TAX EXECUTIVES INSTITUTE, INC.

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Tax Treaties, Transfer Pricing and
Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic
Co-operation and Development
2, Rue André Pascal
75775 Paris
France

VIA EMAIL: taxtreaties@oecd.org

Re: *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention – Revised Public Discussion Draft*

Dear Sir or Madam:

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

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

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.[1] 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 rather on their substance . . . ."[2] The Revised Draft notes that these comments will be examined at a meeting of Working Party No. 1 in February of this year.[3]

General Comments on the Revised Draft

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.

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.

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

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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.

2 Revised Draft, page 1.

3 *Id*.

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

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)"[4]

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 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.[5] 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.

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.

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"

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4 *Id*. at 5-8.

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

period at a particular location, which would be consistent with Paragraphs 6 and 42 of the Commentary.

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**).

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

> 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)"[6]

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 . . . ."[7] 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)"[8]

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.[9] 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.

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 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.

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6 *Id*. at 9-11.

7 *Id*. at 10.

8 *Id*. at 12-15.

9 *Id*. at 14.

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.

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"[10] 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.

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)"[11]

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

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10 *Id*.

11 *Id*. at 17-19.

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 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.

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.

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)"[12]

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).

Conclusion

TEI appreciates the opportunity to present its views on the Revised Draft. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose

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12 *Id*. at 33-35.

Chair is Anna M. L. Theeuwes. If you have any questions about the submission please contact Ms. Theeuwes at +31 70 377 3199 (or an.m.l.theeuwes@shell.com), or Benjamin R. Shreck of TEI's legal staff at +1 202 638 5601 (or bshreck@tei.org).

Respectfully Submitted,

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