company does not raise any new issues not already considered above.

270. In the second scenario, an employment agency employs personnel which it seconds to the hotel owning company. The personnel become part of the hotel owning company’s management team. The secondment service obviously requires the employment agency’s personnel to be physically present in the hotel. The question whether the hotel constitutes a PE of the employment agency is a difficult one. Is the secondment service one which is carried on, at least partly, “through” the hotel? Or, is the only business which is carried on in the hotel that of the hotel owning company? The Commentary needs to address this difficult issue.

271. In the third scenario, a parent company employs personnel which it seconds to other group companies, one of which is an hotel owning company. The personnel seconded to the hotel owning

company become part of that company's management team. The secondment service obviously requires the employment agency's personnel to be physically present in the hotel. Under the law of the host country, the personnel are regarded as employees of the hotel owning company, as that law comprises a principle similar to the "economic employer" in the Commentary on Article 15. In this case, we agree that the hotel is not a PE of the parent company, as the only business which is carried on in the hotel that of the hotel owning company.

***Section 8: Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)***

272. In our view, the question whether a main contractor can be considered to carry on its business through a fixed place of business where the only personnel present at the relevant premises are employed by its sub-contractors cannot be decided by reference to whether or not the main contractor itself controls access to and use of the premises.

273. The answer to this question depends, in our view, on whose business is carried on at the premises. If the main contractor's business is carried on there, it will have a PE at those premises (provided the other requirements of a PE are met). As the main contractor will have a contract with the customer and will earn profits from that contract (after deducting the fees which it pays to its sub-contractors), it should in most cases follow that the main contractor's business is carried on at the premises (albeit it is carried on on its behalf by the sub-contractors).

274. This must be contrasted with the CarCo/SubCar example discussed above. In that case, we concluded that CarCo's business was not carried on at SubCar's premises, even though CarCo had subcontracted to SubCar work which it had previously performed itself. What distinguishes this example from that of the main contractor is that the main contractor supplies the "output" side of its business (the provision of a service to its customer) through the agency of its subcontractors, whereas CarCo merely subcontracts an "input" function (manufacturing) to SubCar and retains the selling part of the business for itself.

***Section 19: Meaning of "to conclude contracts in the name of the enterprise" (paragraph 32.1 of the Commentary)***

275. We agree with the recommendation of the Working Party (to be reflected in para 32.1) that, where an agent has authority to conclude contracts on behalf of the enterprise and concludes them in its own name as undisclosed agent but, under the relevant law, the enterprise as undisclosed principal is bound by the contracts, the agent "has authority to conclude contracts in the name of the enterprise".

276. However, where an agent has authority to conclude contracts on behalf of the enterprise, concludes them in its own name as undisclosed agent and, under the relevant law, the enterprise as undisclosed principal is *not* bound by the contracts, we do not agree that the agent "has authority to conclude contracts in the name of the enterprise". The fact that the enterprise may indemnify the agent against the legal consequences of having acted, at least apparently, as a principal does not, in our view, make any difference.

277. Where an agent solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse of the enterprise from which goods are delivered and where the enterprise routinely approves the transactions, the agent does not, in our view, have "authority to conclude contracts in the name of the enterprise". Authority lies with the enterprise. The fact that it routinely gives such authority does not matter.

**15. ICON WIRTSCHAFTSTREUHAND GMBH**

[These comments were submitted in PDF format only. They will be made available separately]

**16. INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES (ICAEW)  
TAX FACULTY****COMMENTS*****Issue 2: Meaning of “at the disposal of”***

278. We suggest the addition of "and exercises that right via one or more employees or dependant agents physically present at the location" after "(e.g. where it has legal possession of that location)" in paragraph 4.2.

279. We do not believe it can be right that the mere right to legal possession, even if exclusive, constitutes a PE at that location if the right to possession is never exercised. A mere right of possession does not constitute economic activity. It simply excludes others from lawfully occupying the location.

***Issue 6: Time requirement for the existence of a permanent establishment***

280. We remain extremely concerned by the proposed exceptions to the general rule, which has been in place for more than 50 years, that a place of business can only constitute a permanent establishment (PE) if it has been in use for a period of more than six months.

281. Since the earlier discussion draft of October 2011 the examples have been changed and rather than an annually recurrent 5 week period there is now one of 3 months and while the single period of occupation remains at 4 months for the catering facilities example the background facts have been altered.

282. The likelihood is that countries will begin to argue that a PE has been established even though the fixed place of business has been in existence for less than 6 months and this will lead to considerable uncertainty.

283. One of the underlying rationales behind the OECD work in this area is to stimulate international trade and we are worried that the changes, currently proposed, will have exactly the opposite effect. Businesses will be concerned about beginning to operate in countries where they fear that those countries will begin to argue, almost from the outset, that what they are doing constitutes a PE. Business requires clear rules and certainty. The current proposals will create the opposite effect.

284. We accordingly recommend adding "The existence of a permanent establishment as illustrated above should be viewed as arising only in very exceptional circumstances and the general rule remains that a permanent establishment should not exist unless the local presence has subsisted for 6 months or more." at the end of each of paragraphs 6.1 and 6.2.

***Issue 8: Main contractor subcontracting all aspects of a contract (paragraphs 10 and 19 of the Commentary)***

285. Despite the fact that some changes are proposed in the revised discussion draft, the issue relating to the overall responsibility of the contractor on the on-site operation by the sub-contractor has not been solved.

286. As previously stated, Issue 8 should surely be dealt with under the dependent agency type PE rule rather than deeming the subcontractor(s) to be a PE of the non-resident main contractor. Also, this "principle" of deeming a third party subcontractor to be a new type of PE of the main contractor could be extended to other industries e.g. financial services regarding brokers acting for non-resident principals. We believe this to be a very unhelpful proposal from the perspective of business.

287. We therefore strongly recommend that the wording change in paragraph 19 i.e. the addition of the words "all or" is not proceeded with and the necessary consequential changes are made.

288. Equivalently, the "acting alone or" wording in paragraph 10.1 should be deleted and the necessary consequential changes should be made.

## 17. INTERNATIONAL AIR TRANSPORT ASSOCIATION (IATA)

### ***Background***

289. On 19 October 2012 the OECD published its revised proposals on Permanent Establishments (Article 5 of the OECD Model Tax Treaty). The proposals follow an earlier discussion draft released in October 2011. The OECD work was not intended to lead to any changes in the text of Article 5, but rather focused on specific areas of guidance in the Commentary to Article 5.

290. It is expected that the OECD proposals will form the basis of an updated version of the Commentary to Article 5 when the Model Treaty is next updated (expected 2014). Comments on these OECD proposals are requested by 31 January 2013.

291. The International Air Transport Association (IATA) is pleased to hereby submit comments on behalf of its membership on the OECD's revised proposal on Permanent Establishments as follows.

### ***Relevance to the airline industry***

292. The concept of PE is generally of secondary concern to the airline industry, as a consequence of the overriding application of the Article 8 Airlines Profits Article. In this regard, we refer to the ongoing communication between IATA and the OECD (including submission dated 17 February 2012) in relation to possible amendments to the Model Tax Treaty Commentary in relation to Articles 8 and 15. However, the definition of PE remains relevant in relation to activities of the airline enterprise which are not international airline operations (or activities which are ancillary or incidental to those operations). These might include:

- Aircraft leasing to the extent those activities are not ancillary or incidental to the operation of an international airline.
- Non-airline commission sales activities (such as sale of hotel and car hire) through on-line systems, call centres or through sales staff who may be temporarily located at foreign airport facilities.
- Provision of other services (such as management; IT systems and support, procurement etc.) which may be provided to other affiliated or third party enterprises through employees temporarily located in a foreign jurisdiction (with either continuing direct employment or through secondment to a local company).

293. In addition, third party or affiliated enterprises that provide services to the airline industry will often need to address the scope and interpretation of Article 5. These providers might include aircraft

leasing companies, providers of communications/entertainment systems operated on aircraft and providers of cabin crew. In many instances, airlines will contractually indemnify such suppliers' tax liabilities.

294. Moreover, many airline non-treaty jurisdictions will look to the OECD interpretation of PE when interpreting their own domestic legislation definition of PE. Also, many jurisdictions indirect tax regimes will commence with the corporate tax definition of PE and as such the OECD commentary can even be relevant in those cases.

295. It is acknowledged that determining whether a PE exists is often difficult being a factual enquiry of activity and, given the importance of this inquiry in determining the impost of taxes, we view the commentary as playing an extremely important role. As such, IATA is very supportive of further updates including the provision of more specific examples.

### ***COMMENTS ON PROPOSALS OF INTEREST TO THE AIRLINE INDUSTRY***

#### ***Section 2 – Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)***

296. The existing Commentary to Article 5 requires a place of business to be “at the disposal of” the enterprise before a permanent establishment may be created under the fixed place of business test. The OECD now proposes a three-fold test: (i) a new test for an “effective power to use” the location; (ii) the extent (i.e. duration) of actual presence; and (iii) the “nature” of the relevant activity.

297. The additional wording and new examples are somewhat helpful in providing further guidance on the meaning of the term “at the disposal of”. However, in doing so, the proposed changes introduce a new concept of “effective power to use” with little explanation, particularly around what is meant to be conveyed by the reference to “effective”. For example, should there be some power of exclusion of other parties to the extent it impedes the relevant “use”?

298. **We recommend that the Commentary be expanded to provide further guidance on the concept of “effective power to use”.**

#### ***Section 5 – Shops on ships operated in international traffic***

299. The Discussion Paper proposes the introduction of the following new paragraph in the Model Treaty Commentary:

*5.5 Similarly, a ship or boat that navigates in international waters or within one or more States is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship or boat, such as a shop or restaurant, must be treated the same way for the purposes of determining whether paragraph 1 applies (paragraph 5 could apply, however, where contracts are concluded when such shops or restaurants are operated within a State).*

300. This new paragraph provides useful additional guidance.

301. **However, we would strongly recommend that the last few words of this new paragraph are revised as follows:**

*... are operated solely within a State for an extended period of time)*

302. If a ship [or aircraft] is engaged in the international transit of passengers or freight, the fact that it temporarily moves into and out of the territorial waters or airspace of a particular country during the course of those international operations, should not render the activities conducted on that vessel (e.g. the activities of parties not protected by Article 8) to be treated as giving rise to a PE in any such State (under any paragraph of Article 5). This issue should not be confused with the issue discussed at section 6. A ship (or aircraft) which temporarily enters and leaves the territorial waters or airspace of a particular country is a moving object. Neither it, nor the activities conducted on that ship (or aircraft) can constitute a fixed place of business in any one territory – no matter how recurrent are the visits of that ship (or aircraft) to that country. This is perhaps contrasted with activities on board a ship that operates solely within one State for an extended period of time.

303. In the context of the airline industry, historically, any services and sales activities provided to passengers on an international flight have been provided by the airline as activities which are directly connected or ancillary to the operation of the international airline (and therefore covered by Article 8). However, new communications and entertainment services may be provided by third party service providers. While these services are unlikely to require the physical presence of employees on the aircraft, the question of “fixed place of business” may arise under Treaties which contain a “substantial equipment” clause.

304. Similarly, the example will be of interest to a third party or affiliated provider of cabin crew.

#### ***Section 6 – Time required for the existence of a permanent establishment***

305. The main changes to the Commentary proposed under section 6 are to introduce two new examples – one dealing with activities of a recurrent nature (a drilling site operate 3 months a year for 5 years stated to constitute a PE); and the other dealing with a business carried on exclusively in a country but, due to its nature, is only a business of short duration (cafeteria set up to cater for the crew of a television production).

306. As discussed above we do not believe that examples of activities undertaken in a particular country on a recurrent basis are of relevance to those activities undertaken on board a ship or aircraft carrying on international operations.

307. However, we would observe that the changes proposed to the Commentary (including the new examples) do little to provide any additional guidance in relation to the issues covered.

308. **We suggest that the current Commentary has created considerable uncertainty in relation to the circumstances of “recurrent activities”. And we would recommend that further examples are provided to address this uncertainty.**

#### ***Section 7 - Presence of foreign enterprise's personnel in the host country***

309. The proposed revision of the Commentary to amend clause 10 and insert new clause 10.2 is helpful (and appropriate) in indicating that multinational corporations seconding employees to a foreign company (often a subsidiary or affiliate) would typically not create a PE unless they are carrying on the business of the foreign company (as opposed to the business of their temporary employer).

310. **We agree with the proposed changes.**

***Section 10 - Meaning of “place of management”***

311. The proposed new paragraph 12 of the Commentary appropriately provides a useful reinforcement of the position that the examples listed at paragraph 2 of Article 5 must still satisfy the requirements of paragraph 1 in order to constitute a PE.

312. **We agree with the proposed changes.**

***Section 12 - Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature?***

313. The amendments to the Commentary proposed at section 12 appropriately provide a useful reinforcement of the position that the activities of subparagraphs (a) to (d) of paragraph 4 of Article 5 need not be “preparatory or auxiliary” in order to fall within the PE exclusion.

314. ***We agree with the proposed changes.***

**18. INTERNATIONAL BAR ASSOCIATION**

315. [These comments were submitted in PDF format only. They will be made available separately]

**19. INTERNATIONAL CHAMBER OF COMMERCE (ICC)****A. General remarks**

316. The requirements for qualification as a permanent establishment have been steadily lowered through various revisions of the OECD Commentary on the Model Tax Convention. Furthermore, the definition of permanent establishment has become increasingly broader, a trend that seems to have been perpetuated by the existing draft content of the Commentary for the 2014 update of the OECD Model Tax Convention. What is at issue here essentially involves an “expansion” of the definition of the term permanent establishment (e.g. through what are referred to as service permanent establishments and agency permanent establishments).

317. Although the clarifications that have been included in the draft of the Commentary on Article 5 are intended to provide more legal certainty in practice and are as such welcome, the proposed changes at the same time tend to blur the definition of permanent establishment. Consequently, business increasingly finds itself in a less than acceptable situation since, when confronted with ambiguous cases, we are hardly able to make reliable statements as regards the question of the existence of a permanent establishment and the myriad fiscal implications. In our view, the tendency towards a more and more flexible definition of what constitutes permanent establishment contravenes the implementation of the Authorized OECD Approach into Article 7 of the OECD Model Tax Convention 2010. Where for reasons of profit allocation the permanent establishment has at present reached a status of being almost as functionally separated as corporations, the planned changes to the Commentary on Article 5 at the same time seem to add momentum in the opposite direction.

318. The implementation of the Authorized OECD Approach requires both tax practitioners and companies with cross-border operations to furnish detailed valuation and documentation of inter-company transactions at an accelerated pace. However, the planned changes to the Commentary on Article 5 often fail to provide clear guidelines on whether the creation/existence of a permanent establishment will make such efforts likely to incur or not. Against this background, we think that strengthening permanent establishments in terms of profit allocation should also be underpinned by a clear and restrictive definition of what permanent establishment actually is.

319. We fear that an ever wider definition of permanent establishment and continuing ambiguities will harm commercial ties between countries. There is a high risk for businesses of omitting inadvertently to treat commercial activities as permanent establishments. This can have severe consequences varying from country to country. Beside all the tax consequences (payroll tax etc.) criminal proceedings may be triggered quasi-automatically.

## B. *Specifics*

### I. *Expansion of the meaning of ‘at the disposal of’*

320. Major changes planned in the Commentary on Article 5 of the Model Tax Convention will concern the meaning of “at the disposal of”, which is fundamental to the understanding of a definition of permanent establishment. The working party seems to be essentially of the opinion that a place of business is clearly at the disposal of an enterprise if the enterprise has an exclusive legal right to use the premises – for example, in the form of a rental agreement or lease. Nevertheless, a permanent establishment will also be considered to exist when an entrepreneur uses the premises of another entrepreneur on a continuous and regular basis over an extended period of time or premises that are used in such a manner by several entrepreneurs. Seen the other way around, a permanent establishment cannot be assumed to exist if an entrepreneur is present on such premises irregularly or only occasionally. Finally, such premises can therefore not be considered to represent a fictitious place of business. According to the draft, the same will apply if an entrepreneur has no right to use premises as he sees fit and in fact maintains no presence on such premises.

321. Such cases, however, in practice lead to tremendous difficulties not only with regard to income taxation but also to payroll and value added tax issues.

322. The revised discussion draft adds that whether a location may be considered to be at the disposal of an enterprise depends on the foreign enterprise ‘having the effective power to use that location’.

323. The proposed examples provided in para. 4.2 on Article 5 as amended by the Working Party to illustrate whether an enterprise has the effective power to use a certain location do not provide sufficient clarification. In each example a situation is described which is rather clearly based on the practice of the Member Countries.<sup>1</sup>

324. An example should be included which provides facts respectively illustrates the ‘thin borderline’ when an enterprise has the effective power to use a location and when not. The meaning of the Commentary must become clearer and the language used must be understandable to the typical reader versed in international tax principles. The example should make clear that “at the disposal of” requires a qualified access. The qualifying moment should be the foreign enterprise’s ability to decide oneself about when, how, and to which business purpose to access the client’s premises.

## C. *Time requirement*

325. We agree with the elimination of the commercial fair example. However, we still doubt that the drilling example provides sufficient clarity. It is e.g. unclear, if all installations disappear entirely during the non-drilling period.

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<sup>1</sup> The first example provides a case where an enterprise has an exclusive legal right to use a particular location. The second example describes a situation where an enterprise is allowed to use a specific location that belongs to another enterprise and performs its business activities at that location on a continuous basis during an extended period of time.

326. However, the drilling example does not provide a reliable minimum time threshold. To make it all depend on ever-changing facts and circumstances is poison for international economic activities. The missing certainty will trigger additional costs and therefore inhibit growth and job creation.

327. The current wording of the Commentary does not specify any ‘own’ recommendation of the OECD. It is all left to ‘best practice’ of the Member Countries. Para. 6 of the Commentary mentions that ‘experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months’. This statement reflects the general practice executed by the Member Countries but does not provide a recommendation of the OECD itself. If at all, the statement indicates that the OECD shares the same view. OECD should provide here an ‘own’ clear statement that this practice should be maintained.

#### **D. Subcontractor**

328. With regard to the involvement of subcontractors the wording of the future commentary must make clear, under which circumstances the enterprise (general contractor) has the effective power to use a location where subcontractors perform work for the enterprise. Para. 10.1 distinguishes two cases. Firstly, where only parts of aspects of a contract are subcontracted and secondly, where all aspects of a contract are subcontracted.

329. In case only parts of aspects are subcontracted, whether a location is at the disposal of the enterprise (general contractor) will be determined on the basis of the general rule according to para. 4.2 of the commentary on Article 5.

330. In cases where the enterprise subcontracts all aspects of the contract to a subcontractor, para. 10.1 provides that the enterprise ‘clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of the location and controls access to and use of the location’.

331. Unfortunately the draft still doesn’t elaborate on this statement.

#### **E. Attribution of time spent by the subcontractor vs. activities**

332. Furthermore, the wording of para. 48 of the discussion draft is not coherent with the wording of para. 19 of the commentary. Para. 19 deals with the attribution of time spent by the subcontractor to the general contractor, whereas para. 48 of the discussion draft states that the working party concluded that the implication of para. 19 was that the activities of the subcontractor were allocated to the main contractor.

333. Hence, it would be desirable, if this case could be cleared. From the wording of para. 19.1 in connection with para. 10.1 of the Commentary only the time spent by the subcontractor must be considered as time spent of the general contractor.

#### **F. Subcontracting all aspects of a contract in the context of the AOA**

334. The attribution of time spent is now extended to cases where all aspects of a contract are subcontracted. The commentary on Article 5 does not provide any comment or reference to the AOA. According to the AOA no profit could be attributed to a PE in the absence of the enterprise’s personnel (significant people function).

335. It would be desirable, if a statement or reference could be included in the commentary how the AOA is treated in cases where all aspects of a contract are subcontracted.

**G. *Questions of doubt regarding agency permanent establishments (draft para. 106 et seqq. of the draft)***

336. The nature of an agency permanent establishment as defined in Article 5 para. 5 of the Model Tax Convention hinges on the “authority” of the agent to execute contracts “in the name of the enterprise” in a contracting state with the additional condition that this authority is “habitually exercised”. In this regard the proposed Commentary stipulates that the reference to “authority to conclude contracts on behalf of an enterprise” is by no means intended to restrict application exclusively to agents literally executing agreements that are binding upon the enterprise. Instead, Article 5 para. 5 of the Model Tax Convention is intended to apply equally to agents who enter into agreements that are binding upon an enterprise even if they are not actually signed in the name of that enterprise. There is some disagreement as to whether the opposite holds, i.e. whether commission agents who conclude contracts in their own name also fall under Article 5 para. 5 of the Model Tax Convention. The national courts have not yet shown a common stance in respect of the question as to whether possession of “authority” requires a valid (direct) legal relationship with a third party or whether an economic (indirect) commitment of a principal by its agent would suffice<sup>1</sup>.

337. The draft makes reference to the peculiarities of civil or commercial law of various OECD member countries according to which an enterprise may under certain circumstances be bound by an agreement entered into with a third party by an agent not in the name of the enterprise, but in its own name and on behalf of the enterprise. This would also apply if the third party does not formally disclose the name of the enterprise (para. 32.1 of the Commentary).

338. Finally, it will in the future likely remain necessary to take into account the views of the contracting states for the purposes of construction of the term “authority” pursuant to Article 3 para. 2 of the Model Tax Convention with regard to consignment structures. In a number of national laws a commission agent can still not be assumed to have an agency permanent establishment. This point of view also reflects the judgment of the French Conseil d’État (“Zimmer” case) and the recent decision of Norway’s highest court, the NorgesHøyesterett, (“Dell Computers” case) to the effect that a consignment agent acting in his own name cannot be considered a dependent agent due to a lack of authority. Both rulings follow the same line of reasoning, i.e. the construction of the term agency permanent establishment does not depend on economic ramifications, but on the legal structure of the business relationships involved. As a result, an agency permanent establishment cannot exist in cases in which the consignment agent cannot bind the principal vis-à-vis customers.

339. The current version of the Commentary does not make reference to such specifics of national commercial law. We would therefore appreciate seeing in the final version of the revised Commentary on Article 5 some form of qualifying remark in order to illustrate that such distinctions need to be taken into consideration in certain cases.

340. ICC appreciates the opportunity to present its views on the “Revised Proposals concerning the interpretation and Application of Article 5 (Permanent Establishment)”. We would be thankful for keeping in mind that any lack of certainty with regard to the existence or non-existence of a permanent establishment will be detrimental to business creating jobs and prosperity. We remain at your disposal for any further discussion.

**20. JAPAN FOREIGN TRADE COUNCIL (JFTC)**

341. The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. in response to the invitation to public comments by OECD regarding “Interpretation

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1 Judgment of the French Conseil d’État of March 31, 2010, “Zimmer” and the decision of the Norwegian BorgartingLagmannsrett of March 2, 2011, “Dell Computers”.

and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention.” The Japan Foreign Trade Council is a trade-industry association with trading companies and trading organizations as its core members, while one of the main activities of its Accounting & Tax Committee is to develop the trade environment by submitting specific policy proposals and requests to government authorities concerning tax matters. [...]

***Issue 2. Meaning of “at the disposal of***

*Revised proposal: Para. 4.2, 2<sup>nd</sup> Sentence*

“...that enterprise *having the effective power to use that location as well as* the extent of the presence of the enterprise...”

*Comments on the revised proposal*

342. In this revised draft, the concept of “effective power to use that location” is stressed. We are concerned that, based on this concept, it could be interpreted that a mere fact that an enterprise are controlled by the other enterprise (even if there is no legal right to use) constitutes a situation where the controlling enterprise has effective power to use the location that belongs to the controlled enterprise.

343. In this respect, the OECD Model Tax Convention specifies in paragraph 7 of Article 5 that “The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other”. So that this statement is not overlooked, we suggest inserting that the following sentences in this commentary.

“A fact that an enterprise controls the other enterprise shall not of itself constitute a situation where the controlling enterprise has effective power to use the location that belongs to the controlled enterprise”.

344. In addition, we consider that “power” in the context of this paragraph should be power that is clearly agreed between the parties. Therefore, we suggest that, as well as using a term “*exclusive legal right*” in the paragraph 4.2, the commentary replaces “*effective power*” with “*effective legal power*”.

*Revised proposal: Para. 4.2, 5<sup>th</sup> Sentence*

(e.g. *where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time*).

*Comments on the revised proposal*

345. We understand that the purpose of adding this example is to provide some guidance for interpretation of the meaning of “*intermittent or incidental*”. However, if it is the purpose, we consider that it would be necessary to provide further clarification on the definition of “*for an extended period of time*”.

***Issue 3. Can the premises of a (converted) local entity constitute a permanent establishment of foreign enterprise under paragraph 1?***

*Revised proposal: Para. 3.1*

*It is also important to that the way in which business is carried on evolves over the years so that the facts and arrangements applicable at one point in time may no longer be relevant after a change in the way that the business activities are carried on in a given State. Clearly, whether or not a permanent establishment exists in a State during a given period must be determined on the basis of the circumstances applicable during that period.*

*Comments on the revised proposal*

346. We agree with the Working Party's conclusion that no distinction should be made in the application and interpretation of Article 5 based on whether or not the facts and arrangements relevant to determination of a permanent establishment resulted from a business restructuring. However, it appears to us that the new paragraph doesn't explain directly relationship between such business restructuring and determination of a permanent establishment. Therefore, to make clarification on this point, we suggest the following sentence is added after the second sentence of the new paragraph.

"For example, cross-border transfer of functions, risks and/or assets between associated entities does not necessarily constitute a permanent establishment for the transfer in the country in which the transferee exists."

***Issue 6. Time requirement for the existence of a permanent establishment***

*Para. 6.1, 4<sup>th</sup> Sentence*

*Time requirement for the existence of a permanent establishment*

*An enterprise of State carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for 5 years.*

*Comments on the revised proposal*

347. We appreciate that, the commercial fair case is deleted and instead the drilling operations case which would be more realistic one is added in the illustrations of the revised draft. We believe that the important factor for determination of a permanent establishment in a situation where the activities are of a recurrent nature is whether the operation period is "clearly" expected "at the beginning of the activities". In this respect, we suggest adding some words into the second sentence as follows (see the underlined part).

"The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are clearly expected to last for 5 years under a specific contract or similar legal arrangements at the beginning of the activities."

***Issue 11. Additional work on a construction site***

*Para. 19.1, 9<sup>th</sup> sentence*

*Depending on the circumstances, however, any subsequent work (including work done under a guarantee) performed on the site during an extended period of time may need to be taken into*

*account in order to determine whether such work is carried on through a distinct permanent establishment.*

*Comments on the revised proposal*

348. For the last sentence, as discussed in the public consultation meeting on September 7, 2012, we suggest that the following sentences are added to clarify the meaning of the “*distinct permanent establishment*”.

*This determination should be made separately from determination of a permanent establishment for the original construction work. Therefore, even if such subsequent work constitutes a permanent establishment, it shall not be deemed retrospectively that the original construction work constituted a permanent establishment.”*

**21. E. MANCILLA RENDON & M. ASTUDILLO MOYA**

349. Non-profit organizations, civil partnerships, business corporations, limited liability companies, cooperatives, rural production companies, etc. may enter into joint venture agreements; the federal government, the states and municipalities may also do so. State-owned companies may also exercise such right. Legally, the joint venture agreement is recognized as the group of individuals or business entities who gather in order to produce a business agreement to carry out a business transaction, where the general partner will have a share in its results, whether these are profits or losses, at the proportion agreed upon.

350. Individuals and business entities may also enter into joint venture agreements. However, the Mexican legal principles do not define a joint venture as a business entity. For tax purposes, the Income Tax Law (*Ley del Impuesto Sobre la Renta*) sets forth that a business entity includes, among other definitions, a joint venture whenever business activities are carried through it in Mexico; thus, a joint venture must comply with the tax regulations. The joint venture shall have legal existence for tax purposes when carrying business activities in Mexico, when the agreement is entered into under the laws of Mexico, or when the joint venture is a resident in Mexico. In this regard, whenever the laws make reference to a business entity, the joint venture is included, followed by the legend “*A. en P.*”, for its abbreviation in Spanish.

351. In tax law, the joint venture is a business entity bound to comply with the tax regulations. In commercial law, the General Corporation Law (*Ley General de Sociedades Mercantiles*) sets forth that the joint venture has no legal existence or corporate name, and these characteristics do not provide evidence of being classified as a business entity, but as an entity with no identity of its own. Business corporations have characteristics of their own, such as having legal existence, having a corporate name, and being Mexican corporations when incorporated under the Mexican laws.

352. A joint venture which remains in Mexico and is interested in extending its commercial alliances to favor its internal growth falls within the scope of a business entity and, with this, it acquires obligations before the tax government authorities, as it is subject to income tax in view that the source of income is located within the Mexican territory.

353. For tax law purposes, the joint venture shall have legal existence when carrying business activities in the country, when the agreement is entered into under the laws of Mexico, or when the residence in Mexico of the company or partnership is evidenced. In light of the above, the joint venture is bound to comply with the same tax obligations, under the same terms, and under the same legal provisions as those set forth in the tax laws for business entities.

354. Permanent establishment is considered to be any place of business where business activities are carried out, in whole or in part, including, among others, branches, agencies, offices, factories, workshops, premises, mines, quarries, or any site for the exploration, extraction or exploitation of natural resources.

355. When a non-resident operates in Mexico through an individual or business entity, it is considered that such non-resident has a permanent establishment in the country, in regards to all the activities that such individual or business entity performs for the non-resident, if such individual or business entity exercises the powers to enter into agreements in the name or on behalf of such non-resident, which are not related to the use or maintenance of premises for the sole purpose of storing or exhibiting goods or merchandise belonging to such non-resident; keeping stock of goods or merchandise for storing or exhibiting them or for their transformation by another individual or business entity; the use of a business place for the sole purpose of acquiring goods or merchandise for the non-resident; to carry out advertising, information supply, scientific research, placement of loans, or other similar activities; and the customhouse deposit of goods or merchandise of a non-resident in a public bonded warehouse, or the delivery of such goods or merchandise for their importation into the country.

356. Despite the above, it is considered that a non-resident has a permanent establishment in the country when it operates in Mexico through an individual or business entity who is an independent agent. Such agent acts in the name of the non-resident when it has stocks of goods or merchandise and makes deliveries on behalf of the non-resident; assumes risks; acts under detailed instructions or control; carries out activities that economically correspond to the non-resident; earns income independently from the results of its activities; and carries out transactions with the non-resident using prices or compensations other than those used by non-related parties in comparable transactions.

357. In this sense, a business entity or individual who enters into a joint venture agreement in Mexico with a non-resident falls within the scope of a permanent establishment for tax law purposes, even when the commercial principles may contravene the tax principles.

## 22. PwC (RICHARD COLLIER)

358. As PwC has played an active role in the compilation of the detailed response from BIAC to the above OECD document, our views on the detail of the proposals (including the specific points of drafting where they can be made), have been channelled into that response. We do not repeat the various specific points here.

359. However, we do consider that it is appropriate to make the following high-level points:-

- 1) A number of the changes proposed in the Discussion Draft do seem to have the effect of widening the substantive scope of the PE rules. If that is intended, it would clearly be preferable to change the terms of the Article itself and/or make express the intended changes to be delivered so that the position is entirely clear.
- 2) At a practical level, and following from the point made above, the effect of a number of the changes proposed seems very likely to make the application of the Article 5 PE rules much less certain and this inevitably makes compliance by tax payers more difficult. It is hard to see how the objective of clarifying the PE rule can be achieved in the absence of clear definitions and tests and precise/clear explanations.
- 3) Of a special concern to us are the proposed changes relating to the issues "main contract or who sub-contracts all aspects of a contract" (Issue 8) and "meaning of 'to conclude contracting the name of the enterprise'" (Issue 19). We believe it likely that that the changes proposed in both these areas are very likely to lead to confusion and increased disputes between tax payers and tax

authorities. This is on the basis that the changes are likely to be interpreted by tax authorities as widening appreciably the scope of the PE rules. Given the fundamental nature of the issues raised by these particular proposals, we do not believe it is possible to remedy the situation through drafting amendments. In our view, the likely disruption these changes would cause outweighs any benefit of including the text currently proposed. Therefore, we would advise dropping these two specific amendments from the changes to be made to Article 5.

360. We would of course be very pleased to discuss these comments should that be useful.

### 23. REPSOL

361. First of all, Repsol would like to welcome the OECD Committee of Fiscal Affairs' efforts to provide guidance and clarification in relation to the concept of Permanent Establishments in the Model Tax Convention.

362. For Repsol, as an international integrated oil and gas company, operating in almost 40 countries across five continents, the meaning of Permanent Establishment is a relevant tax issue. In this respect, Repsol has actively participated with the OECD Committee on Fiscal Affairs since it released for public comment the discussion draft on the definition of Permanent Establishment. Repsol has already sent its comments on the discussion draft, which were discussed at the meeting held in September 2012. Repsol is grateful for this new opportunity to refine our opinion regarding the Interpretation and application of Article 5 of the OECD Model Tax Convention.

363. In particular, we would like to recommend minor amendments to the following paragraphs:

A) The inclusion of 3.1 paragraph:

“It is also important to note that the way in which business is carried on evolves over the years so that the facts and arrangements applicable at one point in time may no longer be relevant after a change in the way that the business activities are carried on in a given State”

In this case we would add “*vice-versa*” at the end of this sentence.

B) The example included in paragraph 4.2:

“Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities (e.g. where it has legal possession of that location) that location is clearly at the disposal of the enterprise.

We would suggest the follow small amendment to the text:

“Where an enterprise has ~~an~~ exclusive legal rights to use a particular location **or locations** ~~which is~~ used only for carrying on that enterprise’s own business activities (e.g. where it has legal possession of that location) that location **or locations is are** clearly at the disposal of the enterprise.

C) We think that the example included in paragraph 6.1. is appropriate.

D) We would include “force majeure” in paragraph 6.6 as an example of a circumstance to consider a place of business as a permanent establishment even if this business has exists for a short period of time in a location:

“A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure, *force majeure*)

- E) We think that the example included in paragraph 32.1 clarifies the concept of “authority to conclude contracts in the name of the enterprise”:

“For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract”

364. We would welcome any feedback on the comments made.

## **24. TAX EXECUTIVES INSTITUTE (TEI)**

365. On behalf of Tax Executives Institute, I am pleased to respond to the OECD’s request for comments on its Revised Public Discussion Draft concerning changes to the Official Commentary (Commentary) to Article 5 of the OECD Model Tax Convention (hereinafter the “Revised Draft”). Article 5 Permanent Establishment of the OECD Model Tax Convention (Convention) sets forth the definition of the permanent establishment (PE) concept, which is primarily used to allocate taxing rights when an enterprise of one state derives business profits from another state. The OECD’s Committee on Fiscal Affairs (CFA), through a subgroup of its Working Party No. 1 on Tax Conventions and Related Questions, has examined various questions related to the interpretation and application of the definition of a PE. This examination culminated in the release of a first discussion draft regarding the Interpretation and Application of Article 5 (Permanent Establishment) of the Convention on 12 October 2011 (hereinafter the “Original Draft”). After considering written comments regarding the Original Draft and holding a public consultation on 7 September 2012, the OECD released the Revised Draft on 19 October 2012, requesting further comment from interested parties by 31 January 2013. This letter responds to that request.

### **TEI Background**

366. Tax Executives Institute, Inc. (TEI) was founded in 1944 to serve the needs of business tax professionals. Today, the Institute has 55 chapters in North America, Europe, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting sound tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent 3,000 of the largest companies in North America, Europe, and Asia.

### **Revised Draft Background**

367. The Revised Draft addresses the same 25 issues that were the subject of the Original Draft and provides additional proposed revisions to the Commentary that, in certain respects, reflect comments from interested parties, including TEI.<sup>1</sup> The Revised Draft requests additional comments on the proposed changes to the Commentary, but asks that such comments “focus on the drafting of the recommendations

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1 TEI submitted its comments on the Original Draft to the OECD on 17 February 2012, and also participated in the public consultation in September 2012.

rather on their substance . . .”<sup>1</sup> The Revised Draft notes that these comments will be examined at a meeting of Working Party No. 1 in February of this year.<sup>2</sup>

### ***General Comments on the Revised Draft***

368. TEI welcomes the opportunity to provide additional comments on the proposed changes to the Commentary and commends the OECD for incorporating a number of comments from the business community, including TEI, in the Revised Draft. Regrettably, the request to focus further comments on the “drafting” of the changes to the Commentary, rather than matters of substance, limits the utility of additional comments from interested parties. In this regard, we ask the OECD to revisit some of the issues in the Revised Draft and consider further input on substantive matters as well as the specific wording of the draft.

369. Of general concern is language in the Revised Draft that would permit Member States to assert taxing jurisdiction based upon services performed in a state – that is, to assert a “services PE” – when such a concept is not embraced by the Convention itself, and only introduced under the alternative provisions of Paragraphs 42.11 to 42.48. The Revised Draft introduces such a concept again in its proposed changes to Paragraph 4.2 and the consultant example. TEI submits that the general definition of a PE as a “fixed place of business” in the Convention leaves little room for the creation of a PE through the mere provision of services. If the OECD believes that services may constitute a “fixed place of business” under the Convention, TEI submits that the Convention itself should be amended because such a concept should not be introduced through the Commentary when addressing the phrase “at the disposal of” – particularly when that phrase does not appear in the Convention.

370. Moreover, recent discussions indicate that Member States may push to substantially broaden the definition of a PE in respect of services through revisions to the Commentary. For example, we understand that certain tax authorities believe it proper to assert the existence of a PE where (i) the services relate to a business transaction in the relevant jurisdiction, and (ii) the payment for such services is sourced from that jurisdiction. TEI submits that such a concept would go beyond even a deemed services PE and render the PE concept a nullity, contravening the purpose of the PE concept as a means of promoting cross-border commerce by clarifying the allocation of taxing rights. Again, if this is the OECD’s intention, we recommend that it address the issue in a straightforward manner and propose changes to the definition of a PE in the Convention itself and invite public consultations on its revisions.

### ***Specific Comments on the Revised Draft***

371. Below we provide additional specific comments on certain issues in the Revised Draft. However, we believe that the recommendations in our letter of 17 February 2012 continue to be relevant to the extent they are not reflected in the Revised Draft and invite the OECD to revisit them.

#### ***Revised Draft Issue #2: “Meaning of ‘at the disposal of’ (paragraph 4.2 of the Commentary)”<sup>3</sup>***

372. Paragraphs 4 to 4.2 of the Commentary explain that a place of business may constitute a PE if that place is “at the disposal” of an enterprise. The phrase “at the disposal” is not found in the definition of a PE in Article 5 of the Convention, but instead is set forth in paragraph 4 of the Commentary to explain the concept of a “place of business.” The additional changes to paragraph 4.2 in the Revised Draft explain

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1        Revised Draft, page 1.

2        *Id.*

3        *Id.* at 5-8.

that whether a location is at the disposal of an enterprise depends on whether the enterprise has “the *effective power* to use that location” as well as the presence and activities of the enterprise in that place.<sup>1</sup> It is not clear whether the use of the term “effective power” in the Revised Draft raises or lowers the threshold for when an enterprise has established a PE. The Original Draft refers only to an enterprise’s presence and activities. We recommend that the OECD clarify whether this term is intended to raise or lower the PE threshold.

373. In addition, since the term “effective power” over the use of a location has been introduced for the first time in the Revised Draft, we recommend that the OECD provide additional clarification or examples to illustrate the meaning of the term and whether or how it expands upon the draft language in revised Paragraph 4.2 (which refers to “exclusive legal rights” and the use of a location on a “continuous basis”). TEI also recommends that Paragraph 4.2 make explicit that an enterprise must *actually use* a location to carry on its business before a PE can be asserted; mere legal or effective power to use or access a location should not give rise to a PE. Although TEI’s interpretation of the draft is inferred from revised Paragraph 4.2 and has been made explicit in discussions, the current language permits Member States to conclude otherwise.

374. Additionally, TEI recommends that the phrase “extended period of time” be defined by reference to a minimum period. Specifically, we recommend that six months is the minimum amount of time before a business should be considered to have spent an “extended” period at a particular location, which would be consistent with Paragraphs 6 and 42 of the Commentary.

375. To clarify Paragraph 4.2 and generally implement TEI’s recommendations, we suggest the following changes to Paragraph 4.2 (additions are in bold and underlined, deletions are struck-through; the remaining wording is as set forth in the Revised Draft):

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the actual use of the location, ~~and~~ the extent of the presence of the enterprise at that location~~,~~ and the activities that it performs there. This is illustrated by the following examples. Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise. This will also be the case where an enterprise is formally allowed to use a specific location that belongs to another enterprise ~~or that is used by a number of enterprises~~ and performs its business activities ~~at~~ through that location on a continuous basis during an extended period of time. This will not be the case, however, where the enterprise’s presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise (e.g. where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time – such as 6 months as referred to in paragraph 6).

376. To promote consistency throughout the Commentary, TEI also recommends modifying Paragraph 5.4 to refer to “effective power” as follows:

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1 *Id.* at 6 (emphasis added).

5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations. **The consultant must, however, have the effective power to use – and actually use – a fixed place of business at that location as set forth in Paragraph 4.2.**

***Revised Draft Issue #4: “Home office as a PE (proposed new paragraphs 4.8 and 4.9)”<sup>1</sup>***

377. TEI appreciates the clarification in the Revised Draft that before a home office may constitute a PE of an enterprise the enterprise must require the individual to use his or her home as a “location to carry on the enterprise’s business . . .”<sup>2</sup> We reiterate our prior comment, though, that even in cases where an employee works from home continuously, the home should not be considered “at the disposal” of the employer except in rare circumstances. Such circumstances may exist if the employer has access to the employee’s home pursuant to the employment contract, the employee regularly conducts business with customers at the home, or the employee represents to the public that the home office is a place of business of the enterprise. TEI recommends that these circumstances be made explicit in the Commentary.

***Revised Draft Issue #6: “Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)”<sup>3</sup>***

378. TEI welcomes the deletion of the “commercial fair” example in the Revised Draft that was added to Paragraph 6.1 of the Commentary in the Original Draft. The Revised Draft replaces the commercial fair example with that of an artic drilling business that is “expected” to last for five years but that can only be carried on for three months each year due to seasonal conditions.<sup>4</sup> The Revised Draft notes that in this case, “given the nature of the business operations,” a PE may exist even though any continuous presence lasts less than six months.

379. While the artic drilling example is an improvement over the Original Draft’s commercial fair example – because of the new example’s reference to the “expected” duration of the business – we remain concerned that the new example may unduly influence other situations. That is, the revised language and example leave open the possibility that Members States may use hindsight to assert the existence of a PE even in cases where an enterprise has no legal right or expectation to continue a recurring business over a period of years. In such cases, tax authorities may point to the language of Paragraph 6.1 in the Revised Draft as authority to refer to the actual course of business activity after the activity has taken place, even where the enterprise made year-by-year decisions whether to continue its business activity in a particular location (*i.e.*, the business did not have a legal right to conduct its activity at the location beyond the current year). In addition, the Revised Draft retains the cliff effect of the Original Draft. Once a PE is deemed established through recurrent activity, the determination is retroactive – *i.e.*, there is a “springing” PE. In other words, tax authorities may determine that recurrent activity that takes place over three

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1       *Id.* at 9-11.

2       *Id.* at 10.

3       *Id.* at 12-15.

4       *Id.* at 14.

consecutive years does not indicate a PE, but then decide that a fourth year of activity suddenly creates a PE, and then tax the enterprise retroactively to the first year of activity.

380. To avoid these possibilities, TEI recommends clarifying the treatment of recurring activities in Paragraph 6.1 by stating either (i) business intent or expectations must be inferred from objective facts present at the inception of the business activity (such as a long-term contract to conduct such the activities of the enterprise) and not in hindsight based on recurrent conduct in the absence of other facts or (ii) if the OECD determines that recurrent activity may establish a PE in the absence of other facts, that taxation of such a PE should be applied prospectively from the year of the determination and not retroactively to prior years.

381. Finally, the concluding language of paragraph 6.1 in the Revised Draft noting that “the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business”<sup>1</sup> is troubling because it may permit taxing authorities to assert a PE in virtually any circumstance. We therefore recommend that this language be clarified to make the “shorter” periods conditional on a minimum level of accumulated time and also upon the legal right of the enterprise to conduct its business over a multi-year period.

382. To implement TEI’s recommendations, TEI suggests the following changes to Paragraph 6.1 (as above, additions are in bold and underlined, deletions are struck-through; the remaining wording is as set forth in the Revised Draft):

... That exception is illustrated by the following example. An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for 5 years and a contractual right has been acquired by the enterprise that enables it to perform the operations during that 5 year period. In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the continued effective right to the location and the recurring nature of the actual activity regardless of the fact that any continuous presence lasts less than 6 months; the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business so long as the amount of time contemplated by the contractual right totals more than a 6 month period (or whatever time period specified by the relevant treaty).

***Revised Draft Issue #8: “Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)”<sup>2</sup>***

383. Overall, TEI commends the OECD for the Revised Draft’s clarification of this issue. Regrettably, the new language in paragraphs 10.1 and 19 still raises difficult issues. For example, the language suggests that a general contractor may have a PE in a jurisdiction even if the general contractor itself is never physically present in that jurisdiction, because, for example, it has sub-contracted all of the activities to be carried out in that jurisdiction to unrelated parties. In other words, the new language implies that subcontractors are dependent agents of the general contractor and thus may create a PE of the general contractor. If this is the intention then these paragraphs should be clarified, especially if the use of the fixed place by the subcontractor causes, in the OECD’s view, such a place to be “at the disposal” of the general contractor. In our view, the Commentary’s use of the phrase “at the disposal of” in interpreting the

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1           *Id.*

2           *Id.* at 17-19.

meaning of a PE stretches the general definition of a PE in the Convention – a “fixed place of business through which the business of an enterprise is wholly or partially carried on” – to the breaking point as the enterprise itself (*i.e.*, the general contractor) does not carry out any if its business “through” the fixed place.

384. On the other hand, this language could be read to conclude that without a physical presence at the site over which an enterprise has “effective power” then the enterprise would have no PE because of the reference to Paragraph 4.2. We recommend that the OECD clarify which interpretation is correct. At a minimum, TEI recommends that the Commentary include an example that describes the circumstances where an enterprise can engage a subcontractor without causing the enterprise to have a location “at its disposal” through the subcontracting arrangement.

385. Finally, the Revised Draft appears to open the door to significant over-taxation (perhaps even double taxation in certain cases) because the state in which a subcontractor operates could tax both the profit of the subcontractor as well as the profit of the general contractor based upon the theory that each enterprise has a PE in that state, even where the general contractor conducts no activity in the state. TEI suggests that in these circumstances the only party that could have a PE is the subcontractor and, if so, it may be appropriately taxed in that country. In our view, it would not be proper for the source country to tax the profit of both the subcontractor and general contractor because the general contractor lacks a physical presence in the country.

***Revised Draft Issue #19: “Meaning of ‘to conclude contracts in the name of the enterprise’ (paragraph 32.1 of the Commentary)”<sup>1</sup>***

386. The Revised Draft makes no changes to the Original Draft’s addition to the Commentary on this issue. Thus, we reiterate our prior comment that the Commentary should clarify that an enterprise can only be “bound” by a contract in the legal sense, and not economically. In addition to creating uncertainty and confusion about the interpretation of Article 5, the concept of being “economically bound” by a contract injects “economic substance” (in the U.S. sense) concepts into the Commentary. This is unnecessary as Member States have their own, generally well-developed, authority in this area (whether judicially developed or implemented through general anti-abuse rules).

**25. S. TOWERS<sup>2</sup> (DELOITTE & TOUCHE LLP SINGAPORE)**

387. It is with pleasure that we submit comments<sup>1</sup> on the OECD’s Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment) (the “Revised Draft”).

**1. *Proposed Paragraph 4.2: Visiting employees example***

388. Paragraph 4.2 of the Revised Draft includes an example of intermittent or incidental presence of an enterprise which does not meet the “at the disposal” test. The example is “*where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time.*”

389. The use of the word “often” in the example indicates a recurring presence, which seems to be at odds with the use of “intermittent” contained in the preceding statement of principle.

390. Accordingly, we propose that the word “often” be replaced with “occasionally”.

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1 *Id.* at 33-35.

2 The significant contribution of Ms Melissa Dejong in preparing these comments is gratefully acknowledged.

## 2. *Proposed Paragraph 4.2: Contract manufacturer / cost-toller*

391. Paragraph 17 of the discussion (description of issue 3) recognises that there is concern as to when “activities of a supplier of goods or services, such as contract manufacturer or cost-toller, can create a permanent establishment for the client.” Paragraph 17 then includes the CARCO example, which describes a cost-tolling arrangement (the goods remain the property of CARCO throughout the assembly process, which is not the case in a contract manufacturing arrangement) and concludes that it does not create a PE for the client. Paragraph 18 goes on to provide that this conclusion is now reflected in the penultimate sentence of proposed paragraph 4.2 of the Commentary. However, proposed paragraph 4.2 only refers to a contract manufacturer or supplier.

392. In some cases, the client enterprise in a cost-tolling arrangement would be protected by Article 5(4)(c) and would not need to rely on establishing that the premises of the cost-toller are not at its disposal. However, Article 5(4)(c) does not assist where the cost-toller also stores or delivers the finished goods after processing is complete and the combination of such activities is not considered to be preparatory or auxiliary within the meaning of Article 5(4)(f), or where Article 5(4)(f) is not present in the relevant Treaty. Likewise, where the UN Model Treaty is used (in which Articles 5(4)(a) and (b) do not include an exception for delivery of goods), the client in a cost-tolling arrangement in which delivery services are also provided must rely on establishing that the “at the disposal” test is not met. This is a critical issue in Asia Pacific where the UN Model Treaty is widely used.

393. The same issue arises for logistics service providers. For instance, where a warehouse logistics company manages importation processes, stores goods and arranges delivery to the customer, it is not certain to fall within the Article 5(4) exceptions.<sup>1</sup> Although the cross-reference to paragraph 42 of the Commentary assists, an explicit mention of logistics service providers would significantly enhance certainty, particularly for multinational companies engaged in supply chain management.

394. In our submission, proposed paragraph 4.2 should explicitly include cost-tolling arrangements and logistics service providers, in addition to contract manufacturers and suppliers.

## 3. *Proposed Paragraph 4.8: “regular and continuous”*

395. Proposed paragraph 4.8 (discussing the home office PE) reads “Where, however, a home office is used on a **regular and continuous** basis for carrying on business activities for an enterprise...” (emphasis added). The phrase “continuous and regular” previously appeared in paragraph 4.2 and has been amended in the Revised Draft to read “This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a **continuous and regular** basis during an extended period of time.”

396. It is not apparent that there is a need for “regularity” in the use of the home office but not in general as contained in paragraph 4.2. For the sake of consistency, we propose that the phrase “regular and continuous” in paragraph 4.8 be redrafted in line with paragraph 4.2.

## 4. *Proposed Paragraph 10.1: the use of subcontractors / service providers*

397. Commentators have noted that the creation of a PE through the provision of services by a contractor in the source country is a potentially significant expansion of Article 5. The additional guidance

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1 For example, see India’s Authority for Advance Rulings decision in *Seagate Singapore International Headquarters Private Ltd.*

contained in the Revised Draft in response to this issue, in particular that the enterprise must have “effective power to use that site”, is a welcome addition.

398. In our view, the creation of a PE by the presence of a sub-contractor is appropriately limited to situations in which the sub-contractor’s access to the premises is derived from the general contractor’s access to those premises. For instance, in the construction site example contained in paragraph 19 of the Commentary, the premises in question are the customer’s construction site, which the general contractor has legal possession and control of during the construction project (regardless of its own physical presence at the site). The sub-contractor is present on that same site only by virtue of the access granted by the general contractor. The same analysis applies to the hotel management services example in paragraph 10.1 because the enterprise owns the hotel and grants access to the sub-contractor for the purpose of the service contract.

399. However, in the case of other contracts for services, the premises in question are ordinarily the service provider’s own place of business. The sub-contractor in these cases has access to its premises irrespective of the general contractor’s access. Although it is possible that the enterprise receiving the services could have a PE at the service provider’s place of business, it is less likely that it would have effective power to use those premises (consistent with paragraph 42 in the Commentary). For this reason, the general contractor – sub-contractor situation is quite different from the case of ordinary contracts for services.

##### **5. *Proposed Paragraph 10: Secondment of employees***

400. Proposed paragraph 10 cross-references paragraphs 8.13 – 8.15 of the Commentary on Article 15. Those paragraphs explain that in determining whether an employee is acting as an employee of the source country enterprise or is providing services on behalf of the resident country enterprise, the source country’s characterisation of the employment relationship is determinative. Where the source country is driven by substance rather than form, the guidance in paragraphs 8.13 – 8.15 will be relevant. Where the source country’s characterisation is driven by form rather than substance, there will be no occasion for reference to the guidance contained in paragraphs 8.13 – 8.15.

401. Proposed paragraph 10 in the Commentary on Article 5 does not direct that the substance of the secondment arrangement is to apply in determining the existence of a PE, but rather follows the lead of Article 15. Consequently, in form driven countries, the existence of a PE will follow the formal characterisation of the employment relationship by the source country. This is at odds with the entirety of the Commentary on Article 5, which provides that the existence of a PE must be determined on the basis of substance rather than form.

402. Although some commentators have argued that there should be consistency between Article 15 and Article 5, in our view this is not necessary. For instance, an individual may be present in the source country for more than 183 days, allowing the source country to tax the individual’s compensation. In that case, the identification of the “employer” under Article 15(2) is irrelevant. However, the character of the employment / service relationship remains relevant for the purpose of Article 5. Likewise, if using the principles in paragraphs 8.13 – 8.15 an employment relationship in the source country is determined to exist, Article 15(2) may apply to protect the employee from source country taxation where the employee’s presence is below the 183 day threshold; however, Article 5 is not likely to apply by virtue of that limited time period. Thus, Article 15(2) and Article 5 are not likely to operate simultaneously, and consistency between them is needless.

403. Proposed paragraph 10 should be revised to provide that irrespective of the Article 15 determination, the existence of a PE should be based on substance. The Commentary on Article 15

regarding the implications of the Article 15 determination on the existence of a PE (see paragraph 8.11 of the Commentary on Article 15) should reflect the same conclusion.

#### **6. *Paragraph 6: Six month threshold for a PE to exist***

404. During the September 2012 public consultation meeting, differing opinions were expressed relating to the comment in paragraph 6 of the Commentary that in the “experience” of member countries, a PE has normally not been considered to exist where a place of business is maintained for less than six months. Practitioners and business persons have tended to view the six month period as an indicative (but not determinative) test, whereas the OECD has characterised the comment in paragraph 6 as a mere observation on the practice of member countries from which no inference can be drawn.

405. There is sufficient guidance in the Commentary to establish that the six month threshold will never be determinative, and to otherwise protect against artificial use of a time test for a PE (e.g. paragraphs 6 – 6.2 and “Improper Use of the Convention” in the Commentary on Article 1). Accordingly, in our view, the six month duration of a place of business can safely be stated to be an indicative rule, rather than a mere observation. This would significantly assist in providing a higher level of certainty for taxpayers and ease of administration, as persuasively advocated by BIAC in paragraph 32 of the Revised Draft.

#### **7. *Proposed Paragraph 10.1: Profit attributable to general contractor***

406. The consequence of the creation of a PE by the presence of an enterprise’s sub-contractor is that profits must be attributed to that PE, after arm’s length compensation is provided to the sub-contractor. Under the arm’s length principle, a related sub-contractor’s fees should reflect the functions performed, assets employed and risks assumed by the sub-contractor. In most cases, the general contractor will also assume risks in connection with the sub-contractor’s performance and accordingly, in those cases, the PE should have a residual profit after deducting compensation paid to the sub-contractor, in addition to profit reflecting the functions performed through the PE by the general contractor directly.

407. Consequently, the general contractor may be required to attribute profits to the PE arising through the presence of a sub-contractor after deducting the fees paid to the sub-contractor. There is a potential for double taxation where the residence country disagrees with this approach.

408. For that reason, we recommend that a reference to this point be made in proposed paragraph 10.1.

#### **8. *Proposed Paragraph 32.1: Contract “binding” on an enterprise***

409. Proposed paragraph 32.1 provides that an agent concludes contracts in the name of an enterprise where such contracts are “binding” on the enterprise. We agree with the proposed addition to the Commentary noting that member countries may determine that a contract which does not name an enterprise and in which the agency relationship is undisclosed may nonetheless be binding on that enterprise. The word “binding” is not defined in the paragraph.

410. We note that in a growing number of OECD member country judicial decisions, the word binding in this context has been interpreted to mean *legally* binding (e.g. *Dell DUF, Zimmer Ltd, Boston Scientific*). In order for a contract concluded by an agent to be binding on the enterprise (whether or not the enterprise is named and the agency is disclosed), it must be legally enforceable by and against the enterprise. It is difficult to conceive of an alternative interpretation; if “binding” was to include contracts which are merely commercially or morally binding (whatever that might mean), this would create significant confusion and necessitate increased “facts and circumstances” enquiries to administer Treaties.

411. In our submission, proposed paragraph 32.1 should explicitly provide that binding means *legally* binding.

#### 9. Article 5(6)

412. As a consequence of the relationship between Article 5(5) and 5(6) not being explicitly described, the relationship between Article 5(5) and 5(6) has long been the source of debate.

413. Some commentators have taken the view that Article 5(6) is a stand-alone provision. Article 5(6) states that certain agents of independent status will not cause the creation of a PE for their principals. Drawing an inference therefrom, such commentators conclude that agents which are not independent, whether or not contract-concluding, can create a PE for their principals. If this view is correct, significant consequences arise such as in the area of supply chain management.

414. In our view, Article 5(6) is not an operative provision permitting the creation of a PE through the actions of an agent; rather, it is a limitation on Article 5(5). This is consistent with the language of the Convention and the Commentary; Article 5(5) positively defines an alternative type of PE to that described in Article 5(1), whereas the language in Article 5(6) and its Commentary is expressed in the negative, excluding arrangements which may otherwise fall within Article 5(5). Further, if Article 5(6) allows the creation of a PE by the actions of a non-contract concluding agent, Article 5(5) is rendered meaningless.

415. In order to prevent disagreements as to whether a non-contract concluding agent can create a PE for its principal under Article 5(6), we propose the insertion of a statement explicitly describing Article 5(6) as merely an exception to, or limitation on, Article 5(5).

#### 26. TREATY POLICY WORKING GROUP

416. We are writing to offer the recommendations of the Treaty Policy Working Group on the OECD's revised public discussion draft of October 19, 2012, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*. The Treaty Policy Working Group is an association of large global companies based throughout the world that represent a broad spectrum of sectors. We have been working together since 2005 to analyze and address tax policy and administration concerns relating to permanent establishment, transfer pricing, and other issues.

#### **General Recommendations**

417. TPWG members welcomed this OECD initiative to address common questions and known points of disagreement by clarifying the OECD Commentary on permanent establishments, given the recent increase in controversies regarding these issues. A broad international consensus on the permanent establishment threshold is critically important to our members as they seek to avoid double taxation and taxation not in accordance with applicable conventions and the associated uncertainty and controversy. Clear guidance on the permanent establishment threshold is particularly important to TPWG members as they seek to satisfy their tax obligations, because it often determines whether a taxpayer must file returns in a particular jurisdiction and pay income tax on a net basis in addition to applicable taxes at source. An unclear permanent establishment threshold can result years later in very substantial, unexpected assessments, which taxpayers and treaty partners then have no alternative but to contest.

418. The issues selected by Working Group 10 of Working Party 1 for resolution in this project included the most important practical issues that business commenters had identified. The Working Group and Working Party have proposed many useful clarifications. However, as noted in our earlier comments, the initial discussion draft also left ambiguities that promised to give rise to continuing or even increased

controversy. We were disappointed to see that these ambiguities generally remain in the revised discussion draft. We were also surprised that a number of the current practical issues identified by business throughout the project have simply gone unaddressed, often on the basis that the current Commentary provides adequate guidance. Such results are not typical of the OECD's usual consensus-building efforts.

419. We understand that these shortcomings were due primarily to the inability of the Delegates to reach agreement on many of the major issues. In addition, it was clear even at the September 2012 consultation on this project that some Delegates were reluctant to agree to general principles that might restrict their ability to find a permanent establishment on the facts of some future cases. Others expressed a reluctance to draw "bright lines" that could permit taxpayers to conduct a specified level of activity without creating a permanent establishment, because taxpayers might conduct such activity "up to the line" (*i.e.*, to the full extent allowed).

420. Our sense is that the difficulty may be that some are viewing the permanent establishment threshold less as a threshold for net-basis income taxation than as an anti-"abuse" measure or even as a tool for increasing taxation at source. We believe that such views undercut the ability of the permanent establishment concept to perform its intended role, which is to facilitate cross-border trade and investment by permitting agreed minimum levels of business activity to be conducted in a jurisdiction without local income tax reporting burdens. Application of the permanent establishment threshold in accordance with its intent does not constitute tax "avoidance" or base erosion or raise other tax compliance concerns. The permanent establishment threshold is a fundamental part of the agreed overall balance established by treaties to facilitate trade and investment, and its proper application is critical to the intended operation and orderly administration of the international treaty network.

421. Any view of the permanent establishment threshold as creating undesirable opportunities for tax planning also diverges from the business community's experience in practice of the permanent establishment threshold as an ill-defined area of the law that has become a major source of risk and controversy. In any event, we would note that the permanent establishment threshold is policed by the anti-fragmentation rules and other safeguards already provided in the Model Tax Convention and Commentary, which operate well to address identified concerns.

422. As stakeholders seeking to comply with their tax obligations around the world, TPWG members find the failure of this project to produce agreement on many important issues under the existing Model Tax Convention and Commentary disconcerting. We are concerned that this portends more controversies among OECD member countries and others and that the proposed new OECD guidance will not provide an adequate principled basis for resolution of those disputes. If the issue is that current permanent establishment provisions are now seen by tax administrations as too restrictive in some respects, we submit that such concerns should be considered separately as matters of policy rather than through reinterpretation of existing guidance. Any agreed change should be implemented through prospective amendments to OECD and bilateral tax convention texts, to establish a legal basis for the change and avoid controversies regarding use of the Commentary for this purpose. In the meantime, we respectfully urge Delegates to redouble their efforts to draft a clearer set of guidelines for determining under current treaties when a permanent establishment does and, equally importantly, does not exist. This is necessary to facilitate tax compliance and administration and minimize cross-border controversy. It is also essential to preserve the value of OECD guidance in the Model Tax Convention and Commentary as the international standard for treaty interpretation.

### ***Specific Recommendations***

423. Consistent with our general comments above, we would like to offer some specific recommendations for the consideration of Delegates. While we remain concerned about many of the

issues noted in our earlier comments on this project, we note the Working Party's request that comments focus on drafting points rather than issues of substance. Accordingly, our recommendations at this stage address only three of the most critical points where the intent appears to be unclear or unsettled or where the proposed additions to the Article 5 Commentary seem inconsistent with Article 5 or with the existing Commentary. The changes suggested below are offered in the hope of inspiring clearer guidance that will minimize interpretive issues and controversies.

1. *When may a foreign enterprise be considered to have a place of business at a location of another enterprise, and when should its presence there be disregarded?*

424. To determine whether a foreign enterprise has a place of business at the location of a third party that may create a permanent establishment for it under Article 5(1), the current Commentary generally looks, in paragraph 4, to whether the place of business is "at the disposal" of an enterprise. The Commentary indicates that this may be the case where an enterprise using premises owned by another enterprise "has at its constant disposal certain premises or a part thereof owned by the other enterprise." Paragraph 4.2 adds that while no "formal legal right" to use a place is required, the "mere presence" of an enterprise at a location does not necessarily mean that that location is at the disposal of that enterprise. The current Commentary then provides a series of examples that were added in 2003 and continue to be the subject of some debate.

425. Proposed new Commentary paragraphs 4 and 4.2 retain these provisions but propose some important additions in paragraph 4.2 that attempt to clarify the meaning of the phrase "at the disposal." New paragraph 4.2 states as a central principle that whether a location will be considered to be at the disposal of an enterprise "will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there." New paragraph 4.2 also helpfully confirms a series of other important points, including that:

- The enterprise does not have a location at its disposal if it does not have a right to be present there and does not, in fact, use the location itself;
- Premises owned and used exclusively by service providers do not create a permanent establishment for their customers, for example, where a plant owned and used exclusively by a supplier or contract manufacturer supplies goods produced there for use in the business of the enterprise;
- A location is not at the disposal of the enterprise if its presence there is "so intermittent or incidental" that it cannot be considered a place of business of the enterprise, as where its personnel "have access to" the premises of an associated enterprise, which they "often" visit without working there for "an extended period of time";
- An enterprise that "is allowed to use" a "specific" location and performs its business activities there "on a continuous basis during an extended period of time" will be considered to have that place at its disposal; and
- The preparatory or auxiliary exceptions of Article 5(4) must be taken into account and may preclude the finding of a permanent establishment where applicable.

426. The meaning of the term "at the disposal of" is an important issue for TPWG members, and we appreciate the efforts of the Working Party and the Working Group to bring more clarity to the interpretation of this expression. We believe that the principles enunciated in new paragraph 4.2 are consistent with the OECD's long-standing interpretation of the permanent establishment threshold. They

appropriately confirm that the standard is neither a high bar that requires legal ownership of the premises, nor a low bar that treats the mere availability of or mere presence at a location as sufficient.

427. Our experience in practice, however, continues to be that tax auditors too often assert the existence of a permanent establishment based on “at the disposal” arguments that are inconsistent with these well-established principles. For example, we regularly encounter arguments that, notwithstanding the mandate of Article 5(7) to the contrary, a foreign enterprise has a permanent establishment at the premises of a local associated enterprise because their control relationship automatically puts the premises of the local enterprise “at the disposal of” the foreign enterprise. Such arguments are sometimes made even in situations where employees of the foreign enterprise are not present at the local premises at all or are present there only occasionally for short periods. Although such assertions do not, in our view, represent a fair reading of the Commentary, their prevalence shows the need to examine very carefully any language to be added to the Commentary to minimize the possibility that it can be interpreted in an unintended way.

428. We are concerned that the text of new paragraph 4.2 may be vulnerable to misinterpretation in two important respects. The first concern is that, as noted above, paragraph 4.2 introduces new terminology providing that whether a location is at the disposal of a foreign enterprise depends in part on the foreign enterprise “having the effective power to use that location.” A shorter formulation, “power to use,” was not well-received at the September 2012 consultation, and the term “effective” was subsequently added to the revised discussion draft, presumably to signal a higher standard. However, there is no discussion of what might constitute an “effective power to use,” how long such power to use must be held, or how it may be exercised. We remain concerned, therefore, that some might seek to equate effective power to use with mere presence, on the theory that presence at a location necessarily demonstrates an effective power to use it.

429. Our second concern about potential misinterpretation of paragraph 4.2 relates to its suggestion that the “extent of the presence” of the enterprise is also relevant to the “at the disposal” determination. This phrase focuses on whether the enterprise is present at the location, without specifying a time or other quantitative threshold. We are concerned that the introduction of this very general reference to presence might be read by some to support a contention that a mere presence for a short period of time would suffice to cause a location to be deemed to be “at the disposal” of the enterprise.

430. We are concerned about these potential misinterpretations because they might be perceived as eliminating the distinction between the “fixed place of business” permanent establishment provisions of Article 5(1) and the alternative “services PE” provisions of paragraphs 42.11 – 42.48 of the Commentary, which depart from Article 5 of the Model Convention and apply only if added to the text of the applicable bilateral convention. The “services PE” provisions require that the foreign enterprise be present for more than 183 days during the taxable period but do not require that it have a fixed place of business at its disposal. Article 5(1) does not set a specific time threshold for the enterprise’s presence but requires a fixed place of business. Therefore, if the “at the disposal” provision of paragraph 4 of the Commentary on Article 5(1) could be read to require only a mere presence, without a fixed place of business or a clear time threshold applied in all instances, a permanent establishment might be found in cases that are not reached even by the “services PE” provisions. This would be an illogical result, because the intended effect of the “services PE” provisions was to deem a PE to exist where none would otherwise be found. The Working Party should take care not to add text to the Commentary that could lend itself to such an incoherent interpretation of Article 5.

431. To avoid all of these potential misinterpretations, we would recommend that, instead of relying on new, undefined terms, the Working Party replace the proposed reference to “that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location

and the activities that it performs there” with familiar terminology that would more clearly express the intention of the “at the disposal” requirement. We continue to believe that “control” would most clearly communicate the intended meaning of the “at the disposal” standard. However, we understand that at least some members of the Working Party are reluctant to rely on the term “control” alone in paragraph 4.2, perhaps due to concerns that it would establish too high a threshold. If these concerns cannot be addressed through more precise drafting, we would recommend that the Working Party consider using one of the following alternative formulations in paragraph 4.2, to communicate that a foreign enterprise will not be considered to have premises of another enterprise at its disposal unless it:

1. “Either owns or has legal possession of the premises, or controls access to and use of the premises” (adapted from proposed new paragraphs 10.1 and 19); or
2. “Uses the premises, with the ability to exclude others, over an extended period of time to conduct, without limitation, the most important functions of its business” (adapted from existing paragraph 4.5, proposed to be renumbered as paragraph 4.7).

432. If no consensus on clearer language can be reached, we would prefer that new paragraph 4.2 follow the long-established standard of paragraph 4 for presence at another enterprise’s premises, namely, whether the foreign enterprise “has the premises at its constant disposal.” In our view, this approach would be less desirable because it would do little to resolve existing issues, but it would at least avoid creating the new issues that seem likely to result from introduction of the new terminology proposed in paragraph 4.2.

433. . On a separate point, we also believe that it would be appropriate for the Working Party to confirm explicitly that the discussion of suppliers and contract manufacturers in paragraph 4.2 also applies to consignment or toll manufacturers. This is consistent with the discussion of the CARCO example in paragraphs 17 and 18 of the revised discussion draft, because the CARCO example clearly involves a consignment or toll manufacturing arrangement under which the foreign enterprise maintains ownership of the raw materials, work-in-process, and final product through the manufacturing process. This clarification would help prevent unintended negative inferences and avoid future controversies. It can be accomplished simply by adding “or a consignment or toll manufacturer” after “supplier or contract-manufacturer” in paragraph 4.2, to confirm that the same conclusion applies equally to a consignment or toll manufacturing arrangement.

2. *When may a third party performing services for a foreign enterprise be considered, as a result of those activities, to be carrying on the business of the foreign enterprise?*

434. A permanent establishment does not arise under Article 5(1) unless the enterprise is carrying on its business, in whole or in part, through a fixed place of business. The current Commentary acknowledges, in paragraph 10, that the business of the foreign enterprise is carried on “mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel),” including dependent agents, or in some cases through automated equipment. However, neither the current Commentary nor the revised discussion draft discusses directly the critical issue of whether a third party performing services for a foreign enterprise may be considered, for this purpose, to be carrying on the business of the enterprise.

435. This issue is an important one, because enterprises today commonly decide for strategic business reasons to outsource certain functions, such as manufacturing or other industrial activity, in order to concentrate on other functions. This often involves independent third parties, but, as many company groups have centralized their functions to realize efficiencies, a particular group entity may also perform certain cross-border services for other entities in the group.

436. The issue of whose business is being carried on in such situations raises a number of questions. Should the activities of the third party be considered to constitute the carrying on of its own business? Or may the provision of services by a third party create a permanent establishment for its customers on the theory that the third party is thereby carrying on their business? What would be the technical and policy basis for such a result? What criteria should govern the determination? What profits, if any, would be attributable to a permanent establishment that is deemed to be created by the third party's activities? If, as seems likely, the third party is also considered to carry on a business of its own in performing its services, how can the duplicative attribution of profits from those activities be avoided?

437. Currently, Article 5 attributes the activities of one entity to another only in the case of a dependent agent that has and habitually exercises an authority to conclude contracts in the name of another entity (Article 5(5)), or an entity that carries on business through an agent of independent status operating outside the ordinary course of its business (Article 5(6)). The other provisions of Article 5 do not provide for the attribution of activities from one entity to another.

438. The revised discussion draft would amend the Article 5 Commentary to attribute activities in ways that are inconsistent with the existing Commentary and with the apparent intent of Article 5. For example, in discussing its proposals to attribute the *presence* of a “subcontractor” for purposes of Article 5(1) and Article 5(3) generally, the revised discussion draft provides the following “Background”:

“48. The Working Party concluded that the implication of paragraph 19 was that the activities of the subcontractors were allocated to the main contractor. It was also noted that it would be fairly unlikely that a main contractor would not have some employees on a construction site and that it would seem strange to have a different result if the main contractor’s employees spent only one day on the site.

“49. The Working Party also concluded that the issue was not restricted to construction sites and to paragraph 19 of the Commentary but was in effect related to the more general issue of whether an enterprise can carry on its business through subcontractors and, therefore, to paragraph 10 of the Commentary.”

439. The revised discussion draft thus suggests that attributing the activities of subcontractors is generally appropriate, based on a reading of paragraph 19 as providing for the *activities* of a subcontractor to be “allocated” to the main contractor. Noting in the passive voice the view that the main contractor would likely have some employees on the construction site anyway and that it would seem strange to treat minimal presence differently from no presence, the revised discussion draft concludes that enterprises generally may be regarded as carrying on their business through their subcontractors under paragraph 19 even where the enterprise has no presence at the location.

440. Although the discussion appears in a section captioned “Main contractor who subcontracts all aspects of a contract,” the revised discussion draft goes on to state that “the issue” is not limited to construction sites and proposes to apply the same approach under paragraph 10 of the Commentary as well. Proposed paragraph 10 uses the term “subcontractors,” presumably drawn from current paragraph 19, but neither the current Commentary nor the revised discussion draft defines the term “subcontractors” for this purpose.

441. The revised discussion draft thus curiously proposes to interpret a treaty provision conditioned explicitly on physical presence at a particular location in a manner that equates no presence with some presence, on the basis that a different interpretation would “seem strange.” The revised discussion draft does apparently recognize, however, that this approach would produce inappropriate results in at least some cases where the foreign enterprise has no presence at the location, so it provides exceptions for the

premises of suppliers or contract manufacturers (in proposed paragraph 4.2), for other locations at which the foreign enterprise does not have a right to be present and which it does not “use” itself (in proposed paragraph 10.1), and for other limited cases. These exceptions are welcome, but would be more helpful if their scope were stated in more definitive terms than, for example “so intermittent and incidental.” In addition, we remain concerned about the general presumption that the activities of a third party should be attributed to its customer and be considered to constitute the carrying on of the customer’s business, even where the customer has no presence at the location concerned.

442. The Working Party clearly recognized that there may be an issue as to whose business a third party is carrying on because it raised that issue in the CARCO example of a subsidiary, SUBCAR, performing contract manufacturing for its parent, CARCO, but did not answer it. The TPWG noted this omission in its comments of February 13, 2012 on the prior discussion draft and requested guidance on the issue of whose business was being conducted. While the revised discussion draft reaches an appropriate conclusion on the example, it unfortunately remains silent on this key issue. It may not be technically necessary to determine whether the subcontractor is carrying on the business of the foreign enterprise if the creation of a permanent establishment is precluded on other grounds, as in the CARCO example. However, the issue is determinative in some cases, including the “small hotel” example in proposed paragraph 10.1 of the Commentary, so it remains an appropriate issue for clarification in the Commentary, especially given that the Working Party has identified it as an issue.

443. We submit that, in the CARCO case, it should be clear that the business activity being carried on at the manufacturing location is the business of SUBCAR, not of CARCO. It is generally the case that a third party that provides services to an enterprise is carrying on its own business and not the business of the foreign enterprise, even when the business activities of the two entities are integrally related, as is normally the case in an affiliated group where two entities contract with each other as participants in a single production chain. The revised discussion draft’s apparent presumption to the contrary should be reconsidered.

444. The revised discussion draft does not articulate a technical or policy basis for attributing activities across entities. As noted above, the proposed attribution approach appears to be derived from the provisions of paragraph 19 of the Commentary, which attribute the time spent by a subcontractor on a construction site to a main contractor that is also on the site, solely to address the specific concerns identified in paragraph 18 regarding the Article 5(3) time threshold. However, that provision is very narrow in scope and conspicuously refrains from attributing either the subcontractor’s activities or the profits, if any, from those activities to the main contractor. It does not, in our view, provide a clear foundation for the significant changes proposed by the revised discussion draft, which seem fundamentally inconsistent with the provisions of Article 5(1) requiring that an enterprise conduct its own business through a fixed place of business.

445. The expanded attribution proposed by the revised discussion draft also seems inconsistent with existing provisions of the Commentary, such as paragraphs 42 and 42.23, which correctly indicate that a service provider generally does not carry on the business of the service recipient.

446. Looking at Article 5 as a whole, the proposed attribution of activities would also seem to render the provisions of Article 5(5) largely irrelevant, as a third party could create a permanent establishment for an enterprise in many cases even without being a dependent agent, having an authority to conclude contracts in the name of the foreign enterprise, or habitually concluding such contracts, and absent any presence of the enterprise itself at the fixed place of business. Could such a result really have been the intent of Article 5(1) and Article 5(3)? Given that attribution of activities from one entity to another is fundamentally in tension with the separate entity accounting principle of taxation, we would suggest that it

should occur only in limited exceptional circumstances and on the basis of carefully considered and fully articulated technical and policy considerations.

447. Finally, the lack of clarity on the profit attribution consequences of attributing activities of one person to another also makes it appropriate for the Working Party to further deliberate the proposed approach, in coordination with Working Party 6, to ensure that the proposed changes to Article 5 do not conflict with the OECD's recent guidance on Article 7.

448. We request that the revised discussion draft be amended to clarify these issues as follows:

449. The very broad statement in proposed paragraph 10.1 that an "enterprise may also carry on its business through subcontractors" should be removed pending further consideration. When read together with the statement in proposed paragraph 4.2 suggesting that an enterprise which "performs business activities ... at a location" has that location at its disposal, and absent any definition of the term "subcontractors," proposed paragraph 10.1 could be misinterpreted to suggest a third party that performs services for an enterprise generally may create a permanent establishment for the enterprise. To avoid this, the Commentary should explicitly confirm that a third party generally will not be regarded as carrying on the business of an enterprise for which it is performing services. If the Working Party believes that circumstances exist where a third party should be so regarded, then specific guidance should be proposed to identify those circumstances.

450. Similarly, we would suggest that the revised discussion draft either articulate the basis for treating the subcontractor as carrying out the business of the foreign enterprise in the "small hotel" example in proposed paragraph 10.1 or delete that example pending further consideration. We believe that its conclusion is inconsistent with the underlying premises of the "manpower company" hotel scenario in paragraph 39 of the revised discussion draft and that the cost plus remuneration of the on-site management company is irrelevant. Absent discussion of the technical and policy grounds for the conclusion drawn in this example, its addition to the Commentary would seem likely to result in confusion and controversy rather than clarification.

451. If the proposed provisions are retained, we request that the Commentary require, in any event, that the additional requirements of proposed paragraph 10.1 be met in order for any third party to create a PE for an enterprise under Article 5(1).

3. *When may the presence of a third party at a place of business be attributed to a foreign enterprise?*

452. In our experience, there is often disagreement about whether the presence of a third party conducting its own business at a place of business may be attributed to the foreign enterprise to determine if the foreign enterprise has a permanent establishment there for purposes of Article 5(1). This fundamental question underlies a number of the issues considered in this project but has not yet been addressed with sufficient clarity. In fact, we believe that some of the language proposed by the revised discussion draft could create even more confusion and controversy.

453. The current Commentary on Article 5(1) generally focuses on whether a place of business is "at the disposal" of the foreign enterprise itself. The Article 5(1) Commentary does not attribute the presence of another enterprise conducting its own business to the foreign enterprise, even in the case of associated enterprises. This is specifically confirmed by paragraph 42 of the Commentary on Article 5(7), added to the Commentary in 2005 in response to the Italian court decision in *Ministry of Finance (Tax Office) v. Philip Morris (GmbH)*, Corte Suprema di Cassazione, No. 7682/02 (25 May 2002), which provides that services performed for a foreign enterprise by personnel of an associated enterprise do not create a permanent establishment for the foreign enterprise under Article 5(1) where the services are part of the

associated enterprise's own business and are provided at the associated enterprise's own premises. In that situation, paragraph 42 specifies that the associated enterprise's premises are not at the disposal of the foreign enterprise. The revised discussion draft retains the key provisions of paragraphs 10 and 42, with a helpful confirmation in paragraph 10 that, where activities are conducted by dependent agents of the enterprise, they must be conducted at the fixed place of business of the enterprise in order to give rise to a permanent establishment under Article 5(1).

454. The approach taken under Article 5(3) for building sites and construction or installation projects is currently very different from the approach of Article 5(1). Paragraph 19 of the current Commentary does provide for a limited attribution where a general contractor subcontracts *parts of* the project to subcontractors. In such situations, the time spent by subcontractors at the site is attributed to the general contractor for purposes of determining whether the general contractor has a permanent establishment under Article 5(3). However, this provision does not attribute activities or profits from one enterprise to another.

455. Under current OECD guidance, the time spent by one entity is attributed to another only in these specific limited circumstances involving building sites and construction or installation projects, where the main contractor is also present to some extent. Paragraph 18 of the Commentary indicates that this attribution provision was included to address specific perceived "abuses" involving the division of a project among associated enterprises to avoid exceeding the twelve-month threshold of Article 5(3). The revised discussion draft suggests, however, that the paragraph 19 exception is provided because the site should be considered to be "at the disposal" of the general contractor. The revised discussion draft then proposes to expand the reach of paragraph 19 to cover even cases where the general contractor is not present at all on the site, because it has subcontracted *all* of the project. Where the general contractor is not there, proposed paragraph 19 does caution that "the general contractor [must] clearly [have] the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during the period." This exception is helpful, but it turns on novel factors that do not otherwise appear in Article 5, its current Commentary, or elsewhere in the revised discussion draft except, as discussed below, in proposed paragraph 10.1.

456. The revised discussion draft also proposes to change the current Article 5(1) approach by adding a novel rule for subcontractors in a new paragraph 10.1 of the Commentary. The general principle under proposed paragraph 10.1 is that the presence of a subcontractor may be attributed to a foreign enterprise only if the place of business it uses is "at the disposal of" the foreign enterprise "determined on the basis of the guidance in paragraph 4.2." However, in reconsidering whether the Article 5(3) attribution rule of paragraph 19 of the Commentary should apply when all parts of a project are subcontracted, the revised discussion draft proposes the application of such an attribution rule for purposes of Article 5(1) as well. As noted above, in discussing paragraph 19, paragraph 46 of the revised discussion draft asserts that, "[a]s was noted when the issue was discussed by the Working Party, the issue goes beyond the scope of Article 5(3) and raises questions concerning the interpretation of paragraph 10 of the Commentary, which discusses how the business of enterprise *[sic]* is carried on for the purposes of the application of Article 5(1)." This assertion is curious for three reasons: it seeks to extend by Commentary the scope of current paragraph 10, which has long clearly applied only to the conduct by personnel of the enterprise or through automated equipment of the enterprise's own business; it mentions a hypothetical case study used in an IFA discussion but cites no authority or policy rationale for the proposed change; and, unlike most of the revised discussion draft, the new proposition is stated in the passive voice, without any indication of its source or level of Working Party support. Given the magnitude of this change to a long-standing Commentary text, it would be useful to have a more clearly articulated rationale for the proposal.

457. The revised discussion draft nonetheless proposes to add new paragraph 10.1 to expand the scope of current paragraph 10 to include "subcontractors, acting alone or together with employees of the

enterprise.” It specifically states that this approach would not be limited to construction sites (or, presumably, building sites or installation projects), as under new paragraph 19.1. This introduces for the first time the possibility that the presence of an associated enterprise or even an independent third party may be deemed to create a permanent establishment for a foreign enterprise under Article 5(1), even where the foreign enterprise is not itself present there. In apparent recognition of this expansion, new paragraph 10.1 adds that “in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of that site.” This exception is, again, useful but perhaps less so than it might otherwise be, given its use of undefined terms such as “clearly” and “effective power.”

458. The revised discussion draft thus proposes to introduce two important changes to the Article 5 permanent establishment threshold by Commentary, without amending the text of the Article. These proposals would represent a significant lowering of the permanent establishment threshold in many cases. They would not merely clarify the current Article 5 Commentary; they would extend Article 5(3)’s limited anti-“abuse” provision to situations previously excluded under Article 5(3) and to permanent establishment determinations under Article 5(1) generally, including situations involving independent third parties. The proposed changes to paragraph 10.1 would also seem difficult to reconcile with the provisions of paragraph 42 of the Commentary. They seem equally difficult to reconcile with the policy conclusion reflected in the “services PE” provision at paragraph 42.23 of the Commentary, which, as indicated by paragraph 42.43 of the Commentary), “clarifies” that “services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.” Thus, even the “services PE” alternative refrains from attributing activities conducted by a local service provider to a foreign enterprise where the enterprise is not closely supervising the manner in which those services are performed. It is difficult to conclude that activities should be attributed to foreign enterprises more broadly.

459. Given the expansive nature of the proposed changes and the limited scope of the current Working Party 1 project, we respectfully suggest that it would be appropriate to delete proposed new paragraph 10.1 and to amend paragraph 19 to remove the proposed addition of “all or” before “parts of such a project.”

460. If proposed paragraphs 10.1 and 19 are retained, the conditions they suggest for attributing a third party’s presence (and apparently its activities) to the enterprise should be stated definitively as the applicable requirements, rather than as examples, to avoid a further lowering of the permanent establishment threshold. It will also be essential for Working Party 1 to work closely with Working Party 6 to determine how profits can be attributed appropriately, particularly where the presence of an independent third party at a location other than the enterprise’s premises is considered to create a place of business for the enterprise.

461. If paragraph 10.1 is retained, it also would be helpful to add as a conforming change to proposed paragraph 4.5 a statement or at least an example confirming that, even where the “preparatory or auxiliary” exceptions of Article 5(4) do not apply, no permanent establishment is created in a contract manufacturing arrangement by reason of the fact that the foreign enterprise has the right to enter upon the premises of the contract manufacturer solely to conduct oversight and quality control activities. We believe this is the intent of proposed paragraph 4.5, but our experience indicates that an explicit statement to this effect may be needed to ensure its proper application in practice and prevent it from being read together with paragraph 10.1 to allege that such operations give rise to a permanent establishment for any principal that engages in regular oversight, even where those operations are conducted by independent third parties. Consistent with the changes recommended above to paragraph 4.2, we also recommend that paragraph 4.5

confirm explicitly that its discussion of contract manufacturers also applies to consignment or toll manufacturers and other suppliers.

462. In addition to the three major concerns discussed in detail above, TPWG members continue to have serious concerns about a number of other issues that the revised discussion draft does not address fully or, in some cases, at all. These include especially:

- The inconclusive guidance on the time required to create a permanent establishment in the context of recurrent activities or short-term business activities carried on exclusively within a State;
- The continuing reluctance of the Working Party to establish definitive time thresholds for creation of a permanent establishment in these and other circumstances;
- The suggestion that the phrase “to conclude contracts in the name of the enterprise” may be interpreted in the case of civil law commissionaires in a manner that is diametrically opposed to the well-documented history of OECD Article 5 guidance and to several European supreme court decisions already rendered; and
- The Working Party’s failure to provide the guidance requested by business regarding the meaning of contract conclusion in other specified common commercial transactions, on the basis that the issues are factual in nature and that current guidance is sufficient.

463. TPWG members concur with the concerns expressed by BIAC on these points in its comments on the revised discussion draft.

464. The Treaty Policy Working Group appreciates the opportunity to provide recommendations on the revised discussion draft. We trust that our suggestions will be taken in the constructive spirit in which they are offered and hope that they will assist Working Party 1 in its further deliberations on these important issues.

## **27. TRUE PARTNERS CONSULTING INTERNATIONAL NETWORK**

465. Permanent establishment (“PE”) issues are clearly a very important topic for the international business community. Therefore, we welcome the OECD’s efforts to clarify certain issues that arise in assessing a jurisdiction’s ability to tax a company’s cross-border business profits. As business models for conducting business internationally, as well as technologies for disseminating products, continue to evolve and change, we agree with the view that the OECD’s existing commentary on the Model Tax Convention (“MTC”) also needs to change and be updated. In the following sections, we share our ideas on how the Revised Commentary can provide more cohesive and practical international tax guidance.

466. The comments provided below are our own comments as tax professionals and do not necessarily reflect the views of our clients. We have focused our comments on the following specific areas of the Revised Commentary:

### ***Topic number 2 – Meaning of “at the disposal of”– Proposed New Paragraphs 4.2 – 4.4***

467. As a general matter we agree with the approach taken by the Working Party to clarify that “at the disposal of” is not synonymous with “at the direction of,” thereby clarifying that pure contract manufacturing arrangements and toll-charge manufacturing arrangements do not create PEs. In addition, we agree that in order for an enterprise to be considered to have a PE in a particular jurisdiction, that such

enterprise needs to have the ability to use a particular location at its choosing, for a sufficiently long [duration], to carry out its own business activities.

468. With regard to the first point, i.e., that pure contract manufacturing arrangements do not, in and of themselves, create a PE, we believe that the penultimate sentence in new paragraph 4.2 adequately addresses this issue.

469. With regard to the second point, the insertion of the wording “...will depend on that enterprise *having the effective power to use that location as well as...*” in the second sentence of new paragraph 4.2, tries to clarify that a particular enterprise needs to have a certain level of control as to the use of a particular location, before it can be considered to be a PE of that enterprise. This first factor appears to be an objective test, i.e., an enterprise either does, or does not, have effective power over a particular location, whereas the other two factors in that same sentence, 1) the extent of the presence of the enterprise at that location, and 2) the activities that it performs there, are subjective criteria that will depend on the particular facts and circumstances. This formulation, with the objective “having the effective power to use” factor, appears to be in conflict with the continued use of example 4 (former paragraph 4.5, renumbered as 4.7 in the Revised Commentary).

470. In example 4, the conclusion that a PE exists seems to rely solely on the last two subjective factors, i.e., the fact that the painter is conducting the most important functions of his business in a particular location (the “activities that it performs”) and that such activities were being conducted over a period of two years (the “extent of presence”). However, in this case, the painter has no “effective power to use” the parts of the building he is painting, and is merely directed by his client to paint certain rooms or locations as it best suits the client. In this case, the painter has no “fixed place of business” “at his disposal” since he has no effective power over the locations he is painting. The fact that he is performing services within a particular jurisdiction for a prolonged period of time could perhaps give rise to a PE if a particular treaty were to include a new “Services PE” provision, but that would rely on a different provision entirely. In this case, we would recommend that the example be changed to indicate that the painter would not be considered to have a PE by virtue of paragraph 1 of the MTC.

#### ***Topic number 4 – Home office as a PE – Proposed New Paragraphs 4.8 and 4.9***

471. As the trend in many OECD member countries is a growing mobile workforce, and many enterprises are beginning to make use of “virtual offices,” the ability to assess whether a home office constitutes a PE will become more and more critical in the coming years. Accordingly, we are strongly in support of the Working Party’s decision to provide specific Commentary as to what circumstances might lead to a home office being considered to be a PE of an enterprise.

472. The general tenor of new paragraphs 4.8 and 4.9 of the Revised Commentary is that, while it will be a facts and circumstances determination as to whether a home office is at the disposal of an enterprise, unless the enterprise affirmatively requires the employee to maintain a home office, and the nature of the employment is such that an office is required to carry out the bulk of the employment activities, a home office will not constitute a PE. In this regard, we believe that the following additional clarifications would be helpful in achieving the desired objectives of the new paragraphs 4.8 and 4.9.

473. The fourth sentence of new paragraph 4.8 states that where “...it is clear from the facts and circumstances that the enterprise has required the individual to use that location ...” the home office may be considered to be “at the disposal of” the enterprise, and hence, a PE of the enterprise. In this case, we believe that the phrase “it is clear from the facts and circumstances” means that the enterprise has affirmatively required the individual to use that location as an office, and that inferences or implicit requests are not contemplated. In this case, we would suggest adding the following wording: “... it is clear

from the facts and circumstances that the enterprise has affirmatively required the individual to use that location ...”

474. With regard to new paragraph 4.9, since the issue of a home office will frequently arise in the context of dependent salespersons, we believe the first example considered by the Working Party, i.e., a large multinational insurance company with employees in various countries who sell insurance policies in the local market, where such employees are not reimbursed for the cost of maintaining a home office, and the supervisors cannot go to the homes of the employees without being invited, should be included as an additional example in new paragraph 4.9. Our view is that the arrangement discussed in example 1 does not rise to the level of a PE because the sales activity does not require an office (as most of the activity will be undertaken in visiting clients and prospective clients) and the activities undertaken at the home office would be considered as auxiliary or preparatory in nature. Including such an example in new paragraph 4.9 would also help clarify the parenthetical statement at the end of new paragraph 4.8, which, when giving an example of when an enterprise would be requiring an employee to have a home office, adds “(e.g., by not providing an office to an employee *in circumstances where the nature of the employment clearly requires an office*)...”

475. While we understand that a facts and circumstances analysis is applied to determine whether a home office is at the disposal of an enterprise, and is therefore a PE, we believe that additional guidance as to whether an office is *required* to carry out certain activities in question would be helpful. One factor we believe would be useful in making this determination is consideration of whether an enterprise which carries on particular business activities from a home office in a particular location, maintains an actual office in other locations for carrying on those same activities. If this is the case, then it is more likely that such home office is a PE. Similarly, if an enterprise has employees utilizing home offices in multiple states to carry out certain business activities, and none of those states require an actual office for these activities, then it is more likely that such home offices are not PEs. In a general sense, the same comparison analysis could be applied to other business enterprises carrying on a particular business activity in a particular state. This principle is illustrated by the following example.

*Within state A there are many accounting enterprises, most of which operate from an office to carry out their accounting business within the state. Enterprise ABC is in the accounting business and has an office in state B. ABC also has an employee working from a home office in state A, carrying on the same accounting activities as are carried out by ABC in state B. In this case, it is likely that the home office used by an employee of ABC in state A is a PE.*

#### **Topic number 10 – Meaning of “place of management”**

476. We have reviewed the proposed changes of the Working Party and we agree on the new wording of Paragraph 12 of the Commentary to Article 5.

477. The insertion of the words “*place of business*” and the reference to Paragraph 1 of Article 5 recommended by the Working Party in the first sentence of Paragraph 12 of the Commentary to Article 5 clarifies that a link between the listed examples of PE of paragraph 2 and the criteria indicated in paragraph 1 of Article 5 exists so that if a place of business does not pass the set of tests (location test, duration test, ...) of paragraph 1 the existence of a PE is excluded.

478. The changes to the second sentence of Paragraph 12 proposed by the Working Party aim to stress furthermore the principle that the listed examples must be interpreted in the context of Paragraph 1 of Article 5. The words “*it is assumed that a Contracting State interprets*” the examples of Paragraph 2 in the light of Paragraph 1 are deleted with the scope of establishing a guiding principle whereby the interpretation of the examples must be encompassed in the context of paragraph 1.

479. The insertion in the second sentence of Paragraph 12 of a reference to the so-called negative lists contained in Paragraph 4 of Article 5 completes the logic of the guiding principles so that the examples listed in Paragraph 2 have to be considered a PE if they meet the requirements of Paragraph 1 and unless they fall in the list of exceptions of provided in Paragraph 4.

480. We also agree that no clarification is needed with reference to the example of ACO multinational group where some administrative functions have been centralized in ACO and provided by the same to its subsidiary as Paragraph 42 of OECD Commentary to Article 5 already examines the situation of services performed within a group of companies.

***Topic number 12 – Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (Paragraphs 21 and 23 of the Commentary).***

481. We have reviewed and we generally agree with the comments of the Working Party and the recommended changes to Paragraph 21, 23, 42.7 and 42.9 of the OECD Commentary to Article 5 related to the preparatory or auxiliary nature of activities stated as exceptions of permanent establishment in Paragraphs a) to d).

482. The main proposed change of Paragraph 21 effectively clarifies that the exemptions to the consideration of permanent establishment stated in subparagraphs a) to d) of Article 5 are automatic, and consequently it is not necessary to pass an additional “preparatory or auxiliary condition test.” The new wording increases the legal safety for its application.

483. The changes proposed for paragraphs 23, 42.7 and 42.9 are technical, directly derived from the change mentioned in paragraph 21. We believe that adding the additional example below to Paragraph 42.9, distinguishing between activities that are core functions as opposed to preparatory or auxiliary, would provide additional clarity:

*Another example is the activity of operating / managing hardware for the purpose of data storage, in which the core profit generating function of the service is storing data for customers (i.e., not storage of internal data). In such cases, this activity cannot be considered to be preparatory or auxiliary within the meaning of subparagraph 4 b), but is more appropriately considered an activity “belonging to the enterprise.”*

***Topic number 17 - Negotiation of import contracts as an activity of a preparatory or auxiliary nature (paragraphs 24 and 25 of the Commentary)***

484. Where an enterprise has an office in another member state and the employees working in that office take an active part in the negotiation of the contracts for the sale of goods to buyers in that state, such activity would typically not be regarded as preparatory or auxiliary. Therefore, such an office would constitute a permanent establishment of that enterprise in that member state.

485. Typically, negotiations of the essential parts of sale contracts is one of the key elements of the business activity of an enterprise and thus, it would be difficult to argue that such activities are of a preparatory or auxiliary nature within the meaning of the Article 5(4) of the model convention. This position is consistent with the approach taken in cases of persons acting on behalf of an enterprise and involved in the negotiation of substantial elements of a sales contract (where no fixed place of business of that enterprise exists in the other member state).

486. Consequently, where an enterprise has a fixed place of business in another member state and through that place its employees negotiate sales contracts, it should be concluded that such an enterprise has a permanent establishment in that other member state.

***Topic number 19 – Meaning of “to conclude contracts in the name of the enterprise” - Paragraph 32.1***

487. The Working Group acknowledges that it is not possible to reach a common view on the situations dealt with in current court cases dealing with Commissionaire arrangements, as were raised in the courts in France and Norway. In addition, the Working Group felt that the Commentary already provided enough guidance to deal with a variety of factual questions related to whether a contract was “concluded” by a particular enterprise, and other related questions. We agree with this general sentiment that the current commentary is adequate, and believe that the new inserted language could create additional confusion, as noted below.

488. It appears that the additional wording in paragraph 32.1 is providing an example of a Commissionaire arrangement where an enterprise is acting essentially as an undisclosed agent, as that term would be interpreted in common law states, on behalf of a principal. However, in many civil law countries, such an arrangement is specifically excluded from an “agency” relationship. The insertion of the example directly follows the following phrase: “...the paragraph applies equally to *an agent* who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise” (emphasis added). This sentence is directly addressing the specific question of whether an “agent” can be concluding a contract in the “name of an enterprise” even if the contract itself doesn’t have the actual name of the principal. This could arise where it is clear, from other documents, that an agency relationship exists, that the agent has the power to bind the principal, but that the contract merely doesn’t contain the name of the principal. This is legally different than a commissionaire arrangement. Because the phrase, immediately prior to the example, still refers to “an agent,” the question arises as to whether the example only applies in a situation where an actual agency relationship, under local law, exists between two entities. The actual MTC does not refer to an “agent,” but rather merely refers to “a person ... [who] is acting on behalf of an enterprise.” Accordingly, to avoid any confusion we would recommend that the first sentence of revised paragraph 32.1 be amended by substituting “a person” in place of the words “an agent.”

***Topic number 21 – Does paragraph 6 apply only to agents who do not conclude contracts in the name of their principal?***

489. We are of the opinion that since the criteria of “independence” and “acting in the ordinary course of their business” are included within paragraph 6, the paragraph should equally apply to agents who do conclude contracts in the name of their principal.

490. Once again, we applaud the Working Groups efforts in clarifying and updating the OECD commentary with regard to PEs, and appreciate the opportunity to provide our comments thereon. We would be happy to discuss further with you any of our comments discussed above.

**28. VOLKSWAGEN AG*****COMMENTS ON PROPOSED CHANGES******I. General Comments***

491. The main purpose of the OECD commentary is to provide guidance on and clarification of the interpretation of the OECD Model Tax Convention. However, the impression is that in many cases, it increases ambiguity and even confusion instead of providing more clarity.

492. One of the main reasons for this seems to be an interpretation of Article 5 par. 3 in a way that building sites and construction or installation projects are permanent establishments which fulfill all preconditions of Article 5 par. 1 with the only restriction of a clearly defined minimum duration time of 12

months. From our point of view, par. 1 and 3 are separate provisions, and construction or installation projects are a special form of permanent establishments which need not fulfill all the requirements of a “fixed place of business”. But due to a different approach in the commentary, which negates the significant differences between a “permanent” establishment and a temporary construction site, the problem occurs that the requirements for a permanent establishment in par. 1 are lowered in such a way that they can be fulfilled even by a construction site. This has a detrimental effect on the clarity of the threshold and gives rise to an ongoing erosion of the permanent establishment definition.

493. An example for this is the proposed addition to par. 10.1 (Issue 8): “Paragraph 19.1 illustrates such a situation in the case of a construction site; this could also happen in other situations”. This way of interpreting the relationship of par. 3 and 1 contributes to the dissolution of the definition of permanent establishment. The general tendency of broadening the definition of a permanent establishment leads to higher complexity and legal uncertainty for the international business community with the consequence of increasing risks for double taxation.

494. Besides that we would like to add another general comment: Examples may on the one hand help to illustrate the wording. On the other hand – if not clearly limited to explain a specific requirement - they can also encourage tax administrations to arbitrarily transfer the applied regulations to other cases and broaden the scope of the commentary beyond the intended content.

495. In the following we are commenting on three different issues of the revised proposal, which we regard as being of high importance.

## ***II. Comments on special Issues***

### ***Issue 2. Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)***

496. As stated by the WP1, “a place of business through which the business of an enterprise is wholly or partly carried on” is related to the nature of the business. We agree that service providers do not necessarily have contracts or other formal legal rights to use a particular location but still offer their services and create value even over a longer period of time.

497. With the wording “on a continuous basis during an extended period of time” the proposed commentary acknowledges that only a short period of time is not sufficient to create a permanent establishment. However, this term refers not to a fixed minimum time requirement and therefore as a vague legal term adds even more uncertainty to the application of Article 5.

498. Particularly critical is in our view that as a consequence of the ambiguous concept of “legal possession”, the mere legal capacity to use and control is sufficient independently from the decisive question whether this capacity is in fact exercised by the enterprise. In our view this requirement is not met in cases, where the actual on-site use and control of a location has been delegated to (and is in fact exercised by) another enterprise, e.g. a subcontractor.

### ***Issue 6. Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)***

499. Due to the reference of the revised paragraph 4.2 of the Commentary to the time requirement, the legal uncertainty of the determination of a permanent establishment is neither avoided nor improved. The exceptions from the six month time requirement in paragraph 6.1 and 6.2 are generally a good approach towards the prevention of double taxation but not feasible in practice. Unlike in the drilling example, the entrepreneur often does not know in the beginning of an activity whether it will be recurrent or not.

Recurrent businesses and businesses exclusively carried on in another state that do not last for at least six months should not constitute a permanent establishment.

***Issue 8. Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)***

500. The extension of paragraph 10 regarding the existence of permanent establishments to businesses through subcontractors referring to the regulations for construction sites in paragraph 19 leads to double taxation, because the same personnel constitutes a PE for the subcontractor as well as for the general contractor. In our view, it is not possible to deem the subcontractor's personnel to be also personnel of the general contractor, because both are separate enterprises. The fact that the contributions by the subcontractor are elements of the fulfillment of the contract that the general contractor has concluded with his customer cannot justify the attribution of the subcontractor's activities to the general contractor.

501. Furthermore the regulation goes far beyond the permanent establishment rules for construction sites since the time requirement is only six instead of twelve months.

502. The introduction of the general contractor's legal possession of a location as mere precondition to constitute a permanent establishment for construction sites is very problematic, because a PE can be assumed without any presence of own personnel of the general contractor. This contradicts the AOA approach in Art.7 requiring a "significant people function" performed by personnel of the enterprise on the site of a PE for the attribution of profits to the PE. For this reason, even if a PE is going to be assumed, no profits can be allocated to the PE due to a lack of the enterprise's own personnel functions being employed at the PE.

503. In case this concept of "legal possession" will still be followed, we propose at least to add in par. 19 after "...has legal possession of the site" the additional words "**which is exercised by the own personnel of the general contractor**". This wording is suitable to avoid the abovementioned contradiction with the AOA.

**29. WTS GMBH**

504. WTS GmbH is pleased to provide you with comments regarding the revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment) of the Commentary of the OECD Model Convention (Revised Proposed Changes) dated October 19, 2012.

505. First of all we would like to thank you for the opportunity to participate in this interesting and important project. Especially, we would like to highlight the fruitful discussions and hospitality of the OECD in Paris on September 7, 2012.

506. Unfortunately, we found that the already weak concepts of the first draft towards a fixed place of business have been even further diluted. Now nearly any business activity **in** a foreign country can establish a permanent establishment (PE). Overall this leads to the erosion of the OECD principle that business profits should be generally (without PE) taxed in the country where the enterprise carries on its business (Art 7, paragraph 1, sentence 1 of the OECD Model Convention).

507. Further the Revised Proposed Changes are contradictory to the separate legal entity approach, since activities will constitute PEs which will hardly be performed by a separate legal entity.

## 1. *Proposed Changes in light of the separate entity approach*

508. In the last years the definition of PEs and the allocation of profits to PEs have been under ongoing discussions.

509. The most important development has been the change of the OECD Model Convention (OMC) towards the **exclusive** application of the (functionally) separate entity approach in the revised Article 7 OMC. The revision of Article 5 OMC has now to be discussed in the light of the separate entity approach.

510. We fully agree to the separate entity approach and believe that the separate entity approach is the best way to allocate profits to a “fixed place of business PE” in most cases. We also believe that the separate entity approach requires a rather strict concept of a fixed place of business. Without such a fixed place of business it will become difficult to treat a PE “as if it were a separate and independent enterprise”.

511. Thus, we still believe that the application of the separate entity approach is limited for PEs which do not require a fixed place of business (e.g. construction activities, dependent agents, service activities). In our view the idea of a separate entity under Article 7 is related to a well-defined fixed place of business under Article 5.

512. In our remarks to the first draft of the proposed changes we have already mentioned that the separate entity approach requires objective criteria to define a fixed place PE, and that such criteria have been missing.

513. We elaborated in line with the Commentary of the OECD Model Convention that the following criteria need still to be more objectively defined:

- Local requirement criterion
- Power of disposal criteria which can be separated in
  - Legal requirement criterion
  - Temporal requirement criterion

514. We also objected to the approach of discussing a lot of rather complicated and exotic examples based on weak concepts.

515. We now find the Revised Propose Changes fundamentally unchanged. In some cases, the already weak concepts have even been further diluted, as will be shown below.

## 2. *Power of Disposal Criteria is further diluted*

### 2.1 *Legal Requirement*

516. We mentioned in our remarks to the first draft of the proposed changes that the legal requirement of having effective power over a location is too weak to assess that the location is at the disposal of an enterprise. We proposed that an enterprise should have the effective power **and** should cumulatively have a right to exclude others from the usage of the specific location.

517. Sec. 11 of the Revised Proposed Changes now weakens the “exclusive legal right to use a location” criterion to the “effective power to use the location” criterion. Further an entity should (besides

having an exclusive right to use) even have the effective power to use the location when it is allowed to “use a specific location...”.

518. This concept is too weak since any service provider is allowed to use a specific location to render its services there and could therefore establish a PE.

519. It is the nature of many service contracts that the service provider needs access to the service recipients facilities and therefore has the right to use the specific locations to fulfill its contractual obligation. We do not think that such a situation should give rise to a fixed place of business PE.

520. We already mentioned in our comments to the first draft of the proposed changes, that an obligation to render a service at a specific location/object should not be mixed up with the power of disposal over a specific location/object.

## 2.2 *Temporal Requirement*

521. The same trend to further dilute criteria for fixed place of business PEs is shown in the temporal requirement. We suggested in the comments to the first draft of the proposed changes in line with BIAC that a separate entity should be assumed when the power of disposal is executed for at least one year/12 months. The effects are shown in the following examples.

### 2.2.1 *Text of the example (Arctic example - sec. 33 of the Revised Proposed changes)*

*An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for 5 years. In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any continuous presence lasts less than 6 months.*

### 2.2.2 *Analysis under our proposed criteria*

522. We see the temporal requirement contingent on the fixed place of business and not on the performance of specific business operations. Under these criteria the above example can be easily solved. The drilling operations will most likely qualify for a fixed place of business (e.g. as drilling platform) for five years by which the business of the enterprise is carried on (drilling). It is also probable that the enterprise has an exclusive right to use its drilling platform and exclude others from the usage of the platform for the whole five year period. It can then be concluded that the enterprise has the effective power over its drilling platform for the whole period since the legal and temporal requirement is met for the whole period. The fact that the drilling operations are interrupted is not necessary for this qualification. It would be rather misguiding to make the temporal requirement contingent on the performance of specific business operations instead of the existence of a fixed place of business. Then you would have to pose the question, whether a sales office which is existent for five years but has only two but significant sales each year can constitute a PE.

### 2.2.3 *Text of the example (Catering example - sec. 33 of the Revised Proposed Changes)*

*An individual resident of State R has learned that a television documentary will be shot in a remote village in State S where her parents still own a large house. Since the documentary will require the presence of a number of actors and technicians in that village during a period of four months. The individual contractually agrees with the producer of the documentary to provide catering services to the actors and technicians during the four month period and, pursuant to that contract, she uses the*

*house of her parents as a cafeteria that she operates as sole proprietor during that period. These are the only business activities that she has carried on and the enterprise is terminated after that period; the cafeteria will therefore be the only location where the business of that enterprise will be wholly carried on.*

#### 2.2.4 Analysis under our proposed criteria

523. When the temporal requirement is contingent on the fixed place of business the example should not establish a PE, since the fixed place is under the effective power of the individual for four months only. It is a rare situation that an enterprise will carry on its business in one PE only. And even if this is the case it will be hard to prove for the relevant tax office or tax payer.

524. The assumption that the tax payer does not intend to “carry on such activities in the future” was unrealistic and it was good to remove the reference from the Revised Proposed Changes. It would also have been contradictory to the newly included paragraph 3.1 of the Commentary<sup>1</sup>, which clearly states “... whether or not a PE exists in a state during a given period must be determined on the basis of the circumstances applicable during that period”.

525. We highly advise to remove this example, since it poses a lot of questions and uncertainties.

#### **Final Conclusion/Proposal (reprise)**

526. The Revised Proposed Changes further dilute the concept of a PE in a way that nearly any activity can be qualified as a PE. On the other hand the separate legal entity approach of Article 7 OMC requires a rather strict concept of a PE since it has to qualify as a functionally separate entity.

527. We therefore still propose to elaborate **objective** criteria on the local, legal and temporal requirements in line with the separate legal entity approach, which have to be met cumulatively in order to constitute a PE.

528. We also still propose to revise or remove many of the examples, which are only referring to a very limited group of interested parties and put more emphasis on the objective criteria described above.

529. The local requirement will become more important when differentiating “fixed place of business PEs” from service and other PEs under the separate legal entity approach. This difference should play a more important role when discussing examples in the Revised Proposed Changes.

530. We propose also to include a decisive reference that a PE in the premises of another legal entity should constitute a PE only in exceptional cases. Especially, a typical contract manufacturer should **never** constitute a PE of its entrepreneur.

531. In case of any questions please do not hesitate to contact us.

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1 Shown on sec. 19 of the Revised Proposed Changes

**ANNEX****REVISED DISCUSSION DRAFT ON THE INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION****Introduction**

532. This note includes a revised version of the recommendations on the interpretation and application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention made by a Working Group composed of delegates to Working Party 1 on Tax Conventions and Related Questions of the OECD Committee on Fiscal Affairs. The Working Group was set up to examine various issues related to the definition of permanent establishment that had been identified in previous work of the Committee, such as the work on business restructurings<sup>1</sup> and on the application to electronic commerce of the current treaty rules for the taxation of business profits,<sup>2</sup> in comments from delegates and in comments from the OECD Business and Industry Advisory Committee (BIAC). In discussing these issues, the Working Group used a number of examples that were developed in the course of the preparation of the branch reports and general report on the topic “Is there a Permanent Establishment?” for the 2009 Congress of the International Fiscal Association (IFA).<sup>3</sup> These examples are included in the relevant parts of this note.

533. The recommendations of the Working Group were released on 12 October 2011 as a discussion draft.<sup>4</sup> This revised discussion draft was prepared on the basis of the discussion, by Working Party 1, of the

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1 In 2005, the Committee on Fiscal Affairs created a Joint Working Group of delegates from Working Party 1 (which deals with tax treaty issues) and Working Party 6 (which deals with transfer pricing issues) to initiate work on treaty and transfer pricing issues related to business restructurings (see [http://www.oecd.org/document/11/0,3343,en\\_2649\\_37989760\\_38087051\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/11/0,3343,en_2649_37989760_38087051_1_1_1_1,00.html)). At the end of 2007, having taken stock of the progress made to that point, the Committee referred the work on the transfer pricing aspects of business restructurings to Working Party 6 and the work related to the definition of permanent establishment to Working Party 1.

2 In 1999, the Committee on Fiscal Affairs set up a Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits with the general mandate to “examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules”. The final report of the TAG “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?” (available at <http://www.oecd.org/dataoecd/58/53/35869032.pdf>) included some suggestions for clarification of the definition of permanent establishment.

3 These reports are available in *Is there a Permanent Establishment?*, Cahiers de droit fiscal international, vol. 94a, Sdu Uitgevers, The Hague, 2009.

4 Available at <http://www.oecd.org/dataoecd/23/7/48836726.pdf>.

Working Group's recommendations and of the comments that were received on that first discussion draft.<sup>1</sup> It includes a number of changes (which are underlined) that were made to the proposals included in the first discussion draft.

534. The recommendations included in this note appear in the order of the paragraphs of the Commentary to which these recommendations relate. For each recommendation, this note includes:

- the description of the issue that led to the recommendation;
- the recommendation, which in most cases includes proposed changes to the Commentary on Article 5 (in these proposed changes, suggested additions to the existing text of the Commentary appear in ***bold italics*** and suggested deletions appear in ~~strikethrough~~; changes made to the proposals included in the October 2011 discussion draft are underlined);
- background explanations on the recommendation (except for a few recommendations that do not include proposed changes to the Commentary).

535. The Annex includes a consolidated version of paragraphs 1 to 42.10 of the Commentary on Article 5 as these paragraphs would read if the proposals included in this note are adopted (unless indicated otherwise, all references to the Commentary included in this note are references to the Commentary on Article 5 of the OECD Model Tax Convention as it read after 22 July 2010).

## 1. Can a farm be a permanent establishment? (proposed paragraph 3.1 of the Commentary)

### Description of the issue

536. Does the fact that income from agriculture is covered by Article 6 prevent a farm from being a permanent establishment?

537. This issue arose from the views expressed by some countries (see the position from India in paragraph 3 of the Positions on Article 5 included in the OECD Model Tax Convention).

### Recommendation of the Working Party

538. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Add the following paragraph 3.2~~1~~ to the Commentary on Article 5 (see new paragraph 3.1 in section 3 below):*

***3.2~~1~~ Also, tThe determination of whether or not an enterprise of a Contracting State has a permanent establishment in the other Contracting State must be made independently from the determination of which provisions of the Convention apply to the profits derived by that enterprise. For instance, a farm or apartment rental office situated in a Contracting State and exploited by a resident of the other Contracting State may constitute a permanent establishment regardless of whether or not the profits attributable to such permanent establishment would constitute income from immovable property covered by Article 6; whilst the existence of a permanent establishment in such cases may not be relevant for the application of Article 6, it would remain relevant for the purposes of other provisions such as***

1 Available at:

<http://www.oecd.org/ctp/taxtreaties/publiccommentsreceivedonthediscussiondraftonthedefinitionofpermanentestablishmentintheoecdmodeltaxconvention.htm>.

*paragraphs 4 and 5 of Article 11, subparagraph 2 c) of Article 15 and paragraph 3 of Article 24.*

### ***Background***

539. Whilst Article 6 applies to income from a farm, nothing seems to prevent a farm from being a permanent establishment under the definition of Article 5. This may be relevant for other provisions of the OECD Model Tax Convention that refer to permanent establishments for purposes unrelated to the taxation of the profits derived therefrom.

540. The Working Party concluded that although there was little doubt that a farm could constitute a permanent establishment even though the income thereof would be covered by Article 6, the issue should be clarified in the Commentary to avoid any negative inference from the fact that the treaties concluded by some countries expressly refer to farms in Article 5.

## **2. Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)**

### ***Description of the issue***

541. Paragraphs 4 to 4.2 of the Commentary on Article 5 explain that a place of business may constitute a permanent establishment of an enterprise if that place is “at the disposal” of the enterprise. Business representatives have expressed concerns about the perceived lack of clarity of the phrase “at the disposal of the enterprise”. In a note prepared for its meeting with WP1 Delegates in February 2005, BIAC expressed concerns about the uncertainty of the concept of “at the disposal” and expressed the view that, at a minimum, a non-exclusive list of criteria should be provided as to what constitutes “at the disposal”:

WP1 stated in its letter to BIAC of 12 April 2004 that, since the words “at the disposal of an enterprise” are not found in the language of Art. 5, MTC but are only included in the Commentary (since 1977), it “sees no benefit in defining that term”. WP1 further stated that “the issue of when a particular location constitutes ‘a place of business through which the business of an enterprise is wholly or partly carried on’, is inherently related to the **nature of the business** under consideration. An abstract definition....would therefore not be possible.”

Too heavy a reliance on an exclusively facts and circumstances approach will inevitably lead to situations where neither tax authorities nor taxpayers will be in a position to determine in advance whether a PE exists. This complete lack of precision is not helpful in interpreting Art. 5 correctly, and arguably, is not a definition per se. At the very minimum, a **non-exclusive list of criteria** should be provided as to what constitutes “at the disposal”. Similarly, safe harbour exceptions could be included.

While BIAC understands the principle which justifies the finding of no PE in the OECD example of a **salesman visiting a customer** at its premises on a regular basis, we do not understand the rationale for finding of a possible PE in the examples of a painter working at the premises of a customer or a farmer repeatedly attending a market for a short period of time; BIAC would have thought under a facts and circumstances analysis that the painter is operating at the premises for the convenience of the customer, a factor that would lead against determining that a PE exists.<sup>1</sup>

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<sup>1</sup> BIAC would think the more relevant inquiry is whether the painter operates at customer premises on a nearly exclusive basis within the host jurisdiction over an extended period of time. Thus the “fixed place of business” standard may have to be read less literally for this professional based on the facts and circumstances surrounding his/her occupation.

The main purpose of the PE concept of Art. 5, MTC is to grant taxation rights to the source state with respect to a foreign enterprise which is performing substantive activities and functions requiring a permanent physical presence. Art. 5, par. 1, MTC has always properly been interpreted to require some degree of **physical presence**, some type of **fixed place** of business at its disposal. For example, a **general contractor subcontracting** all of its work never has this kind of physical presence at its disposal; such a situation would thus never be similar to the painter example. To reiterate, the main purpose of the permanent establishment concept is to give taxation rights to the source state if an enterprise is performing activities and functions which require a permanent physical presence. If a mere **civil law responsibility**<sup>1</sup> would be sufficient to create a permanent establishment, the concept would become so diluted as to be virtually useless. The case of a company buying goods under a toll manufacturing agreement or contracting services, for example, could become problematical because the definition of "at disposal of" seems to have been broadened to include "**at the direction of**". Heretofore, nobody would have assumed a permanent establishment of the enterprise in question at the place of the producer's or service provider's residence. If this were the rule, the existence of a permanent establishment would, in most business arrangements, become the rule instead of the exception. We suggest that "at the disposal of" requires that an enterprise **can make use of a place** to the extent and for the duration it chooses to pursue its own business plan and activities and at the exclusion of the resident enterprise if necessary; the mere use of unutilized capacity of the resident operation should not be viewed as satisfying the requirement of "at the disposal of".

Accordingly, we urge the OECD to reconsider the proposals made by BIAC on page 4 in the paper dated September 15, 2003 relating to the issue of "at the disposal of".

#### *Recommendation of the Working Party*

542. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 4.2 of the Commentary on Article 5 by the following new paragraphs 4.2 to 4.4, renumber existing paragraphs 4.3 to 4.5 as paragraphs 4.5 to 4.7, add new paragraphs 4.8 and 4.9 as recommended under section 4 below and renumber existing paragraph 4.6 as paragraph 4.10:*

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. *Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a "place of business through which the business of [that] enterprise is wholly or partly carried on" will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This is illustrated by the following examples.* Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities (*e.g. where it has legal possession of that location*), that location is clearly at the disposal of the enterprise. This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a continuous and regular basis during an extended period of time *at a location that belongs to another enterprise or that is used by a number of enterprises.* This will not be the case, however, where the enterprise's presence at a

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1 For example, the standard for being subjected to a long-arm statute for product liability purposes should not become the standard for a PE.

*location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise (e.g. where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time). Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise (see also paragraph 42 below). It is also important to remember that even if a place is a place of business through which the activities of an enterprise are partly carried on, that place will be deemed not to be a permanent establishment if the only the business activities carried on at that place are those listed in all fall within the scope of paragraph 4. [the rest of existing paragraph 4.2 is moved to new paragraphs 4.3 and 4.4]*

**4.3** These principles are illustrated by the following additional examples where representatives of one enterprise are present on the premises of another enterprise.

**4.4** A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed-place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

### ***Background***

543. The concept of "at the disposal" is not found in the definition of permanent establishment but is a test put forward in paragraph 4 of the Commentary in order to explain the concept of "place of business". Whilst the Working Party examined the suggestion that it should not try to clarify a concept that is not included in the definition found in Article 5(1) and should focus instead on the meaning of "through which the business of the enterprise is wholly or partly carried on", it concluded that discarding the concept of "at the disposal" would create a number of problems and that it should therefore provide clarification regarding the meaning of that concept.

544. The Working Party discussed the meaning of that concept in light of the following example, which was developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress, of a consultant working at a client's premises for a long period of time:

#### ***Consultant working at the client's premises***

Peter, a resident of State R, is an independent consultant who provides computer training services on the use of specialized software.

CLIENTCO, a resident of State S, has concluded a contract with Peter under which Peter provides training to CLIENTCO's staff in State S over a 20 month-long period. During that period, the work is undertaken at CLIENTCO's headquarters located in a series of office buildings located in a large estate in State S. In these buildings, Peter meets employees in their respective offices and is allowed to use 10 various training rooms, located throughout the complex, where group training sessions take place. When these rooms are not in use, Peter is allowed to use them for preparing his courses (the rooms have internet connection). Peter is given a security card allowing him unrestricted access to the buildings located in the estate during business hours. His contract requires him to use

CLIENTCO's facilities exclusively for the purposes of the contract.

545. Members of the Working Party who expressed a view on the example concluded that the consultant should be viewed as having a permanent establishment in that case. For some, the fact that the room was available to the consultant for the preparation of his training activities was crucial. Others thought that since training was the core part of the consultant's business, a place where he did that training was a place through which that business was carried on.

546. During the discussion of the example, the painter's example included in paragraph 4.5 of the Commentary on Article 5 was also discussed.

547. The Working Party agreed that its conclusion on the CARCO example (see section 3 below) should be included in the proposed paragraph that resulted from its work on this issue. It was also agreed to add a cross-reference to paragraph 42 of the Commentary in order to clarify that the principle put forward in the sentence dealing with the CARCO example applied not only to the supplier or contract-manufacturer referred to in the penultimate sentence of the proposed paragraph but also to a service provider such as the one mentioned in paragraph 42.

### **3. Can the premises of a (converted) local entity constitute a permanent establishment of a foreign enterprise under paragraph 1? (paragraph 4.2 of the Commentary)**

#### ***Description of the issue***

548. Business restructurings may lead to assets being held, risks being managed or activities being performed by a converted local entity for the account of a foreign enterprise. The issue was raised of whether, and if so in which circumstances, the premises of the converted local entity in which these activities take place may constitute a fixed place of business of the foreign enterprise. Two relevant questions are whether these premises are *at the disposal* of the foreign enterprise and whether it is the *business of the foreign enterprise* (and not only the business of the local entity) that is wholly or partly carried on in these premises. This issue was discussed by the Joint Working Group on Business Restructurings before it was referred to Working Party 1. A broader issue that is raised by these questions is to what extent the activities of a supplier of goods or services, such as contract manufacturer or cost-toller, can create a permanent establishment for the client. The following example, which was developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress, illustrates this issue:

CARCO, a company resident in State R, manufactures and sells automobiles worldwide. It sets up a subsidiary, SUBCAR, in State S, a developing country. SUBCAR will assemble cars from parts owned and supplied by CARCO. The parts will be provisionally imported from State R to State S and the finished cars shipped back from State S to State R. The parts necessary for the assembly will remain the property of CARCO. The industrial plant has been built by CARCO but will be sold to SUBCAR. SUBCAR will invoice CARCO for its costs plus the usual margin for this type of activity in State S; the parts and automobiles will be the property of CARCO throughout the entire process.

#### ***Recommendation of the Working Party***

549. The Working Party agreed that, in the above example, CARCO did not have a permanent establishment in State S and that this conclusion should be reflected in the changes to paragraph 4.2 (see the penultimate sentence of the proposed new paragraph 4.2 included in section 2 above).

550. In line with the approach already adopted with respect to the transfer pricing aspects of business restructurings,<sup>1</sup> the Working Party also agreed that no distinction should be made in the application and interpretation of Article 5 based on whether or not the facts and arrangements relevant to the determination of a permanent establishment resulted from a business restructuring. It agreed that this conclusion should be reflected through the following addition to the Commentary:

*Add the following new paragraph 3.1 immediately after paragraph 3 of the Commentary on Article 5:*

**3.1 It is also important to note that the way in which business is carried on evolves over the years so that the facts and arrangements applicable at one point in time may no longer be relevant after a change in the way that the business activities are carried on in a given State. Clearly, whether or not a permanent establishment exists in a State during a given period must be determined on the basis of the circumstances applicable during that period.**

### **Background**

551. When the Working Party discussed the above CARCO example, which deals with a subsidiary that performs contract manufacturing for its parent, the conclusion of the Working Party was that there was no permanent establishment in the situation described. A key factor was that the premises of SUBCAR were not used by CARCO itself and could not be viewed as being at the disposal of CARCO. It was also agreed that there could be no agency-PE issue in such a case because the subsidiary clearly did not exercise any authority to conclude contracts in the name of its parent.

552. The question was then asked whether the same conclusion would be reached if the subsidiary was previously a supplier who was converted into a contract manufacturer. Delegates agreed that the result should be the same; more generally, it was concluded that in line with the approach already adopted with regard to the transfer pricing aspects of business restructurings, no distinction should be made in the application and interpretation of Article 5 based on whether or not the facts and arrangements relevant to the determination of a permanent establishment resulted from a business restructuring.

## **4. Home office as a PE (proposed new paragraphs 4.8 and 4.9)**

### **Description of the issue**

553. This issue is whether an individual's home office (*i.e.* an office located in an individual's own home) would constitute a permanent establishment of the enterprise for which the individual works.

### **Recommendation of the Working Party**

554. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Add the following paragraphs immediately after new paragraph 4.7 of the Commentary on Article 5 (see Issue A):*

**4.8 Even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is at the disposal of**

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1 See paragraph 9.9 of Chapter IX "Transfer Pricing Aspects of Business Restructurings" of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

used by an individual (e.g. an employee) who works for the enterprise. Whether or not a home office constitutes a location at the disposal of the enterprise will depend on the facts and circumstances of each case. In many cases, the carrying on of business activities at the home of an individual (e.g. an employee) will be so intermittent or incidental that the home will not be considered to be a location at the disposal of the enterprise (see paragraph 4.2 above). Where, however, a home office is used on a regular and continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on the enterprise's business the individual to work from home (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise.

4.9 A clear example is that of a non-resident consultant who is present for an extended period in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise. Where, however, a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities. It should be noted, however, that since the vast majority of employees reside in a State where their employer has at its disposal one or more places of business to which these employees report, the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue. Also, the activities carried on at a home office will often be merely auxiliary and will therefore fall within the exception of subparagraph e) of paragraph 4.

### ***Background***

555. This issue was raised by a delegate who asked the Working Party whether and in which circumstances the home office of a resident employee of a foreign company could be considered to be a permanent establishment of the foreign company. After discussion, the Working Party concluded that this question was related to the meaning of "at the disposal" and that it required further analysis and should be clarified in the Commentary.

556. Some delegates, however, questioned whether the issue had practical relevance, noting that employees would normally reside in the State where their employer had business premises and that, in the vast majority of cases, work done at a home office would be preparatory or auxiliary. It was explained that the issue would typically arise in the case of expatriate employees, cross-frontier workers and travelling consultants and it was agreed that this should be reflected in the proposed clarification.

557. The Working Party discussed this issue in light of the following four examples, with a view to reaching a conclusion as to when a home office of an employee should be considered to be a place of business at the disposal of his/her employer:

1. A large multinational insurance company has employees in various countries who sell insurance policies on the local market. These employees are expected to maintain a home office but are not reimbursed for the costs of doing so. The direct supervisors of these employees know the address of the employees but cannot go to their homes without being invited.
2. An engineering company sends one of its employees to work on a number of unrelated building projects in a foreign country. The employee is not present on any construction site for more than

3 months but lives and work in that country for two years. As part of its usual expatriation package, the company pays the rental costs of the house in which the employee will live. The employee uses part of that home as an office where he works one or two hours each day. The direct supervisor of the employee does not know that he does part of his work from home.

3. An engineering company sends one of its employees to work on a number of unrelated building projects in a foreign country. The employee is not present on any construction site for more than 3 months but lives and works in that country for two years. As part of its usual expatriation package, the company pays the rental costs of the house in which the employee will live. The employee uses part of that home as an office where he performs about 50% of his work (the rest is spent on the various construction sites). The company initially intended to rent a separate office for the employee but he convinced his direct supervisor that it was more efficient for him to work from home.
4. A company, resident of one State, has only two employees who are also its shareholders. One employee is a resident of another State who carries on a large part of the activities of the enterprise at her home office, the costs of which are neither paid for nor reimbursed by the company.

558. During the discussion of the issue, the question was asked whether these examples raised any issue that had not been previously discussed by the Working Party or addressed in the Commentary. It was explained that whilst it was clear that the home office of an employee was at the disposal of the employee and was a place where the business activities of the employer were partly carried on, the crucial issue that had not been previously addressed was whether this was sufficient to consider that that place was at the disposal of the employer.

**5. Shops on ships operated in international traffic (proposed paragraph 5.5 of the Commentary)**

***Description of the issue***

559. If an enterprise of State A owns a shop on a ship registered in State B and the ship travels between several countries including States A and B, in which country may the income from the shop be taxed? In the example, it may be assumed that enterprise is not associated with the enterprise operating the ship. Could it be argued that there is a PE on the ship (and if so in which country would the PE be situated)?

***Recommendation of the Working Party***

560. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Add the following paragraph 5.5 to the Commentary on Article 5 (and renumber existing paragraph 5.5 as 5.6):*

***5.5 Similarly, a ship or boat that navigates between States or in within territorial waters or in inland waterways in international waters or within one or more States is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship or boat, such as a shop or restaurant, must be treated the same way for the purposes of determining whether paragraph 1 applies (paragraph 5 could***

**apply, however, where contracts are concluded when such shops or restaurants are operated within a State).**

### **Background**

561. The Working Party concluded that a moving ship would typically not constitute a fixed place and a shop aboard such a ship would not, therefore, constitute a permanent establishment. It was noted, however, that a specific area to which the operation of the ship would be restricted could itself have commercial and geographic coherence and, therefore, could constitute a fixed place of business depending on the circumstances.

562. It was also noted that, in any event, the enterprise operating a restaurant or shop aboard a ship would probably have a deemed permanent establishment under Article 5(5) to the extent that contracts would normally be concluded with customers by the personnel of such a restaurant or shop.

### **6. Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)**

#### **Description of the issue**

563. Business has expressed concerns about the uncertainty concerning the period of time required for a location to be considered a permanent establishment. In a note prepared for its 2005 meeting with the Working Party, BIAC presented its concerns as follows:

We also remain concerned over the uncertainties arising out of the lack of any rules relating to the duration of an activity to be judged a PE.

In its letter to us of 12 April, 2004, the OECD wrote “We read the second sentence of Paragraph 6 of the Commentary to refer to a business which exists for a short period of time by reason of its very nature and to indicate that a place set up for such business would not be set up merely for a temporary purpose **even if it exists for a very short period** of time because of the nature of that activity.” The response merely rearranges the words that we found unintelligible in the revised Commentary without providing any clarification. We still do not understand how the nature of the activity can transform a place that is intended to exist for a short period into a place of business that is not set up for a temporary purpose. By way of example, a non-US resident food vendor that provided food services to its country’s athletes during the Atlanta Olympic games appears to be a PE under the newly evolving definition merely because the duration activity overlaps significantly with the short term nature of the Olympic games. This not the definition many treaty negotiators had in mind when most current double tax treaties were signed. Apparently the definition of “permanency” is a function of the underlying business activity that it relates to. If so, one can posit the creation of a new business enterprise in a host jurisdiction of an indefinite nature and which takes 3 to 5 years to make fully operational. Under the evolving PE definition, one can argue that an entity that provides a subset of services to this entity with a duration of less than 3 years would not be deemed to have a PE.

We understood the former requirement that “the place of business [must be] not set up merely for a temporary purpose” to involve a required and demonstrable intention of the taxpayer. The recent revisions have removed this condition. The elimination of this condition **creates uncertainty** that did not previously exist and introduces greater pressure for clarification. Specifically, what aspect of the nature of the business that will be carried on for only a short period of time distinguishes between a place of business that exists for a very short period of time that constitutes a PE and a place of business that exists for a very short period of time that does not constitute a PE?

The revised Commentary essentially acknowledges that it fails to answer this question. It merely points out, “It is sometimes difficult to determine whether this [a place of business constitutes a PE even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for a very short period of time] is the case.”

The **meaning of the Commentary must become more clear** and the language used must be understandable to the typical reader versed in international tax principles, both tax administrations and taxpayers. The existing Commentary is not serving its purpose if the States that must enforce the treaties and the multinational enterprises that are trying to remain in compliance with the requirements of the treaties cannot determine what the treaties mean. The goal of voluntary compliance would best be served by a presumption that a fixed place of business can exist only if business is **conducted at such place for a minimum period of time**. Let the Commentary note that the minimum period is not meant to be illustrative of the definition of a PE but that it serves for the administrative convenience of all member States; some States will win in some cases and lose in others but that is the nature of a double tax treaty.

We, therefore, suggest that the OECD seriously consider using a **minimum time period** for which an activity has to be performed in a continuous manner before a PE is created. The 183 day rule of Art. 15, MTC uses the concept of a time frame with great success and, notably, with a minimum amount of controversy associated in defining the scope of this definition. Art. 5, par. 3, MTC could be used as a precedent to establish **a twelve month period** as the minimum duration for a foreign enterprise’s activities to rise to the level of PE. This can be derived from the fact that the construction and installation projects often require a substantial physical presence so that other businesses with less physical presence should, at the very least, also enjoy a twelve-month de minimis rule.

A **prescribed time frame** allows businesses and tax authorities to assess, in advance, whether or not a PE will emerge. Except for extraordinary circumstances, for example, when a PE which is initially created to accomplish a long term agenda is closed down after a short period due to unforeseen events, there is little, if any, justification for defining a short term activity as being permanent even if it were of recurrent nature. Such an approach would only result in uncertainty whether or not a PE exists, which is unwarranted because these activities create no substantial permanent presence. In this context, the term “**nature of the business**” used by the OECD is generally not helpful for getting advance guidance.

The Commentary could suggest a minimum period of time as a general rule, even if paragraph 1 does not specify a minimum period of time. The Commentary could conclude that a place of business that does not exist for twelve months should “generally” or “except in the case of changed or unusual circumstances” be viewed as not fixed and, therefore, not constituting a PE. While such an objective standard is clearly preferred, **clarification of the more subjective standard** in the current Commentary is still necessary, especially if the Commentary is not revised to include this more objective standard.

#### ***Recommendation of the Working Party***

564. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 6 of the Commentary on Article 5 by the following (and renumber the existing paragraphs 6.1 to 6.3 as paragraphs 6.4 to 6.6):*

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). [the rest of the paragraph is moved to new paragraphs 6.1 to 6.3]

**6.1** One exception to **this general practice** has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). **That exception is illustrated by the following example.** An individual resident of State R rents a stand at a commercial fair in State S for 15 consecutive years where he sells sculptures during a period of five weeks each year. An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for 5 years. In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any consecutive continuous presence lasts less than 6 months; the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business.

**6.2** Another exception to this **general** practice has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. **That exception is illustrated by the following example.** An individual resident of State R has learned that a television documentary will be shot in a remote village in State S where her parents still own a large house. Since the documentary will require the presence of a number of actors and technicians in that village during a period of four months, she decides to transform the house of her parents into a small restaurant which she will. The individual contractually agrees with the producer of the documentary to provide catering services to the actors and technicians during the four month period and, pursuant to that contract, she uses the house of her parents as a cafeteria that she operates as sole proprietor during that period. These are the only business activities that she has carried on and she does not intend to carry on such activities in the future the enterprise is terminated after that period; the cafeteria-restaurant will therefore be the only location where the business of that enterprise will be wholly carried on. In that case, it could be considered that the time requirement for a permanent establishment is met since the restaurant is operated during the whole existence of that particular business. This would not be the situation, however, where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four week international sports event. In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S.

**6.3** For ease of administration, countries may want to consider these practices *reflected in paragraphs 6 to 6.2* when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

### ***Background***

565. After discussion of BIAC's comments on this issue, the Working Party expressed its support for the conclusions currently reflected in paragraph 6 and concluded that whilst examples could be provided to clarify the exceptions included at the end of the paragraph, no other changes should be made to the guidance on the issue of the time requirement.

## **7. Presence of foreign enterprise's personnel in the host country (paragraph 10 of the Commentary)**

### ***Description of the issue***

566. In which circumstances can the presence in a country of personnel of a foreign enterprise constitute a permanent establishment for the foreign enterprise?

567. This question was raised in the context of the work of the Joint Working Group on Business Restructurings.

### ***Recommendation of the Working Party***

568. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 10 of the Commentary on Article 5 by the following:*

10. *There are different ways in which an enterprise may carry on its business. In most cases, the business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business of the enterprise (see paragraph 35 below). [the rest of the existing paragraph 10 is moved to new paragraph 10.2] As explained in paragraph 8.11 of the Commentary on Article 15, however, there may be cases where individuals who are formally employed by an enterprise will actually be carrying on the business of another enterprise and where, therefore, the first enterprise should not be considered to be carrying on its own business at the location where these individuals will perform that work. Within a multinational group, it is relatively frequent common for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company. In such cases, administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract. The analysis described in paragraphs 8.13 to 8.15 of the Commentary on Article 15 will be relevant for the purposes of distinguishing these cases from other cases where employees of a foreign enterprise perform that enterprise's own business activities.*

*[10.1 See section 8 below]*

**10.2 But also,** a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

### ***Background***

569. Whilst the issue was discussed by the Joint Working Group on Business Restructurings in relation to associated enterprises, similar issues may arise with respect to independent entities, as shown by the following example developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress:

#### ***Presence of employees of a foreign company***

SCO is a company resident of State S that owns a small hotel. The hotel will be operated as a franchise.

SCO has contracted with RCO, a manpower company resident of State R, to provide the services of a hotel manager. During 2008 and 2009, RCO sends successively 3 different persons to perform that role in the hotel for periods of 5, 15 and 4 months respectively. RCO is paid a management fee equal to the total remuneration of the persons that it sends plus 25%.

570. When the Working Party discussed that example, it was suggested that it was ambiguous and it was therefore decided to discuss the following two versions of the example:

#### ***1. Manager employed by the hotel owner***

SCO is a company resident of State S that owns a small hotel. The hotel will be operated as a franchise.

SCO has contracted with RCO, a manpower company resident of State R, to obtain the services of hotel managers. RCO will find the managers and will negotiate employment contracts between each of them and SCO; RCO will not be the legal employer of these managers. During 2008 and 2009, RCO finds successively 3 different persons to perform the hotel manager functions for periods of 5, 15 and 4 months respectively. RCO is paid a "management fee" equal to the total remuneration paid to these persons by SCO plus 25%.

#### ***2. Manager employed by the manpower company***

SCO is a company resident of State S that owns a small hotel. The hotel will be operated as a franchise.

SCO has contracted with RCO, a manpower company resident of State R, to obtain the services of hotel managers. RCO will be the legal employer of the managers and will provide their services to SCO under that contract for services. During 2008 and 2009, RCO sends successively 3 different persons to perform the hotel manager functions for periods of 5, 15 and 4 months respectively. RCO is paid a "service fee" equal to the total remuneration of the persons that it sends plus 25%.

571. The Working Party concluded that the manpower company would not have a permanent establishment in the first example of managers who would become employees of the company that owned and operated the hotel.

572. As regards the second example, reference was made to the last sentence of paragraph 8.11 of the Commentary on Article 15, according to which if the State of source considered the hotel managers to be in an employment relationship with SCO, which operated the hotel, the conclusion should be reached that RCO does not have a permanent establishment. It was noted, however, that if the State of source treated the managers as employees of RCO and RCO as a provider of hotel management services to SCO, the Commentary on Article 15 would not directly address the issue of whether or not RCO had a permanent establishment in that State.

573. The view was expressed that since paragraph 10 of the Commentary on Article 5 provides that an enterprise carries on its business through its employees, it would be difficult to consider that RCO did not have a PE in the situation where the managers were formally employed by RCO unless it was found that the managers were in fact "economically" employed by SCO under the criteria put forward in paragraphs 8.13 to 8.15 of the new Commentary on Article 15.

574. It was suggested that the practical situation in which this issue was most likely to occur was the case where an employee of a company that belonged to a multinational group was temporarily seconded to work for another company of the group. In many cases, the secondment would be done without a formal contract between the two enterprises. Some countries might consider that the services rendered by the seconded employee are services provided by the first company to the second company, which would create the risk that the first company would be found to have a PE in the premises of the second company where the employee would work. The Working Party concluded that the analysis in paragraphs 8.13 to 8.15 of the Commentary on Article 15 would be relevant for the purpose of distinguishing these cases from other cases where employees of a foreign enterprise perform that enterprise's own business activities.

## **8. Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)**

### ***Description of the issue***

575. Does an enterprise (contractor) that has undertaken the performance of a comprehensive project have a permanent establishment if it subcontracts all aspects of that contract to other enterprises (subcontractors)?

576. This issue was discussed some years ago by the Working Party. Whilst changes to paragraph 19 of the Commentary were then tentatively agreed to by the Working Party, it was subsequently decided that these and other changes related to the definition of permanent establishment should be re-examined after the conclusion of the work on other issues, including the work on attribution of profits to permanent establishments.

577. As was noted when the issue was discussed by the Working Party, the issue goes beyond the scope of Article 5(3) and raises questions concerning the interpretation of paragraph 10 of the Commentary, which discusses how the business of enterprise is carried on for the purposes of the application of Article 5(1). This is illustrated by the following example developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress:

### ***Subcontractor***

KCO is a company resident of State R that provides services to the oil industry. KCO has concluded a contract with an independent oil company, OCO, which is resident of State S. Under the contract, KCO is to conduct certain engineering services in addition to providing certain other services related to the managing of the accommodation facilities (“catering”) on an offshore oil platform in State S. KCO subcontracts the catering to an independent company, FCO, which is a resident of State S. KCO is fully responsible for the work done by FCO in relation to OCO. Hence, FCO does not have any obligations towards OCO. FCO is paid on a cost plus basis. KCO itself does not have any physical presence in State S, and performs the engineering services from its offices in State R.

### ***Recommendation of the Working Party***

578. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Add the following paragraph 10.1 immediately after new paragraph 10 of the Commentary on Article 5 (see section 7 above):*

*10.1 An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met. In the context of paragraph 1, that will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise for reasons other than the mere fact that these subcontractors perform such work at that location (see paragraph 4.2 above). Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 4.2; in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. Paragraph 19.1 illustrates such a situation in the case of a construction site; this could also happen in other situations. An example would be where an enterprise that owns a small hotel and rents out the hotel's rooms through the Internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis.*

*Replace paragraph 19 of the Commentary on Article 5 by the following (and renumber existing paragraph 19.1 as paragraph 19.2):*

19. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. [the six subsequent sentences have been moved to new paragraph 19.1] If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts all or parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where the general contractor has overall responsibility for the site and the site is made available to that general contractor for the purposes of carrying on its construction business circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has

**legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period.** The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.

### ***Background***

579. The Working Party concluded that the implication of paragraph 19 was that the activities of the subcontractors were allocated to the main contractor. It was also noted that it would be fairly unlikely that a main contractor would not have some employees on a construction site and that it would seem strange to have a different result if the main contractor's employees spent only one day on the site.

580. The Working Party also concluded that the issue was not restricted to construction sites and to paragraph 19 of the Commentary but was in effect related to the more general issue of whether an enterprise can carry on its business through subcontractors and, therefore, to paragraph 10 of the Commentary.

581. The application of paragraph 10 was discussed on the basis of a variation of the hotel example included in section 7 above. Under the modified facts of the example, the handling of the keys, the cleaning and other aspects of the operation of the hotel would be subcontracted to a local independent enterprise but that enterprise would not conclude contracts on behalf of the hotel owner (the rooms would be rented through the Internet). Members of the Working Party generally agreed that if the operation of a hotel was entirely subcontracted, the owner of the hotel, who would obtain the profits, could still be viewed as having a permanent establishment.

## **9. Application of paragraph 3 to joint venture and partnership activities (paragraphs 10 and 19 of the Commentary)**

### ***Description of the issue***

582. How does paragraph 3 apply when a construction site lasts for more than 12 months but no taxpayer is there for more than 12 months?

583. The following example, which was developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress, illustrates the issue:

#### ***Joint venture***

ACO and BCO are two unrelated companies that are residents of State R. ACO is a construction company and BCO specializes in electronic, sound and light installations.

Both companies have decided to form a joint venture to build and subsequently sell a modern theatre in State S. ACO will be responsible for the construction of the building and BCO will install the furniture and equipment (including the sound, light and electronic equipment). The joint venture contract provides that each company will be solely responsible for its own costs and activities, that neither company will be an agent of the other, that the companies will not be partners in a partnership but that they will share equally the sale price of the theatre.

ACO employees are present in State S for 10 months to build the theatre in State S and BCO's employees subsequently spend 10 months to install the furniture and equipment.

### ***Recommendation of the Working Party***

584. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

Add the following paragraphs 10.3 and 10.4 after the new paragraph 10.2 of the Commentary on Article 5 (the new paragraph 10.2 results from the recommendations in sections 7 and 8 above):

**10.3** *It follows from the definition of “enterprise of a Contracting State” in Article 3 that this term, as used in Article 7, and the term “enterprise” used in Article 5, refers to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form. Different enterprises may collaborate on the same project and the question of whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State. Clearly, if two enterprises carried on by different persons each carrying on a separate enterprise decide to form a company in which these persons are shareholders, the company constitutes a legal person that will carry on what becomes another separate enterprise. It will often be the case, however, that different enterprises will simply agree to each carry on a separate part of the same project and that these enterprises will not jointly carry on business activities and share the profits thereof even though they may share the overall output from the project or the remuneration for the activities that will be carried on in the context of that project (e.g. what is considered to be a “joint venture” according to the law of some countries). In such a case, it would be difficult to consider that a separate enterprise has been set up. Although such an arrangement would be referred to as a “joint venture” in many countries, the meaning of “joint venture” depends on domestic law and it is therefore possible that, in some countries, the term “joint venture” would refer to a distinct enterprise.*

**10.4** *In the case of an enterprise that takes the form of a fiscally transparent partnership, the enterprise is carried on by each partner and, as regards the partners’ respective shares of the profits, is therefore an enterprise of each Contracting State of which a partner is a resident. If such a partnership has a permanent establishment in a Contracting State, each partner’s share of the profits attributable to the permanent establishment will therefore constitute, for the purposes of Article 7, profits derived by an enterprise of the Contracting State of which that partner is a resident (see also paragraph 19.2 below).*

Replace paragraph 19.1 of the Commentary on Article 5 by the following new paragraph 19.2 (the renumbering results from the recommendations in sections 8 and 11):

**19.24** *In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve months, the enterprise carried on by through the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site. Assume for instance that a resident of State A and a resident of State B are partners in a partnership established in State B which carries on its construction activities on a construction site situated in State C that lasts 10 months. Whilst the tax treaty between States A and C is identical to the OECD Model, paragraph 3 of Article 5 of the treaty between State B and State C provides that a construction site constitutes a permanent establishment only if it lasts more than 8 months. In that case, the time-threshold of each treaty would be applied at the level of the partnership but only with respect to each partner’s share of the profits covered by that treaty; since the treaties provide for different time-thresholds, State C will have the right to tax the share of the profits of the partnership attributable to the partner who is a resident of State B but will not have the right to tax the share attributable to the partner who is a resident of State A. This results from the fact that whilst the provisions of paragraph 3 of*

*each treaty are applied at the level of the same enterprise (i.e. the partnership), the outcome differs with respect to the different shares of the profits of the partnership depending on the time-threshold of the treaty that applies to each share.*

### ***Background***

585. The Working Party concluded that whilst members of a partnership would each have a permanent establishment if the partnership had one, the situation would be different, for many countries, in the case of a joint venture that did not constitute a partnership or other type of entity under their domestic law. It acknowledged, however, that the meaning of joint venture would depend on domestic law and that in some countries a “joint venture” could refer to a distinct enterprise.

586. The Working Party therefore agreed that the distinction between a joint venture, an association and a partnership (especially in the case of a transparent partnership that would have legal personality) was an issue that essentially depended on facts and domestic law and that its report should include explanations to that effect. Looking at the particular facts of the example, it was concluded that because the companies were not liable for each other’s activities, there were no co-ownership of assets or joint employment responsibilities and the companies did not share profits (although they each received a part of the overall sales price), the companies were not carrying on a joint business. Whether there was a permanent establishment, especially as regards paragraph 3, should therefore be determined independently for each company.

587. The Working Party also discussed the statement, in existing paragraph 19.1, according to which the twelve-month test of Article 5(3) is applied at the level of the partnership. The question was asked how that principle would be applied in the case of a partnership that would have two partners resident of two different States, one of which would have a treaty providing that a construction site in a third State constitutes a permanent establishment whilst the other State would have a treaty with that third State that would include a different time-threshold according to which the construction site would not constitute a permanent establishment. The Working Party decided that this example and the conclusion that, in that case, the time-threshold of each treaty would still be applied at the level of the partnership but only with respect to each partner’s share of the profits covered by that treaty, should be included in paragraph 19.1.

## **10. Meaning of “place of management” (paragraph 12 of the Commentary)**

### ***Description of the issue***

588. The question has been raised as to whether and in which circumstances a company that is a member of a corporate group may constitute a “place of management” of another company of the group so as to constitute a permanent establishment in accordance with the example in subparagraph 2 a) of Article 5.

589. This issue is illustrated by the following example, which was developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress:

#### ***Place of management***

ACO, a company resident of State S, owns all the shares of BCO, a company resident of State R. Both companies are part of the ACO multinational group.

A part of the administrative functions of the multinational group have been centralised in the headquarters of ACO located in State S. The accounting, legal services, and most of the human resources functions of BCO are provided through ACO employees working at these headquarters.

The tax authorities of State S argue that since the headquarters of ACO constitute a place of management for BCO, BCO has a permanent establishment in State S under paragraph 5(1) and subparagraph 5(2)a).

### ***Recommendation of the Working Party***

590. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 12 of the Commentary on Article 5 by the following:*

12. This paragraph contains a list, by no means exhaustive, of examples ***of places of business***, each of which can be regarded, *prima facie*, as constituting a permanent establishment ***under paragraph 1 provided that it meets the requirements of that paragraph***. As these examples are to be seen against the ~~background read in the context~~ of the general definition given in paragraph 1, it is assumed that the Contracting States interpret the terms listed, “a place of management”, “a branch”, “an office”, etc. ***must be interpreted*** in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1 **and are not places of business to which paragraph 4 applies**.

591. As regards the above example, the Working Party concluded that the real issue underlying that example was the meaning of “at the disposal”, which was an issue that had already been discussed and that is directly addressed in paragraph 42 of the Commentary, which confirms that there would not be a permanent establishment in the example.

### ***Background***

592. The Working Party concluded that this issue raised two different questions. The first was the issue of the relationship between the list of examples in Article 5(2) and the definition in Article 5(1). The second one was the one raised by the above example.

593. As regards the first question, it was agreed that since some non-OECD countries have expressed the view that all examples listed in paragraph 2 were automatically permanent establishments, the relationship between paragraphs 1 and 2 could usefully be clarified even though paragraph 12 of the Commentary already indicated that the list of examples in paragraph 2 had to be interpreted in the light of paragraph 1.

594. As regards the second question, it was noted that paragraph 42 of the Commentary already dealt with the situation of one member of a corporate group providing management services to other members and that there was therefore no need to amend the Commentary with respect to the issue.

595. It was also agreed that no clarification was needed concerning the distinction between a “place of management” for the purposes of subparagraph 2 a) of Article 5 and the concept of “place of effective management” as the residence tie-breaker rule in paragraph 3 of Article 4: whilst an enterprise can have different places of management for the purposes of subparagraph 2 a) of Article 5, an entity such as a company can have only one place of effective management for the purposes of paragraph 3 of Article 4.

**11. Additional work on a construction site (proposed new paragraph 19.1 of the Commentary)*****Description of the issue***

596. To what extent does additional work performed on a construction site count for the application of paragraph 3?

597. The following example, which was developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress, illustrates the issue:

***Additional work on a construction site***

CCO is a company resident in State R that carried on a technologically advanced construction project in State S for OILCO. The project lasted for 10 months and two weeks (assume 6 weeks less than the 12-month test in paragraph 3 of Article 5). The testing of the facilities took place over the following three weeks and the site was delivered to OILCO immediately after the testing was completed. Two employees of CCO remained on the site for one more week to train the employees of OILCO, for which OILCO did not make any additional payment. After three weeks of operation, a minor construction problem had to be fixed by employees of CCO; five employees of CCO returned to the site to make the reparation. The reparation work took two weeks; OILCO did not pay for that work as the initial construction work was guaranteed by CCO.

598. Whilst paragraph 19 of the Commentary on Article 5 indicates that a construction site continues to exist until work is completed or abandoned, the general report on the topic "Is there a Permanent Establishment?" that was prepared for the IFA 2009 Congress indicated that some tax administrations have been asked to clarify the practical application of that general guidance.

***Recommendation of the Working Party***

599. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 19 of the Commentary on Article 5 by the following (and renumber existing paragraph 19.1 as paragraph 19.2):*

[19. See section 8 above]

**19.1** In general, ~~a site~~ continues to exist until the work is completed or permanently abandoned. *The period during which the building or its facilities are being tested by the contractor or subcontractor should therefore generally be included in the period during which the construction site exists. In practice, the delivery of the building or facilities to the client will usually represent the end of the period of work, provided that the contractor and subcontractors no longer work on the site after its delivery for the purposes of completing its construction.* A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1 May, stopped on 1 November because of bad weather conditions or a lack of materials but resumed work on 1 February the following year, completing the road on 1 June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1 May) and the date he finally finished (1 June of the following year). *Work that is undertaken on a site after the construction work has been*

*completed pursuant to a guarantee that requires an enterprise to make repairs would normally not be included in the original construction period. Depending on the circumstances, however, any subsequent work (including work done under a guarantee) performed on the site during an extended period of time may need to be taken into account in order to determine whether such work is carried on through a distinct permanent establishment.*

### ***Background***

600. The Working Party supported the suggestion that some clarification should be added to the Commentary as to when work on a construction site should be considered to be completed for the purposes of computing the twelve-month period of paragraph 3. It was generally agreed that the period during which the facilities are tested would normally be included, that the hand-over of the building to the client would usually represent the end of that period, and that work undertaken subsequently pursuant to a guarantee would not be taken into account.

### **12. Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)**

#### ***Description of the issue***

601. The question was raised as to whether the activities that are mentioned in subparagraphs *a*) to *d*) of paragraph 4 are automatic exceptions or whether these exceptions are conditional on the activities being of a preparatory or auxiliary nature.

602. This issue was discussed in section 4.A.*d*) of the 2004 report of the Business Profits TAG “Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?”:

The alternative option to subject the activities covered by the exception to the overall limitation that they be of a preparatory or auxiliary nature is based on the same rationale but is arguably better targeted as it implicitly restricts the exceptions to activities that contribute only marginally to the profits of the enterprise. It could also be argued that this alternative option is fully in line with the purpose of paragraph 4, which is described as follows in paragraph 21 of the Commentary:

“The common feature of these activities is that they are, in general, preparatory or auxiliary activities” [...] “Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.”

...The alternative option to make all the exceptions subject to the “preparatory or auxiliary” condition would reduce certainty by subjecting the existing exceptions that currently apply automatically and therefore provide a bright line test to a condition that is inherently more subjective. The change would therefore increase the potential for disputes between taxpayers and tax authorities. In light of paragraph 21 of the Commentary on Article 5, it could be argued, however, that there is already some uncertainty as to whether or not all the existing exceptions are implicitly subject to this condition.

603. The issue was also discussed by the Joint Working Group on Business Restructurings.

#### ***Recommendation of the Working Party***

604. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 21 of the Commentary on Article 5 by the following:*

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. Where the only activities carried on at a fixed place of business are activities to which one of subparagraphs a) to d) apply, Where each of the activities listed in subparagraphs a) to d) is the only activity carried on at a fixed place of business, the place is deemed not to constitute a permanent establishment. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. Since subparagraph e) deals with other unspecified activities, however, the requirement that the activity must have a preparatory or auxiliary character has been This is laid down explicitly in the case of the exception mentioned in that subparagraph-e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

*Replace paragraph 23 of the Commentary on Article 5 by the following:*

23. Subparagraph e) 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~~s~~ is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business; and may well contribute to the productivity of the enterprise, involve activities which are so remote from the actual realisation of profits by the enterprise that they should not be treated as permanent establishments. ~~It is recognised 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 realisation 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 or auxiliary character.

*Replace paragraphs 42.7 and 42.9 of the Commentary on Article 5 by the following:*

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary covered by paragraph 4 include:

- providing a communications link — much like a telephone line — between suppliers and customers;
- advertising of goods or services;

- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary within the meaning of subparagraphs 4 e) and f) or otherwise covered by paragraph 4. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary or not otherwise covered by paragraph 4. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet or are otherwise covered by paragraph 4 (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary covered by paragraph 4.

605. As explained below, however, the Working Party notes that whilst the last sentence of paragraph 23 is technically correct, it should not be misinterpreted as suggesting that research and development is, as a general rule, a preparatory or auxiliary activity.

### ***Background***

606. The Working Party agreed that the wording of subparagraphs *a*) to *d*) did not support the view that the application of these subparagraphs was subject to the additional condition that the relevant activity be of a preparatory or auxiliary character, which was a condition that was expressly included in subparagraphs *e*) and *f*). It therefore agreed that the Commentary should be amended to clarify that subparagraphs *a*) to *d*) were not subject to the extra condition that the activities referred to therein be of a preparatory or auxiliary nature and that a similar clarification should be made in paragraphs 42.7 and 42.9 of the Commentary.

607. During its discussion of the issue, the Working Party also discussed the last sentence of paragraph 23 of the Commentary, which provides that “[e]xamples 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 or auxiliary character.” It was concluded that whilst the sentence was technically correct, it could be misinterpreted as suggesting that research and development was, as a general rule, a preparatory or auxiliary activity. After discussion, the Working Party decided that no changes should be made to the paragraph with respect to this issue but that the Working Party’s report should include that warning.

608. The Working Party agreed, however, to redraft the penultimate sentence of paragraph 23 in order to remove any suggestion that there could be a link between the attribution of profits and the existence of a permanent establishment.

### **13. Relationship between delivery and the sale of goods in subparagraph 4 a) (paragraphs 22 and 27.1 of the Commentary)**

#### ***Description of the issue***

609. Does the exception in subparagraph 4 a) apply to goods or merchandise to be sold from abroad?

610. This question was raised in the context of the work of the Joint Working Group on Business Restructurings, which noted that the exception of subparagraph 4 a) does not apply to the situation in which a fixed place of business maintained for the delivery of goods is also engaged in the sale of goods.

#### ***Recommendation of the Working Party***

611. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 22 of the Commentary on Article 5 by the following [other changes to paragraph 22 resulting from the recommendations in sections 14 and 16 would also be made to the paragraph]:*

22. Subparagraph a) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery.

***Subparagraphs a) and b) apply regardless of whether the storage or delivery takes place before or after a contract for the sale of the goods or merchandise has been concluded provided that the goods or merchandise belong to the enterprise whilst they are at the relevant location (e.g. the subparagraphs would remain applicable if contracts for the sale of some of the goods that are stored at a location have already been concluded but the property title to these goods only passes to the customer after their delivery)... [changes resulting from the recommendations in sections 14 and 16 will be inserted here; the rest of existing paragraph 22 is moved to new paragraph 22.1]***

**22.1** Subparagraph c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many “tentacles” of the parent body; to exempt such a bureau is to do no more than to extend the concept of “mere purchase”.

*Replace paragraph 27.1 of the Commentary on Article 5 by the following:*

27.1 Subparagraph f) is of no relevance-importance in a case where an enterprise maintains several fixed places of business within the meaning of to which subparagraphs a) to e) apply provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing

goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. *The same approach appliesA similar issue arises where an enterprise that maintains in a Contracting State one or more fixed places of business within the meaning of to which subparagraphs a) to e) apply is also deemed, through the application of paragraph 5, to have a permanent establishment in the same State; in that case, if the activities that resulted in that deemed permanent establishment are not separated organisationally from these fixed places of business, it could not be argued that the enterprise is solely engaged in a preparatory or auxiliary activity at these places.*

### **Background**

612. Based on the wording of subparagraphs 4 a) and b), which refer to the use of facilities or maintenance of a stock of goods or merchandise “*solely*” for the purpose of storage, display or delivery, there was general agreement with a member’s conclusion that a place used for display or delivery that was also used for making sales would not be covered by these subparagraphs. The Working Party also agreed, however, that the wording of subparagraph 4 a) did not support the suggestion that the application of that subparagraph would depend on whether or not the goods or merchandise stored, displayed or delivered had already been sold and it was agreed that this should be clarified in the Commentary.

613. During the discussion, a member of the Working Party described a situation where an agent would sell goods stored by the foreign enterprise at a particular location so that the sales activities would constitute a permanent establishment under Article 5(5); in that case, he did not consider that the exception of subparagraph 4 a) should be applicable to the location where the goods were stored. It was agreed that paragraph 27.1 of the Commentary should be clarified to indicate that an agency permanent establishment resulting from Article 5(5) should be treated in the same way as a fixed place of business for the purposes of the application of the non-fragmentation approach described in that paragraph.

### **14. Does a development property constitute a PE? (paragraph 22 of the Commentary)**

#### **Description of the issue**

614. The question has been asked whether, in a situation where a developer develops and sells immovable property, the property would constitute a permanent establishment notwithstanding the fact that the business of the developer is to sell that property.

#### **Recommendation of the Working Party**

615. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 22 of the Commentary on Article 5 by the following [other changes to paragraph 22 resulting from the recommendations in sections 13 and 16 would also be made to the paragraph]:*

22. Subparagraph a) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. *[the changes resulting from the recommendations in sections 13 and 16 will be inserted here] In the context of these subparagraphs, the words “goods” and “merchandise” refer to tangible property that can be stored, displayed and delivered and would not cover, for example,*

*immovable property and data (although the subparagraphs would cover tangible products that include data such as CDs and DVDs). [the rest of paragraph 22 is moved to new paragraph 22.1 – see section 13]*

### **Background**

616. One member of the Working Party described the situation of a non-resident developer who sells land situated in a country without having a sales office or other similar permanent establishment in that country and who argues that Article 7 prevents that country from taxing the profits from these sales (in that case the country would not tax these profits as capital gains). The Working Party concluded that the last part of paragraph 4 of the Commentary on Article 13<sup>1</sup> already clarifies that the Convention allowed the country to tax these profits and that it was purely a question of domestic law how the country decided to tax them (*i.e.* as business profits or as capital gains).

617. This led to the discussion of another example in which a non-resident developer would hold a stock of recently-built houses for sale without having another form of physical presence in the country. In that case, the issue would be whether it could be argued that the developer does not have a permanent establishment on the basis that the houses constitute “a stock of goods or merchandise” for the purposes of subparagraph 4 b).

618. It was concluded that whilst this would not affect the State of source’s right to tax the gains from the sales (since this right is granted by paragraph 1 of Article 13 regardless of whether or not there is a PE), the issue could be relevant for the application of provisions such as paragraph 5 of Article 11. It was therefore agreed that the Commentary on subparagraphs a) and b) should clarify that these subparagraphs do not cover property such as real estate and data, although they would cover tangible products that included data, such as CDs and DVDs.

### **15. Do “goods or merchandise” cover digital products or data? (paragraph 22 of the Commentary)**

#### **Description of the issue**

619. Does the reference to “goods or merchandise” in subparagraphs 4 a), b) and c) apply to digital products or, more generally, data?

620. This issue was discussed in the Business Profits TAG’s report “Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?” (section 4.A.d)):

For instance, it is not clear to what extent the reference to “goods or merchandise” in subparagraphs a), b) and c) can apply to digital products or, more generally, data. It is also not clear to what extent the words “storage” and “delivery” can apply to digital products downloaded from servers through computer networks ... Regardless of the views expressed on the option to eliminate these exceptions, the TAG agreed that it would be useful if these questions were dealt with in the Commentary in order to provide greater certainty to taxpayers and tax administrations as to the exact scope of the current exceptions included in paragraph 4.

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1     “...Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.”

***Recommendation of the Working Party***

621. The recommendation included in section 14 above addresses this issue.

***Background***

622. The Working Party concluded that since the storage of digital products would be done on servers, this issue appeared to have already been addressed through the explanations included in paragraphs 42.7 to 42.9 of the Commentary, which deal with the issue of whether activities carried on through servers are covered by the exceptions of Article 5(4). After the discussion of the issue in section 14 above, however, the Working Party concluded that the issue of the application of subparagraphs *a), b) and c)* to digital products and data could be easily addressed in combination with that other issue.

**16. Carrying on various activities listed alternatively in subparagraphs 4 *a) and b)* (paragraph 22 of the Commentary)**

***Description of the issue***

623. To what extent do the specific exceptions in subparagraphs 4 *a) and b)* apply if various activities listed alternatively in these subparagraphs are carried out at the same location and if these activities, taken together, go beyond the preparatory or auxiliary threshold so as to preclude the application of paragraph *f)*?

624. This issue was discussed in the Business Profits TAG's report "Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?" (section 4.A.e)):

The question was also discussed whether or not paragraph 4 would apply where various activities listed alternatively in subparagraph *a) and b)* are carried on at the same location and these activities go beyond the preparatory or auxiliary threshold so as to preclude the application of subparagraph *f)*. Regardless of the views expressed on the option to eliminate these exceptions, the TAG agreed that it would be useful if these questions were dealt with in the Commentary in order to provide greater certainty to taxpayers and tax administrations as to the exact scope of the current exceptions included in paragraph 4.

625. The Joint Working Group on Business Restructurings raised one specific example of that issue when it discussed whether the exception of subparagraph *a)*, which is applicable to "storage, display *or* delivery", would apply if two or all three of these activities were performed simultaneously at the same location.

***Recommendation of the Working Party***

626. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 22 of the Commentary on Article 5 by the following [other changes to paragraph 22 resulting from the recommendations in sections 13 and 14 would also be made to the paragraph]:*

22. Subparagraph *a)* relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph *b)* relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. *[the changes resulting from the recommendation in section 13 will be inserted here] These subparagraphs also cover situations where a facility is used, or a stock of goods or*

*merchandise is maintained, for any combination of storage, display and delivery since facilities used for the delivery of goods will almost always be also used for the storage of these goods, at least for a short period. [the changes resulting from the recommendation in section 14 will be inserted here; the rest of existing paragraph 22 is moved to new paragraph 22.1 – see section 13]*

### **Background**

627. The Working Party agreed that the issue, which relates to the fact that subparagraphs 4 a) and 4 b) refer alternatively to storage, display or delivery, was a relatively minor drafting issue; it concluded that the phrase “storage, display or delivery” in subparagraphs 4 a) and 4 b) should be interpreted as “storage, display and/or delivery” and that this should be made clear in the Commentary.

### **17. Negotiation of import contracts as an activity of a preparatory or auxiliary nature (paragraphs 24 and 25 of the Commentary)**

#### **Description of the issue**

628. The question was asked whether the observation in paragraph 44 of the Commentary reflects a disagreement with the interpretation of the permanent establishment definition included in the Commentary or with the views of other countries.

629. This observation by the Czech Republic and the Slovak Republic reads as follows:

44. The *Czech Republic* and the *Slovak Republic* would add to paragraph 25 their view that when an enterprise has established an office (such as a commercial representation office) in a country, and the employees working at that office are substantially involved in the negotiation of contracts for the import of products or services into that country, the office will in most cases not fall within paragraph 4 of Article 5. Substantial involvement in the negotiations exists when the essential parts of the contract — the type, quality, and amount of goods, for example, and the time and terms of delivery — are determined by the office. These activities form a separate and indispensable part of the business activities of the foreign enterprise, and are not simply activities of an auxiliary or preparatory character.

#### **Recommendation of the Working Party**

630. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 24 of the Commentary on Article 5 by the following:*

24. 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. 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 subparagraph e).  
[the rest of paragraph 24 is moved to new paragraph 24.1]

**24.1** A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or

auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called "management office" in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a "place of management" within the meaning of subparagraph *a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph *e*) of paragraph 4.

**24.2 Similarly, where an enterprise that sells goods worldwide establishes an office in one State, and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State (e.g. by participating in decisions related to the type, quality or quantity of products covered by these contracts) even if they do not exercise an authority to conclude contracts in the name of their employer, such activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph *e*) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment.**

Delete the following paragraph 44 of the Commentary on Article 5:

44. ~~The Czech Republic and the Slovak Republic would add to paragraph 25 their view that when an enterprise has established an office (such as a commercial representation office) in a country, and the employees working at that office are substantially involved in the negotiation of contracts for the import of products or services into that country, the office will in most cases not fall within paragraph 4 of Article 5. Substantial involvement in the negotiations exists when the essential parts of the contract — the type, quality, and amount of goods, for example, and the time and terms of delivery — are determined by the office. These activities form a separate and indispensable part of the business activities of the foreign enterprise, and are not simply activities of an auxiliary or preparatory character.~~

### **Background**

631. The Delegate for the Czech Republic indicated that the observation in paragraph 44 of the Commentary was an additional clarification rather than a disagreement with an interpretation included in the Commentary and that the reference to contracts "for the import of products or services" was merely illustrative. The situation that was envisaged in that observation was that of an office situated in a State that would be involved in the negotiation of important parts of contracts for the sale of goods to buyers in that State without exercising an authority to conclude contracts in the name of the enterprise. The Working Party agreed that a proposed clarification should be added to the Commentary to address the issue raised in that observation.

632. The Delegates for the Czech Republic and the Slovak Republic have both indicated that their countries would delete their its observations if the proposed change is included in the Commentary.

**18. Fragmentation of activities (paragraph 27.1 of the Commentary)*****Description of the issue***

633. Paragraph 27.1 of the Commentary on Article 5 reads as follows:

27.1 Subparagraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

634. In the context of the work on business restructurings, the question was asked whether and to what extent the language in paragraph 27.1 of the Commentary on Article 5 on the fragmentation of activities may be relevant in dealing with the situation in which a non-resident is doing through a converted (“stripped”) local enterprise what was previously done as a full-fledged operation.

***Recommendation of the Working Party***

635. The Working Party concluded that no changes should be made to the Commentary with respect to this issue because paragraph 27.1 of the Commentary deals with the combination of activities carried on by a single enterprise at different locations in a given State and is therefore not relevant in the situation where a foreign enterprise maintains places of business covered by the exceptions of Article 5(4) and a converted (“stripped”) local enterprise is also carrying on in that State activities that were previously carried on as a full-fledged operation. The Working Party also noted, however, that such situations could, depending on the circumstances, be addressed through the application of legislative or judicial anti-abuse rules (as was the case for the fragmentation of contracts referred to in paragraph 18 of the Commentary).

***Background***

636. The Working Party noted that paragraph 27.1 of the Commentary dealt with the fragmentation of an enterprise’s activities between different places of business of that same enterprise and was therefore not relevant in the situation where a foreign enterprise maintained places of business covered by the exceptions of Article 5(4) and a converted (“stripped”) local enterprise was also carrying on activities that were previously carried on as a full-fledged operation. It was also agreed, however, that whilst no changes should be made to the Commentary with respect to this issue, the report of the Working Party should recognise that such situations could, depending on the circumstances, be addressed through the application of legislative or judicial anti-abuse rules (as is the case for the fragmentation of contracts referred to in paragraph 18 of the Commentary). It was noted, however, that, in practice, a better approach will often be to examine whether the various local companies have received an arm’s length consideration for their activities.

**19. Meaning of “to conclude contracts in the name of the enterprise” (paragraph 32.1 of the Commentary)*****Description of the issue***

637. Does the phrase “to conclude contracts in the name of the enterprise” only refer to cases where the principal is legally bound vis-à-vis the third party, under agency law, by reason of the contract

concluded by the agent, or is it sufficient that the foreign principal is economically bound by the contracts concluded by the person acting for it in order for a permanent establishment to exist (provided the other conditions are met)?

638. This issue was discussed by the Joint Working Group on Business Restructurings and is illustrated by the following example, which was developed in the course of the preparation of the branch reports and general report for the IFA 2009 Congress:

#### ***Commissionnaire arrangements***

PARENTCO, a company resident of State R, and SUBCO, a company resident of State S, are parts of the same multinational group.

Until 2008, SUBCO is the distributor in State S of the products of PARENTCO, which it buys from its parent and resells in State S. In 2008, the distributorship arrangement is replaced by a contract of *commissionnaire*. Under that contract, SUBCO will act as an agent of PARENTCO to sell in State S products owned by PARENTCO. As such, SUBCO will accept orders, submit quotes and documents in tender offers and conclude sales contracts for PARENTCO's products and will be authorized to engage in price negotiations and to grant discounts or terms of payment with current or new customers without specific prior approval by PARENTCO.

In jurisdictions where agency law recognizes indirect representation, the contract will provide that SUBCO is acting as a *commissionnaire*. In jurisdictions where this is not possible, each contract concluded by SUBCO with a customer will specifically provide that the contract is exclusively between the parties and does not bind any other party, including PARENTCO.

In a separate agreement, PARENTCO has agreed to fully reimburse SUBCO for any amount that it may be required to pay customers under its contractual liability. PARENTCO will also control the types of products that will be sold through SUBCO.

639. A related issue that was discussed by the Joint Working Group on Business Restructurings in relation to such arrangements was whether a dependent agent permanent establishment could be deemed to exist if it were established that the arrangements entered into in a particular case did not make commercial sense and were primarily structured in such a way as to avoid the creation of a permanent establishment.

#### ***Recommendation of the Working Party***

640. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 32.1 of the Commentary on Article 5 by the following:*

32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.

***For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract. [the rest of existing paragraph 32.1 is moved to new paragraph 32.2]***

32.2 Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to

conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

### ***Background***

641. The Working Party had an extensive discussion of this issue based on recent court decisions on *commissionnaire* arrangements in France (*Zimmer Ltd.*) and Norway (*Dell DUF*).

642. A large part of the discussion focused on the meaning of the first sentence of paragraph 32.1 of the Commentary, the relevant part of which reads “paragraph [5] applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise”. Whilst there was also a reference to the second part of paragraph 32.1,<sup>1</sup> it was explained that this part of the paragraph did not deal with the issue of “in the name of” (*i.e.* whether or not the contract, once concluded, was binding on the foreign enterprise) but focussed instead on whether the activities of the agent were enough to consider that the agent had concluded the contract.

114. The Working Party agreed that whilst it was not possible to reach a common view on the situations dealt with in the court decisions, it would be helpful to add to paragraph 32.1 of the Commentary an example of a situation where a foreign principal would be bound by a contract even though the contract would not literally be concluded in his name.

643. The Working Party also examined comments received from BIAC on the phrase “concluding contracts in the name of”. It was explained that these comments referred to three particular situations: (1) “when a multinational group’s contracting policies require multiple personnel in an organization to approve contracts, not all of whom may be employees of the enterprise being bound”; (2) “when contracts are in a standard form for all customers (e.g., online contracts) so that no negotiation occurs when the contracts are formed”; and (3) “when sales are governed by a framework contract applicable to all group companies and there follows specific purchase orders in which various personnel are able to conclude contracts for specific entities within the framework agreement”. It was suggested that in cases 2 and 3, as long as sales contracts were concluded in the name of a foreign enterprise, the extent to which the person concluding these contracts (*e.g.* by accepting an order) was using standard contracts or was constrained by a framework contract would not seem to matter. With reference to case 3, one delegate indicated that his administration had dealt with a similar situation and had concluded that the acceptance of the order was the conclusion of the contract. It was clarified that this was done when the final nature and quantity to be delivered under the framework agreement was determined under a specific purchase order. As regards case 1, it was suggested that Article 5(5) referred to the level of approval that was decisive for the contract to be legally concluded, subject to the comments in paragraphs 32.1 to 33.1 of the Commentary. The Working Party agreed that these three cases raised questions of fact and that the Commentary already provided enough guidance to deal with them.

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1 “Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions”.

**20. Is paragraph 5 restricted to situations where sales are concluded? (paragraph 33 of the Commentary)**

***Description of the issue***

644. One of the conditions for an agency permanent establishment to exist is that the agent must have an *authority to conclude contracts* in the name of the foreign enterprise. The question was raised whether this means that the possible application of paragraph 5 to business restructurings is restricted to situations in which a full-fledged distributor is converted into a *commissionnaire* or other sales agent (that has and habitually exercises an authority to conclude contracts). Where a local manufacturer is converted into a contract or toll manufacturer or where a full-fledged research operation is converted into contract research, the converted local entity will not, in general, have an authority to conclude contracts with third parties.

645. This issue was raised during the work of the Joint Working Group on Business Restructurings.

***Recommendation of the Working Party***

646. The Working Party recommends that the following changes be made to the Commentary on Article 5 in order to address this issue:

*Replace paragraph 33 of the Commentary on Article 5 by the following (and renumber existing paragraph 33.1 as paragraph 33.2):*

33. *The types of contracts referred to in paragraph 5 are not restricted, however, to contracts for the sale of goods: the paragraph would cover, for example, a situation where a person has and habitually exercises an authority to conclude leasing contracts or contracts for services.* The authority to conclude contracts must, *however,* cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. *The types of contracts referred to in paragraph 5 are not restricted, however, to contracts for the sale of goods: the paragraph would cover, for example, a situation where a person has and habitually exercises an authority to conclude leasing contracts or contracts for services.* [the rest of paragraph 33 is moved to new paragraph 33.1]

33.1 Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. 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 fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

***Background***

647. The Working Party agreed that whilst paragraph 5 required the conclusion of contracts in the name of the foreign enterprise and could therefore not apply in the case of a local entity that did not have an authority to conclude contracts with third parties, the word “contracts” did not refer exclusively to contracts for the sale of goods and would include, for example, leasing contracts. It was agreed that this should be clarified in the Commentary.

**21. Does paragraph 6 apply only to agents who do not conclude contracts in the name of their principal?*****Description of the issue***

648. Does paragraph 6 only apply to agents who do not conclude contracts in the name of their principal?

649. The issue was discussed, but not addressed, during the work that led to the adoption of the report on Issues Arising under Article 5 (Permanent Establishment) of the Model Tax Convention, which was adopted by the OECD Committee on Fiscal Affairs on 7 November 2002.<sup>1</sup>

***Recommendation of the Working Party***

650. The Working Party noted that the term “general commission agent” used in the English version of paragraph 6 of Article 5 does not appear to correspond to the term *commissionnaire* used in the French version. It also noted that the Commentary seemed to include conflicting statements concerning the scope of paragraph 6. For these reasons, the Working Party concluded that this issue could not be addressed merely through changes to the Commentary.

**22. Assumption of entrepreneurial risk as a factor indicating independence*****Description of the issue***

651. As indicated in paragraph 38 of the Commentary, an important criterion for determining whether an agent is of an independent status is whether the entrepreneurial risk is borne by the agent or by the enterprise on behalf of which the agent is acting.

652. In 2002, the Working Party considered the following proposal for clarifying the meaning of entrepreneurial risk for the purposes of paragraph 38:

38.7 As indicated in paragraph 38 above, another important criterion the assumption of entrepreneurial risk is a distinguishing feature of the independent agent. The character of the remuneration which an agent receives may provide a useful indication of whether (or to what extent) the agent bears the commercial risk of his activities. Factors suggesting that risk is not borne by the agent include contractual protection from losses or guaranteed remuneration. However the existence of a guaranteed stream of revenues will not be decisive where the agent is able to show that there remains a real possibility of loss as a consequence of risk borne by him in the conduct of the business. Where the overall scale of the agent’s business is substantial this may be suggestive of the strength of the agent’s position vis-à-vis his principals and hence his independence. And instances

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1 Reproduced at page R(19)-1 in volume II of the full version of the Model Tax Convention.

where an agent has demonstrated the strength of his position in reaching agreements with principals may provide firm evidence of independence.

653. As a result of comments from business representatives concerning that proposed paragraph, the Working Party concluded that whilst there was no doubt that bearing the entrepreneurial risk was an important criterion to identify an independent agent (as already stated in paragraph 38), the clarification proposed in paragraph 38.7 raised a number of questions that should be more fully examined, in particular in light of the OECD Transfer Pricing Guidelines. It was therefore decided not to include paragraph 38.7 in the 2002 Update in order to be able to further examine its wording. It was also decided that the paragraph would be reviewed in the course of other work related to the concept of dependent agent with a view to its possible inclusion in a subsequent update.

#### ***Recommendation of the Working Party***

654. The Working Party concluded that it was not necessary to attempt to clarify the concept of “entrepreneurial risk”, which was used in only one of many factors put forward in paragraphs 38 to 38.6 for determining whether or not a person was an agent of an independent status.

### **23. Activities of fund managers**

#### ***Description of the issue***

655. Representatives of the European Venture Capital Association (EVCA) have put forward permanent establishment issues related to venture capital funds. These issues are described in the *Report of the Venture Capital Tax Expert Group on Removing Tax Obstacles to Cross-Border Venture Capital Investments* (VC Tax Expert Group), which was published on 30 April 2010.<sup>1</sup>

#### ***Recommendation of the Working Party***

656. The Working Party concluded that the issues raised by EVCA, including the question of “independence”, were essentially dependent on facts and circumstances. Some of the conclusions reached on other issues might be relevant and the Working Party did not consider that more specific guidance could be provided to the venture capital industry. The Working Party also agreed, however, that the following analysis of the application of the concepts of “enterprise of a Contracting State” and “permanent establishment” in the case of a venture capital fund set up as a limited partnership could provide useful guidance:

The definition of “enterprise of a Contracting State” in Article 3(1) refers to “an enterprise carried on by a resident of a Contracting State”.

The term “enterprise” itself is not defined, even though subparagraph *d*) of Article 3(1) clarifies that “it applies to the carrying on of any business”. The first part of paragraph 4 of the Commentary on Article 3 reflects different views as to whether the term refers to the organisation that carries on a business activity or to the activity itself:

The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the

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See  
[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/initiatives\\_small\\_businesses/venture\\_capital/tax\\_obstacles\\_venture\\_capital\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/initiatives_small_businesses/venture_capital/tax_obstacles_venture_capital_en.pdf).

domestic laws of the Contracting States. No exhaustive definition of the term “enterprise” has therefore been attempted in this Article.

This ambivalence between the view that an enterprise is a business organisation and the view that it is a business activity appears in different parts of the Convention. In the context of Article 5(1), which refers to “the business of an enterprise”, it seems difficult, however, to refer to an enterprise as an activity and the term therefore seems to correspond to a business organisation. On that basis, the term would cover any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form.

In the particular case of an enterprise taking the form of a fiscally transparent partnership, that enterprise should be viewed as a distinct enterprise carried on by the partners who share the profits of that joint enterprise. Paragraph 19.1 of the Commentary on Article 5 confirms that position (see also the third example in paragraph 42.38); that paragraph deals with the situation of a transparent partnership and concludes that:

In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve month[s], the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site. *[the Working Party’s recommendation in section 9 above would amend paragraph 19.1 without affecting this interpretation]*

Applying this analysis to a venture capital fund set up as a transparent limited liability partnership, one would therefore consider that the fund forms a distinct enterprise carried on jointly by the limited partners and the general partner, who all share in the profits of that joint separate enterprise (*i.e.* separate from the partners’ respective enterprises). This enterprise being carried on by each partner, it constitutes an enterprise of each Contracting State of which a partner is a resident as regards the share of that particular partner.

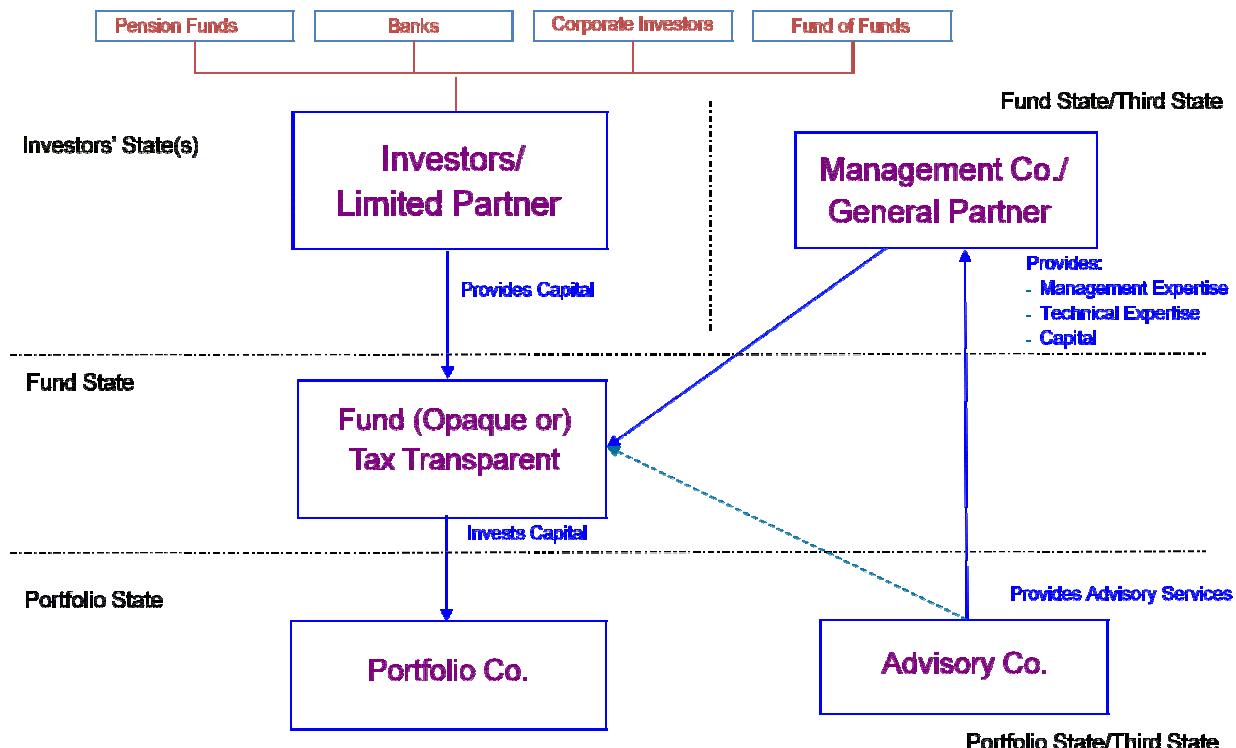
It follows from the above analysis that the reference, in Article 5(5), to a person acting on behalf of an enterprise and having the authority to conclude contracts in the name of that enterprise must therefore be applied with respect to the partnership, which is the relevant enterprise in whose name the fund’s investment contracts could be concluded. If the conditions of paragraph 5 are met, it is that enterprise that will be considered to have a permanent establishment, and the result will be that an enterprise of each Contracting State in which a partner is a resident (in proportion to the share of the profits of that partner) will be considered to have a permanent establishment.

The analysis should be the same for the purposes of Article 5(6) and the independent status of a local fund manager should therefore be determined in relation to the limited partnership itself rather than by reference to each investor in that partnership.

### ***Background***

657. The Working Party discussed this issue on the basis a note presented on behalf of EVCA and the report mentioned above. It also took account of the conclusions reached on the application of paragraph 3

to joint venture and partnership activities (see section 9 above). It examined in detail the following example included in the report:



658. The main issues raised by that example were

- whether the fund carried on a business;
- which enterprise's business was carried on through the activities of the local advisory company;
- how did the transparent status of the fund affect the application of the concepts of "enterprise" and "permanent establishment";
- whether the local advisory company or fund manager could claim to be an independent agent for the purposes of Article 5(6).

659. It was explained that an important practical issue was whether a local fund manager could be considered to be an independent agent in the event that it would be found to conclude contracts in the name of the enterprise. This, in turn, would depend on what was the "enterprise of a Contracting State" in the case of a fund.

660. Whilst it was suggested that the issue would not arise as long as the local fund manager would not exercise an authority to conclude contracts, it was noted that EVCA's concern was that, in practice, it was difficult to ensure that the managers did not practically negotiate all the main elements of the contracts and that it seemed artificial and restrictive to limit the local expert's activities to giving advice on the investments of the fund.

661. The Working Party discussed what clarification, if any, could be provided concerning this issue. It was concluded that it would be difficult to provide specific guidance as the situation was highly factual and was not restricted to venture capital funds. It was also concluded, however, that an analysis of the application of the concept of "enterprise" and "permanent establishment" in the case of a partnership could usefully be provided.

#### **24. Clarification of paragraph 8 of the Commentary on Article 5**

##### ***Description of the issue***

662. Should paragraph 8 of the Commentary on Article 5, which deals with leasing activities, be clarified to provide that there will be a permanent establishment only if there is an office where leasing contracts are signed or rental equipment is stored?

663. When this issue was first discussed, the delegate who had raised it indicated that it related to the issue of whether a server farm that would lease server capacity would constitute a permanent establishment. It was concluded that this was somewhat different from the issue described above and that it seemed clear that a server farm through which an enterprise would lease server capacity to third parties would constitute a permanent establishment of the enterprise but not of the third parties (as indicated in paragraph 42.7 to 42.9 of the Commentary). It was noted, however that the issue would be different in the case of the maintenance of a server farm by an enterprise, such as a bank, which would store its own data on the servers; this led the Working Party to discuss the circumstances in which storing data on its own servers would constitute preparatory or auxiliary activities

##### ***Recommendation of the Working Party***

664. The Working Party concluded that this issue was already dealt with in paragraphs 42.7 to 42.9 of the Commentary; since the question of whether activities carried on through a server are preparatory or auxiliary was essentially factual, it was agreed that no further clarification could be provided.

#### **25. Activities of insurance agents**

##### ***Description of the issue***

665. To what extent do activities of local insurance agents who refer contracts for final approval by the foreign insurance company create a permanent establishment?

666. The issue is illustrated by the following example developed in the course of the preparation of the branch reports and general report on the topic "Is there a Permanent Establishment?" for the IFA 2009 Congress:

##### ***Insurance agents***

ICO is a life insurance company resident in State R. It sells life insurance in State S through agents. All the agents work out of their private homes and thus do not need separate offices. Some minor paper work is done at home. None of the agents are employed by ICO but they work solely for ICO. The agents offer insurance policies on behalf of ICO, receive the applications from the clients and send them over to ICO in State R. The insurance policy is not in force until ICO has received and reviewed the medical information related to each client. In the meantime, a temporary life insurance policy is in force. This policy is automatically terminated when the draft policy is approved or rejected by ICO. Over time, ICO rejects some 10 per cent of the policies submitted by the agents.

***Recommendation of the Working Party***

667. The Working Party concluded that this issue was basically a policy question: whether the conclusion expressed in paragraph 39 of the Commentary that “it did not seem advisable to insert” a special provision for insurance agents was still shared by the member States. Since few countries included such a special provision in their treaties, it was agreed that no changes should be made to the Commentary with respect to this issue.

**ANNEX TO THE DISCUSSION DRAFT****CONSOLIDATED VERSION OF PARAGRAPHS 1 TO 42.10 OF THE COMMENTARY ON  
ARTICLE 5 AS AMENDED BY THE PROPOSALS INCLUDED IN THIS NOTE**

*[Changes to the existing version of the Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions; changes to the proposals included in the discussion draft of 12 October 2011 are underlined]*

1. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

1.1 Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.

*Paragraph 1*

2. Paragraph 1 gives a general definition of the term “permanent establishment” which brings out its essential characteristics of a permanent establishment in the sense of the Convention, *i.e.* a distinct “situs”, a “fixed place of business”. The paragraph defines the term “permanent establishment” as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

- the existence of a “place of business”, *i.e.* a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be “fixed”, *i.e.* it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, *i.e.* contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a “productive character” it is consequently a permanent establishment to which

profits can properly be attributed for the purpose of tax in a particular territory (see Commentary on paragraph 4).

**3.1 It is also important to note that the way in which business is carried on evolves over the years so that the facts and arrangements applicable at one point in time may no longer be relevant after a change in the way that the business activities are carried on in a given State. Clearly, whether or not a permanent establishment exists in a State during a given period must be determined on the basis of the circumstances applicable during that period.**

**3.2 Also, the determination of whether or not an enterprise of a Contracting State has a permanent establishment in the other Contracting State must be made independently from the determination of which provisions of the Convention apply to the profits derived by that enterprise. For instance, a farm or apartment rental office situated in a Contracting State and exploited by a resident of the other Contracting State may constitute a permanent establishment regardless of whether or not the profits attributable to such permanent establishment would constitute income from immovable property covered by Article 6; whilst the existence of a permanent establishment in such cases may not be relevant for the application of Article 6, it would remain relevant for the purposes of other provisions such as paragraphs 4 and 5 of Article 11, subparagraph 2 c) of Article 15 and paragraph 3 of Article 24.**

4. The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. **Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This is illustrated by the following examples. Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise. This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a continuous and regular basis during an extended period of time at a location that belongs to another enterprise or that is used by a number of enterprises. This will not be the case, however, where the enterprise’s presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise (e.g. where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time). Where an enterprise does not**

*have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise (see also paragraph 42 below). It is also important to remember that even if a place is a place of business through which the activities of an enterprise are partly carried on, that place will be deemed not to be a permanent establishment if ~~the only~~ the business activities carried on at that place ~~are those listed in all fall within the scope of paragraph 4.~~ [the rest of existing paragraph 4.2 is moved to new paragraphs 4.3 and 4.4]*

**4.3** These principles are illustrated by the following additional examples where representatives of one enterprise are present on the premises of another enterprise.

**4.4** A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

**4.53** A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

**4.64** A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

**4.75** A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

**4.8** *Even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is at the disposal of used by an individual (e.g. an employee) who works for the enterprise. Whether or not a home office constitutes a location at the disposal of the enterprise will depend on the facts and circumstances of each case. In many cases, the carrying on of business activities at the home of an individual (e.g. an employee) will be so intermittent or incidental that the home will not be considered to be a location at the disposal of the enterprise (see paragraph 4.2 above). Where, however, a home office is used on a regular and continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on the enterprise's business the individual to work from home (e.g. by not providing an office to an employee in circumstances where*

*the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise.*

**4.9** *A clear example is that of a non-resident consultant who is present for an extended period in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise. Where, however, a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities. It should be noted, however, that since the vast majority of employees reside in a State where their employer has at its disposal one or more places of business to which these employees report, the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue. Also, the activities carried on at a home office will often be merely auxiliary and will therefore fall within the exception of subparagraph e) of paragraph 4.*

**4.106** The words “through which” must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business “through” the location where this activity takes place.

5. According to the definition, the place of business has to be a “fixed” one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but see paragraph 20 below).

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single “place of business” (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an “office hotel” in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a

building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

*5.5 Similarly, a ship or boat that navigates between States or in within territorial waters or in inland waterways in international waters or within one or more States is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship or boat, such as a shop or restaurant, must be treated the same way for the purposes of determining whether paragraph 1 applies (paragraph 5 could apply, however, where contracts are concluded when such shops or restaurants are operated within a State).*

5.65 Clearly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State. The question of whether a satellite in geostationary orbit could constitute a permanent establishment for the satellite operator relates in part to how far the territory of a State extends into space. No member country would agree that the location of these satellites can be part of the territory of a Contracting State under the applicable rules of international law and could therefore be considered to be a permanent establishment situated therein. Also, the particular area over which a satellite's signals may be received (the satellite's "footprint") cannot be considered to be at the disposal of the operator of the satellite so as to make that area a place of business of the satellite's operator.

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by ~~n~~Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). [the rest of the paragraph is moved to new paragraphs 6.1 to 6.3]

6.1 One exception to *this general practice* has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). *That exception is illustrated by the following example. An individual resident of State R rents a stand at a commercial fair in State S for 15 consecutive years where he sells sculptures during a period of five weeks each year. An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for 5 years. In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any*

consecutive continuous presence lasts less than 6 months; the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business).

**6.2** Another exception to this **general** practice has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. *That exception is illustrated by the following example. An individual resident of State R has learned that a television documentary will be shot in a remote village in State S where her parents still own a large house. Since the documentary will require the presence of a number of actors and technicians in that village during a period of four months, she decides to transform the house of her parents into a small restaurant which she will. The individual contractually agrees with the producer of the documentary to provide catering services to the actors and technicians during the four month period and, pursuant to that contract, she uses the house of her parents as a cafeteria that she operates as sole proprietor during that period. These are the only business activities that she has carried on and she does not intend to carry on such activities in the future—the enterprise is terminated after that period; the cafeteria-restaurant will therefore be the only location where the business of that enterprise will be wholly carried on. In that case, it could be considered that the time requirement for a permanent establishment is met since the restaurant is operated during the whole existence of that particular business. This would not be the situation, however, where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four week international sports event. In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S.*

**6.3** For ease of administration, countries may want to consider these practices **reflected in paragraphs 6 to 6.2** when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

**6.44** As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

**6.52** Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12 month period provided for in paragraph 3 would equally apply to such cases.

**6.63** Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus—retrospectively—a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated.

**7.** For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances.

9. The leasing of containers is one particular case of the leasing of industrial or commercial equipment which does, however, have specific features. The question of determining the circumstances in which an enterprise involved in the leasing of containers should be considered as having a permanent establishment in another State is more fully discussed in a report entitled "The Taxation of Income Derived from the Leasing of Containers".<sup>1</sup>

9.1 Another example where an enterprise cannot be considered to carry on its business wholly or partly through a place of business is that of a telecommunications operator of a Contracting State who enters into a "roaming" agreement with a foreign operator in order to allow its users to connect to the foreign operator's telecommunications network. Under such an agreement, a user who is outside the geographical coverage of that user's home network can automatically make and receive voice calls, send and receive data or access other services through the use of the foreign network. The foreign network operator then bills the operator of that user's home network for that use. Under a typical roaming agreement, the home network operator merely transfers calls to the foreign operator's network and does not operate or have physical access to that network. For these reasons, any place where the foreign network is located cannot be considered to be at the disposal of the home network operator and cannot, therefore, constitute a permanent establishment of that operator.

10. ***There are different ways in which an enterprise may carry on its business. In most cases, the business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business of the enterprise (see paragraph 35 below). [the rest of the existing paragraph becomes new paragraph 10.2] As explained in paragraph 8.11 of the Commentary on Article 15, however, there may be cases where individuals who are formally employed by an enterprise will actually be carrying on the business of another enterprise and where, therefore, the first enterprise should not be considered to be carrying on its own business at the location where these individuals will perform that work. Within a multinational group, it is relatively frequent common for employees of one company to be temporarily seconded to another company of the group and to perform***

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1 Reproduced in Volume II of the *full* version of the OECD Model Tax Convention, at page R(3)-1.

*business activities that clearly belong to the business of that other company. In such cases, administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract. The analysis described in paragraphs 8.13 to 8.15 of the Commentary on Article 15 will be relevant for the purposes of distinguishing these cases from other cases where employees of a foreign enterprise perform that enterprise's own business activities.*

**10.1** *An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met. In the context of paragraph 1, that will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise for reasons other than the mere fact that these subcontractors perform such work at that location (see paragraph 4.2 above). Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 4.2; in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. Paragraph 19.1 illustrates such a situation in the case of a construction site; this could also happen in other situations. An example would be where an enterprise that owns a small hotel and rents out the hotel's rooms through the Internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis.*

**10.2** *But also, a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.*

**10.3** *It follows from the definition of "enterprise of a Contracting State" in Article 3 that this term, as used in Article 7, and the term "enterprise" used in Article 5, refers to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form. Different enterprises may collaborate on the same project and the question of whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State. Clearly, if two enterprises carried on by different persons each carrying on a separate enterprise decide to form a company in which these persons are shareholders, the company constitutes a legal person that will carry on what becomes another separate enterprise. It will often be the case, however, that different enterprises will simply agree to each carry on a separate part of the same project and that these enterprises will not jointly carry on business activities and share the profits thereof even though they may share the overall output from the project or the remuneration for the activities that will be carried on in the context of that project (e.g. what is considered to be a "joint venture" according to the law of some countries). In such a case, it would be difficult to consider that a separate enterprise has been set up. Although such an arrangement would be referred to as a "joint venture" in many countries, the meaning of "joint venture" depends on domestic law and it is therefore possible that, in some countries, the term "joint venture" would refer to a distinct enterprise.*

**10.4** *In the case of an enterprise that takes the form of a fiscally transparent partnership, the enterprise is carried on by each partner and, as regards the partners' respective shares of the profits, is*

***therefore an enterprise of each Contracting State of which a partner is a resident. If such a partnership has a permanent establishment in a Contracting State, each partner's share of the profits attributable to the permanent establishment will therefore constitute, for the purposes of Article 7, profits derived by an enterprise of the Contracting State of which that partner is a resident (see also paragraph 19.21 below).***

11. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

#### *Paragraph 2*

12. This paragraph contains a list, by no means exhaustive, of examples ***of places of business***, each of which can be regarded, *prima facie*, as constituting a permanent establishment ***under paragraph 1 provided that it meets the requirements of that paragraph***. As these examples are to be seen against the background *read in the context* of the general definition given in paragraph 1, ~~it is assumed that the Contracting States interpret the terms listed, "a place of management", "a branch", "an office", etc. must be interpreted~~ in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1 **and are not places of business to which paragraph 4 applies**.

13. The term "place of management" has been mentioned separately because it is not necessarily an "office". However, where the laws of the two Contracting States do not contain the concept of "a place of management" as distinct from an "office", there will be no need to refer to the former term in their bilateral convention.

14. Subparagraph *f*) provides that mines, oil or gas wells, quarries or any other place of extraction of natural resources are permanent establishments. The term "any other place of extraction of natural resources" should be interpreted broadly. It includes, for example, all places of extraction of hydrocarbons whether on or off shore.

15. Subparagraph *f*) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

- a) shall be deemed not to have a permanent establishment in that other State; or
- b) shall be deemed to carry on such activities through a permanent establishment in that other State; or
- c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

*Paragraph 3*

16. The paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed through that office or workshop, taking into account the assets used and the risks assumed through that office or workshop, are attributed to the permanent establishment. This could include profits attributable to functions performed in relation to the various construction sites but only to the extent that these functions are properly attributable to the office.

17. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Additionally, the term "installation project" is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

18. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses). The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

19. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. *[the six subsequent sentences have been moved to new paragraph 19.1]* If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts ***all or*** parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. ***In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where the general contractor has overall responsibility for the site and the site is made available to that general contractor for the purposes of carrying on its construction business circumstances indicate that, during that time, the general contractor clearly has***

**the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period.** The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.

**19.1** In general, ~~it-a site~~ continues to exist until the work is completed or permanently abandoned. **The period during which the building or its facilities are being tested by the contractor or subcontractor should therefore generally be included in the period during which the construction site exists. In practice, the delivery of the building or facilities by the client will usually represent the end of the period of work, provided that the contractor and subcontractors no longer work on the site after its delivery for the purposes of completing its construction.** A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1 May, stopped on 1 November because of bad weather conditions or a lack of materials but resumed work on 1 February the following year, completing the road on 1 June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1 May) and the date he finally finished (1 June of the following year). **Work that is undertaken on a site after the construction work has been completed pursuant to a guarantee that requires an enterprise to make repairs would normally not be included in the original construction period. Depending on the circumstances, however, any subsequent work (including work done under a guarantee) performed on the site during an extended period of time may need to be taken into account in order to determine whether such work is carried on through a distinct permanent establishment.**

**19.24** In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve months, the enterprise carried on ~~by-through~~ the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site. **Assume for instance that a resident of State A and a resident of State B are partners in a partnership established in State B which carries on its construction activities on a construction site situated in State C that lasts 10 months. Whilst the tax treaty between States A and C is identical to the OECD Model, paragraph 3 of Article 5 of the treaty between State B and State C provides that a construction site constitutes a permanent establishment only if it lasts more than 8 months. In that case, the time-threshold of each treaty would be applied at the level of the partnership but only with respect to each partner's share of the profits covered by that treaty; since the treaties provide for different time-thresholds, State C will have the right to tax the share of the profits of the partnership attributable to the partner who is a resident of State B but will not have the right to tax the share attributable to the partner who is a resident of State A. This results from the fact that whilst the provisions of paragraph 3 of each treaty are applied at the level of the same enterprise (i.e. the partnership), the outcome differs with respect to the different shares of the profits of the partnership depending on the time-threshold of the treaty that applies to each share.**

**20.** The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

*Paragraph 4*

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. *Where the only activities carried on at a fixed place of business are activities to which one of subparagraphs a) to d) apply, Where each of the activities listed in subparagraphs a) to d) is the only activity carried on at a fixed place of business, the place is deemed not to constitute a permanent establishment.* The common feature of these activities is that they are, in general, preparatory or auxiliary activities. *Since subparagraph e) deals with other unspecified activities, however, the requirement that the activity must have a preparatory or auxiliary character has been* This is laid down explicitly in the case of the exception mentioned in *that* subparagraph-e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

22. Subparagraph a) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. *Subparagraphs a) and b) apply regardless of whether the storage or delivery takes place before or after the goods or merchandise have been sold provided that the goods or merchandise belong to the enterprise whilst they are at the relevant location (e.g. the subparagraphs would remain applicable if some of the goods that are stored at a location have already been sold but the property title to these goods will only pass to the customer after their delivery).* These subparagraphs also cover situations where a facility is used, or a stock of goods or merchandise is maintained, for any combination of storage, display and delivery since facilities used for the delivery of goods will almost always be also used for the storage of these goods, at least for a short period. In the context of these subparagraphs, the words "goods" and "merchandise" refer to tangible property that can be stored, displayed and delivered and would not cover, for example, immovable property and data (although the subparagraphs would cover tangible products that include data such as CDs and DVDs).

**22.1** Subparagraph c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

23. Subparagraph e) 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. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business; *and may well contribute to the productivity of the enterprise, involve activities which are so remote from the actual realisation of profits by the enterprise that they* should not be treated as permanent establishments. *It is recognised 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 realisation 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 or auxiliary character.

24. 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. 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 subparagraph e). [the rest of paragraph 24 is moved to new paragraph 24.1]

**24.1** A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called "management office" in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a "place of management" within the meaning of subparagraph a) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4.

**24.2** *Similarly, where an enterprise that sells goods worldwide establishes an office in one State, and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State (e.g. by participating in decisions related to the type, quality or quantity of products covered by these contracts) even if they do not exercise an authority to conclude contracts in the name of their employer, such activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment.*

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph a) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph e) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

26. Moreover, subparagraph e) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph e).

26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a*), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e*) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a*) would be applicable. An additional question is whether the cable or pipeline could also constitute a permanent establishment for the customer of the operator of the cable or pipeline, *i.e.* the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the subparagraphs *a*) to *e*) of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of subparagraph *e*) (see paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in subparagraph *f*).

27.1 Subparagraph *f*) is of no relevance-importance in a case where an enterprise maintains several fixed places of business within the meaning of to which subparagraphs *a*) to *e*) apply provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. The same approach applies  
A similar issue arises where an enterprise that maintains in a Contracting State one or more fixed places of business within the meaning of to which subparagraphs *a*) to *e*) apply is also deemed, through the application of paragraph 5, to have a permanent establishment in the same State; in that case, if the activities that resulted in that deemed permanent establishment are not separated organisationally from these fixed places of business, it could not be argued that the enterprise is solely engaged in a preparatory or auxiliary activity at these places.

28. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts

necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 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 advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

29. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (see paragraph 11 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under subparagraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

30. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

#### *Paragraph 5*

31. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents *i.e.* persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the

paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. *For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract.* [the rest of existing paragraph 32.1 becomes paragraph 32.2]

32.2 Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

33. ~~The types of contracts referred to in paragraph 5 are not restricted, however, to contracts for the sale of goods: the paragraph would cover, for example, a situation where a person has and habitually exercises an authority to conclude leasing contracts or contracts for services.~~ The authority to conclude contracts must, however, cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. ~~The types of contracts referred to in paragraph 5 are not restricted, however, to contracts for the sale of goods: the paragraph would cover, for example, a situation where a person has and habitually exercises an authority to conclude leasing contracts or contracts for services.~~ [the rest of paragraph 33 is moved to new paragraph 33.1]

33.1 Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. 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 fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

33.24 The requirement that an agent must "habitually" exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, *i.e.* not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.

35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

### ***Paragraph 6***

36. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (see paragraph 32 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

- a) he is independent of the enterprise both legally and economically, and
- b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.

38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.5 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of

information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

38.7 Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

39. According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

#### ***Paragraph 7***

40. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

41. A parent company may, however, be found, under the rules of paragraphs 1 or 5 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 is at the disposal of the parent company (see paragraphs 4, 5 and 6 above) and 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, subject to paragraphs 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). 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 (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.

41.1 The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 4, 5 and 6 above) and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article (see paragraphs 32, 33 and 34 above). The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

#### ***Electronic commerce***

42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web

site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise that operates that server.

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5 Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary covered by paragraph 4 include:

- providing a communications link — much like a telephone line — between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary within the meaning of subparagraphs 4 e) and f) or otherwise covered by paragraph 4. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary or not otherwise covered by paragraph 4. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet or are otherwise covered by paragraph 4 (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary covered by paragraph 4.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISPs. Whilst this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a “person” as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph.

*[the rest of the Commentary on Article 5 is unchanged]*