Revised public discussion draft on the interpretation and application of Article 5 (permanent establishment) of the OECD Model Tax Convention

Dear Ms. Perez-Navarro,

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).

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.

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.
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"

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

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

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.

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.

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.

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

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.

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

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.”

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:

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).

For any further information and questions please don’t hesitate to contact us.

Yours faithfully

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