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OECD Model Tax Convention:
Revised proposals concerning the interpretation and application of Art. 5 (permanent establishment)
19 October 2012 to 31 January 2013

Ladies and gentlemen,

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.

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

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.

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.

Paragraph 4.2. 5th 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 "*incidential*" in paragraph 4.2. 6th sentence. Is a one week's disposal sufficient, is it one month, or four months?

The example of a contract- manufacturer in the 7th 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 ver-

sion, where the principal not only provides the goods to be processed but also special tooling and machines and/or 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

Paragraph 4.8. 4th 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.

Paragraph 6 4th 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 1st 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 5th 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."*

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.

Similar objections apply to the example presented in para 6.2. 2nd 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.

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 require, which, how-

ever, 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.

In the **absence of employees** of the enterprise paragraph 10.1., 4th 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

Paragraph 19 2nd 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 3rd 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.

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 func-**

tions" 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 2nd sentence of the Commentary.

OECD-MTC-Commentary, paragraph 19.1.

We support the language of paragraph 19.1. 2nd 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. 2nd 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.

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.

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 ("commissionaire arrangements"). High courts decided in different ways. The **French** High Court considered a commissionaire 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. 2nd 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.

Paragraph 32.2 1st 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.

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.

Kindly yours

Dr. Ralph Wiechers