

To Tax Treaties, Transfer Pricing and
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OECD/CTPA

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Subject Comments regarding revised proposals on article 5

Dear Sir or Madam,

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.

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.

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).

Further the Revised Proposed Changes are contradictive 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

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

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.

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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”.

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.

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.

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

We also objected to the approach of discussing a lot of rather complicated and exotic examples based on weak concepts.

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

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.

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...”.

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.

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.

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

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

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 misleading 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

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.

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 contradictive to the newly included paragraph 3.1 of the Commentary¹, 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”.

We highly advise to remove this example, since it poses a lot of questions and uncertainties.

3 Final Conclusion/Proposal (reprise)

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.

¹ Shown on sec. 19 of the Revised Proposed Changes

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.

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.

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.

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. In case of any questions please do not hesitate to contact us.

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