

From: Hans Pijl (Deloitte Amsterdam, Tax Court of Appeals in The Hague, University of Leiden, and ITC Leiden)

To: Jeffrey Owens

Date: 9 March 2007

Subject: Comments on “The Tax Treaty Treatment of Services: Proposed Commentary Changes” - discussion draft of 8 December 2006

Dear Jeffrey,

Policy

What follows in this paragraph should not be read as my view on the proper tax policy as to service activities, and whether or not your choice is correct. It merely expresses my view on your arguments to justify the OECD’s basic non-extension of the PE concept.

As to paragraphs 42.11 and 42.12 of the proposed Commentary, I have some doubts whether the arguments put forward in these paragraphs can justify the non-inclusion of a service PE.

1. It seems that the final sentence of paragraph 42.11 (which seems to refer to the place of business PE in Article 5(1)) is contradicted by Article 5(5), which is not based on “the same permanent establishment threshold” either.
2. The compliance issue (paragraph 41.12) also arises in case of traditional PEs, as the permanence test under Article 5(1) and the 12 months’ test under Article 5(3) are equally based on counting days.
3. In Article 5(1) and Article 5(3) situations, retrospective compliance issues (you refer to them in paragraph 41.12) arise as well. (These issues become especially manifest in the levying of wage tax, which oftentimes is a monthly obligation.) In addition, practice is able to deal with them in those situations.

As to paragraph 42.13, I believe that the issue of profit determination and collection cannot sufficiently justify non-inclusion. In Article 5(3) and Article 5(5) situations, too, calculating an enterprise’s profit can be problematic (as may be inferred from the pending discussion about the agency part of the Discussion Draft on the Attribution of Profits to Permanent Establishments). In those situations, taxpayers often do not have the accounting records available, and it may be difficult to attribute assets to those PEs as well.

The absence of a dependent agent who could comply with information and collection requirements (paragraph 41.13) may also pose a problem in Article 5(5) cases (as well as in Article 5(3) cases), for instance in situations where the PE triggering person (such as an agent living in a third State) has meanwhile left the PE State.

As for cases where the dependent agent is still present in the PE State, the possibility of making him responsible for the enterprise's obligations is not a treaty issue but rests on domestic law. (E.g., Section 37 of the Dutch Tax Collection Act imposes joint and several liability for wage tax obligations on the manager of a PE in the Netherlands, an agent living or established in the Netherlands, or the person managing the activities performed in the Netherlands.) Currently, we also have the problem described in paragraph 42.13, for which countries have drawn the domestic law consequences ¹.

As a conclusion, I believe that these administrative and compliance arguments are not fully convincing. It would perhaps be better to state that the OECD is of the opinion that the extension of the PE principle has now, after the 2003 additions to the Commentary, reached its maximum reach, and that the business community should not be *further* bothered with situations that trigger additional compliance requirements, and that cross-border investments would suffer from measures introducing a new source State principle. *Further* is of essence here: in that sense the arguments can carry themselves, but in my view not in isolation with regards to the service PE.

The geographical connection

Paragraph 42.18 confirms the view that only income from services that are physically performed *in* the PE State can be taken into account, and that services performed *outside* that State are excluded. That seems correct from a policy perspective, but it leads to a connected issue as to agency PEs.

In general, the geographical location of a PE under Article 5(1) or 5(3) is based on the word “in” as used in Article 7(1), which cannot be explained otherwise than as referring to the local presence meaning of “in” (see also paragraph 1 of the Commentary on Article 7).

For deemed PEs under Article 5(5) - and in the proposed service PE paragraph- the situation is different. There is a double fiction in that paragraph and a double “in”. There is a double fiction, because (i) the enterprise is deemed to have a PE which (ii) is deemed to be locally situated in the PE State. (The second “in” cannot be interpreted other than in a geographical sense, and the fiction created has its influence on Article 7(1): “through a permanent establishment situated therein”.)

¹ Please note that “the person managing the activities performed in the Netherlands” in Section 37 of the Dutch Tax Collection Act already covers possible service PEs.

The first “in” in Article 5(5), i.e. “habitually exercises, *in* a Contracting State an authority to conclude contracts ...”, and the first “in” as used in the alternative services PE paragraph (“performs services *in*”) needs further explanation.

This is –for the service PE- done in paragraph 42.18, which explains that “services in” may not be understood as services being performed outside that State.

This may not be not completely clear ² in relation to the first “in” in Article 5(5). It may be that the geographical interpretation (the agent must be exercising his authority physically “in” the other State –subject to paragraph 32 of the Commentary to Article 5-) is the proper interpretation, but it may also be that the domestic law term "business income derived from carrying on business in that State" (which also refers to factors other than just the place where the contract is concluded, such as the place where the bank account is held or where the goods are located) has an impact on the interpretation of the preposition “in” in the treaty.

As this is a “fundamental issue” (paragraph 42.19), it might be useful to make this into a general statement which applies to Article 5(5) as well, if only to avoid an *a contrario* argument so that what is made explicit in the service paragraph and is omitted from the agency context has interpretational value.

Net or gross profits

As to paragraph 42.19, in a proper interpretation of Article 7, it is left at the State’s discretion whether to levy on a gross or net basis. Article 7 creates the pool of arm’s length economic gross income and costs that are attributed to the PE, but leaves it to the State how to tax it: by excluding certain income and costs, determining the tax rate, and taxing on a gross or net basis (therein limited by the non-discrimination article).

It seems to me that the second sentence of paragraph 42.19 may be –erroneously- interpreted as an exception to that principle.

I believe that paragraph 42.19 intends to provide the conceptual basis for the design of the paragraph on service PEs in paragraph 42.23 and to explain why, contrary to some bilateral agreements (see e.g. Article 14 of the Tax Treaty between Turkey and the Netherlands), the OECD does not choose this gross taxation method for service PEs. In other words, the paragraph concerned intends just to explain why the choice is not for an explicit gross taxation.

However, the paragraph might also be read as stating the OECD view that gross taxation is not allowed at all when the treaty uses the word “profit”, see your statement “... that allow a State to tax the gross amount...”

² Despite paragraph 32 of the Commentary to Article 5’s “act in”.

It might also be appropriate to move this paragraph to the Commentary on Article 7, though I understand that you'd like to deal with this profit taxation theme in the same place where you deal with the factors constituting the service PE.

It may –in this context- also be somewhat unclear how paragraph 42.44 is to be read. It is –as I understand it- intended to be a reminder of Article 7(2) and Article 7(3), but could be understood as a preference for the taxation of net profits. In the latter case, it may go beyond what the treaty can achieve. (It may also be better positioned in the Commentary on Article 7.)

Paragraph 6 versus paragraph 42.20 of the Commentaries

Though paragraph 6 of the Commentary on Article 5 (six months, nature of the business, recurrent activities) is very broadly worded as a suggestion to the tax administrations to take certain administrative practices into account, this paragraph could be read as a contradiction to the policy statement in paragraph 42.20.

Perhaps an explanation is due why in cases where an office is rented for 3 days, this may be enough to assume a PE under Article 5(1), whereas a service provided during 183 days or less is not enough for purposes of paragraph 42.20 and the alternative service PE clause.

The relationship of the paragraphs of Article 5

As to paragraph 42.23, this paragraph proposes an alternative text for a service PE paragraph in Article 5. Regarding the reference to the other paragraphs of Article 5 in the opening sentence of the proposed service PE paragraph, the proposed paragraph is to be placed after paragraph 3 and before paragraph 5. Indeed, the paragraphs referred to in the opening sentence are 1, 2 and 3. In addition, the reference at the end of the proposed text to paragraph 4 indicates that the new provision should be inserted after paragraph 4, as this reference would otherwise be superfluous.

I believe the place of this proposed paragraph after paragraph 4 and before paragraph 5 is fine,³ but the connection between the various paragraphs of Article 5 bothers me.

In the current text of Article 5, the relationship between the paragraphs is made explicit in Article 5(5), which refers to Article 5(1) and Article 5(2), but not to Article 5(3). This is in conformity with the Commentaries, as these see Article 5(3) as a specific case of Article 5-1 (see paragraphs 4.5, 4.6 and 5.1 of the Commentary on Article 5).^{4 5}

³ Your choice not to follow the order used in the United Nations Model may be a reflection of your views – which I share – regarding the nature of the construction PE, to separate the “real” Article 5(1) construction PE from the fictitious PEs for services and agencies.

⁴ Even though Article 5(5)'s reference to Article 5(2) is also problematic, as the question could arise why the mere list of examples of Article 5(1) would need a separate reference. I assume that the move of the construction PE from paragraph 2 to paragraph 3 in 1977, and the

In the alternative service PE paragraph however, reference is made to paragraph 3, which seems to breach the concept expressed in the current structure of Article 5. In my understanding of Article 5's composition, I would suggest to delete it. Should the reference to paragraph 3 indeed be deleted, no change would need to be made to the related paragraph 42.26 of the Commentaries, as this paragraph in itself fits into the concept of Article 5.

Another suggestion, for clarity reasons, to the Member countries could be, for the opening sentence of the agency paragraph, to include a reference to the service PE clause, when the service PE paragraph is part of the treaty, in order to reflect the OECD's view on the internal structure of Article 5. This reference seems required, as the service PE, like the agency PE, is a fictitious PE ("deemed" in both paragraphs, see also paragraph 42.25 which makes this explicit) -as opposed to the construction PE, which is covered by Article 5(1)- which thus needs specific mention.

The meaning of services

The term services is not defined in the draft Commentaries. Whereas the scope of paragraph 3 is rather clear (and is also further explained in paragraph 17 of the Commentaries on Article 5), the nature of services is undetermined.

Paragraph 42.29 makes an attempt to illustrate the contents of the proposed service PE paragraph, but is not really helpful: the first two sentences are circular without further explanation of what services entail, and the second sentence does not add anything.

I believe the open character of "services" is acceptable as the scope of the paragraph is intended to be broad. Indeed, paragraphs 1 and 5 of Article 5 are open too, as they are not limited to certain industries. Thus, the new services PE paragraph should apply in all economic environments where only the formal requirement of a service is met: "work done or duties performed for ..." (as one of the English dictionaries mentions). This formal requirement also follows from paragraph 42.30: "services ... provided ... to a third party".

Having said this, the specific exclusion of fishing activities in paragraph 42.29 is acceptable if it is not intended to exclude services in this specific industry and I believe that the OECD view is that the service PE paragraph should apply to all industries if the formal requirements are met. I assume that the Commentaries' fishing sentence (which refers to an enterprise that "derives revenues from selling its catches") is the illustration of another issue that is dealt with in paragraph 42.30: services are deemed to be provided only when they are performed for someone

corresponding amendment to Article 5(5) in that same year, does not rest on an erroneous failure to refer to paragraph 3 in Article 5(5), which seems confirmed by the 2003 Commentaries' additions mentioned above.

⁵ See about the relationship between Article 5(1) and 5(3) my article entitled "The relationship between Article 5, Paragraphs 1 and 3 of the OECD Model Convention" (Intertax, April 2005, p. 189-193).

else. It might for this reason be better to move the fishing sentence, with some modifications,⁶ to paragraph 42.30.

The service PE thresholds

My remarks are purely technical as to paragraph 42.23's proposed service PE paragraph, and I do not want to suggest alternative thresholds for the service PE clause. I understand that choices have to be made in any legal provision, and borderline cases may always be constructed to illustrate that a certain provision is allegedly not balanced. You are better positioned to consider whether the perceived disbalance in the following situation is acceptable.

An enterprise carried on by a single individual (a small enterprise) and a competitor (a large multinational) consider to bid for service activities in the other State. The service will take 183 days or less to complete. Thus, subparagraph (b) does not apply, but subparagraph (a) might be relevant to both cases: despite the primary purpose of subparagraph (a) to cover single individual enterprises (paragraph 42.34), it is not limited to that situation.

If the individual is present in the other State for more than 183 days, the first condition of that subparagraph is met. The cumulative second condition will then determine the presence of a service PE. As the economics of the small and large enterprise are now decisive - for the sake of my argument, the assumption in this case is that the small enterprise meets the 50% test, and the large multinational does not - the small enterprise will have a PE where the large enterprise does not. It seems that this does not create a level playing field for two enterprises that do exactly the same. (This difference could be detrimental or advantageous to either of them, depending on the further tax rules that apply.)

In the context of Article 15, an employee's presence exceeding the 183 days' threshold also has a tax impact, but this impact is on the individual itself (apart from withholding obligations on the part of the employer), and thus the individual's choice influences his own tax position. There, the result may be considered acceptable, as the behaviour of the individual influences his own tax position.

Where subparagraph (a) of the service PE paragraph is concerned, however, the individual's choice influences the tax position of the enterprise, which may not be the outcome desired. You might argue that in the case of a small enterprise this is acceptable due to the identity of individual and enterprise (one-man limiteds) and that by proper management the stay may be limited to 183 days or less. However, where small enterprises work with employees/non-owners in the other State, management cannot always be effectively exercised to avoid exceeding the 183 days' criterion: individuals make their own unmanageable choices (holidays, moving to another enterprise in the other State etc.).

⁶ E.g.: "... the paragraph would not apply to a foreign enterprise that carries on fishing activities *on its own behalf* ..."

Connected projects

Suppose that a construction company, resident in State R, has been contracted to build the roofs of petrol stations along the highways in the other State. The activities take two years, and are performed for five unrelated oil companies (say for each company appr. 5 months). An umbrella contract has been concluded with each separate oil company so as to lay down the technical and other specifications, and a separate building contract is to be concluded for each roof. Each roof takes 3 weeks, the roofs are built throughout the country, and the roofs are alternately built for oil company A through oil company E (an old case I dealt with in my days as a tax inspector). Let us assume that no physical PE under Article 5(1) is present, and let us also assume that the conditions of Article 5(3) are not met, as a coherent commercial and geographical whole is missing.

It is clear (paragraph 42.26) that the activity potentially falls under the proposed service PE paragraph. However it seems that you are of the view that the policy question whether the other State should have the right to tax the construction company's profits is to be answered negatively, as paragraph 42.40 seems to exclude this case from the PE qualification: only contracts concluded with one and the same enterprise or associated enterprises will be regarded as connected.

If the OECD indeed intends to exclude projects concluded with two separate enterprises (including their associated enterprises), it would be good to clarify that this paragraph indeed intends to exclude what is not covered under its wording. It would not be beneficial to the business community if a tax administration would contend that paragraph 42.20 is only to be considered an example that should not be read *a contrario*, when this paragraph becomes important in the interpretation of the service PE paragraph.

To resolve the difficult question of whether services are connected, guidance may be found in Article 5(3), where the criterion of 'coherent commercial and geographical whole' is decisive. In the field of services, it might be conceivable to explain the connection criterion by referring to commercial aspects such as type of activity, connection via an umbrella contract, (associated) client base, date of the conclusion of the contract, etc. It seems that the geographical criterion is not suitable in the perspective (see also paragraph 42.26). It would obviously be preferable to hand the business community a well-defined criterion of distinction.