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Our Ref: JH/AL/GP

Dear Sir,

Revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention

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

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.

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.

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.

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.

Further detailed comments are provided in the attached appendix.

Yours sincerely

John Henshall
Partner - Transfer Pricing

Deloitte.

Appendix

Meaning of "at the disposal of" (paragraph 4.2 of the Commentary)
It is not clear to us the meaning of the phrases "continuous", "effective power" or "extended period of time".

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.

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)
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)
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.

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)
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.

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.

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.

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.

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

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.

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

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."

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)
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).

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

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.***