



TO  
Ms.  
Perez-Navarro  
OECD Deputy Director, CTPA

BY  
Dr. Arwed Crüger  
Kai-Udo Schwinger

WTS Steuerberatungs-  
gesellschaft mbH  
NL Frankfurt  
Taunusanlage 19

D-60325 Frankfurt am Main

Tel. 0 (69) 133 84 56-15

Fax 0 (69) 133 84 56-99

Reference  
ACR/KSC

Phone/Fax  
+49 (69) 133 84 56 - 15  
+49 (69) 133 84 56 - 99

Date  
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Dear Ms. Perez-Navarro,

WTS GmbH is pleased to provide you with comments regarding the interpretation and application of Article 5 (Permanent Establishment) of the Commentary (Commentary) of the OECD Model Convention (Proposed Changes) dated October 12<sup>th</sup> 2011.

## 1 General remarks

### 1.1 Proposed Changes in light of the separate entity approach

In the last years the definition of permanent establishments (PE) and the allocation of profits to permanent establishments 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.

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".

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WTS Steuerberatungsgesellschaft mbH

Headquarters Munich  
Court of registry Munich  
HRB-Nr. 192 598  
USt-IdentNr. DE205370699  
UniCredit Bank AG  
Bank Code 700 202 70  
Account -Nr. 2 460 998

#### Director of Branch Frankfurt

**Robert Welzel**  
Taunusanlage 19  
D-60325 Frankfurt  
Tel. +49 (69) 133 84 56 - 0  
Fax +49 (69) 133 84 56 - 99  
info@wts.de · www.wts.de  
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Thus, we also believe that the application of the separate entity approach is limited for other 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 clearly delimited fixed place of business under Article 5.

In the past the concept of a fixed place was not so important for the allocation of profits, since profits could be allocated under application of the indirect method. In practice the indirect method was implemented when the concept of a fixed place of business/separate entity did not work out well e.g. for temporary activities, construction activities, service activities.

Now the indirect method is not acceptable anymore, which will pose the question how to allocate profits to a PE without a fixed place of business (e.g. service PE, construction activities) under the separate entity approach of Article 7. The OECD should take this issue into account when discussing the examples of the commentary.

The indirect method might be one reason why the OECD (still) included examples for PEs with rather weak requirements on a fixed place of business in the Proposed Changes (E.g. Clientco example (sec. 13 Proposed Changes), painter example (sec 4.6 Annex to the Proposed Changes)). We clearly object to this development since it is not in line with the separate entity approach of Article 7 OMC and hard to apply in practice.

## 1.2 Objective criteria are missing

It should also be taken into account that the concept of a service PE (Sec. 42.23 Commentary) has been included in the OECD Commentary and that the separation between a “fixed place of business PE” and a “service PE” will most likely be the existence of a fixed place of business. Therefore it is absolutely necessary to clearly differentiate between both types of PE when discussing the examples in the Proposed Changes.

We observe that tax administrations tend to qualify each business activity and especially services as PEs under the OMC. This is a violation of Article 7 OMC which stipulates that as a general rule business profits should be taxed in the state in which the business is located.

We suspect that this development will proceed without a clear differentiation between “service PEs” and “fixed place of business PEs”. The danger of double taxation is rather obvious.

In the following we propose a rather strict implementation of the fixed place of business criteria under the separate legal entity approach. We identify some helpful and **objective** criteria which should be applied. All criteria have to be cumulatively fulfilled in order to constitute a PE.

We then discuss some chosen examples under the strict implementation of the fixed place of business approach.

Overall and in line with BIAC we propose to elaborate more on **objective** criteria to judge on the constitution of PEs. The approach of the Proposed Changes to discuss a lot of rather complicated and exotic examples based on weak concepts is not helpful in practice.

## 2 Proposed objective criteria to constitute a PE under the separate entity approach

### 2.1 Local requirement

We agree with section 4 of the Annex of Proposed Changes on the concept of a *fixed place of business through which the business of an enterprise is wholly or partly carried on*.

We propose to add some kind of **objective** substance requirements in line with the separate legal entity approach. Transferring recent developments on CFC issues (e.g. Cadbury Schweppes), a separate legal entity would have at least some kind of office equipment (room, telephone, computer), and some (administrative) personnel. Other even stricter criteria could be the place of management of a PE or the active participation in a market.

It would be contradictory to qualify activities of an entity in another country as carried out by a “fixed place of business PE” when the same activity carried out by an affiliated entity would be declared as abusive<sup>1</sup> due to lack of substance.

Without such **objective** substance requirements we expect even more conflicts with regard to the taxation of PEs.

### 2.2 Power of disposal

We read section 4.2 of the Annex to Proposed Changes in a way that the power of disposal over a fixed place of business should be assumed when two requirements are met.

#### 2.2.1 Temporal requirement

*The business activities and the power of disposal should be executed on a continuous and regular basis.*

This is in line with the separate legal entity approach since an entity would also be active on a continuous and regular basis. Although we think it is necessary to specify the temporal requirement in line with the separate entity approach.

A separate entity would be generally assumed when the power of disposal is executed for at **least one year/12 months**.

This is in line with the proposal of BIAC in sec. 32 of the Proposed Changes.

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<sup>1</sup> The OECD handles anti abusive issues e.g. in Article 1 section 7 seq. of the Commentary.

## 2.2.2 Legal requirement

*Where an enterprise has an exclusive legal right to use a particular location which is used for carrying on that enterprises own business activities that location is clearly at the disposal of the enterprise (sec. 4.2 Annex to Proposed changes).*

This is in line with the separate legal entity approach since such an entity would also have an exclusive right to use its own property.

We propose under the separate legal entity approach to consider the legal right of the enterprise to **exclude**<sup>2</sup> others from the fixed place of business where its business is performed. A separate legal entity will not only use its own premises but would also be able to exclude others from its usage.

As another negative criterion we propose that an object on which business activities are performed should not constitute a fixed place of business. E.g. when a craftsman/service provider (sculptor) carrying on its work on an object of its client (sculpture) then the object (sculpture) should not constitute a fixed place of business.

Both objective criteria are extremely helpful when discussing the examples further below.

## 3 Example in section 4.5 of the Annex to the Proposed Changes

### 3.1 Text of the example

4.5 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a fixed place of business (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

### 3.2 Analysis under the criteria above

#### 3.2.1 Local requirement

The employee has an office at the newly acquired subsidiary. This office could constitute a fixed place of business as long as certain substance requirements are met. E.g. the office is locally segregated from the business of the newly acquired subsidiary and is equipped with a computer, telephone etc. We assume that this is the case.

#### 3.2.2 Temporal requirement

The temporal requirement is met by assumption and will not be further discussed.

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<sup>2</sup> This criteria is in line with diverse German federal tax court decisions

### 3.2.3 Legal requirement

It has to be discussed how the employee can use the fixed place of business. In practice the fact that she can/does use the office will be of little help, since this would be the case for a service provider or secondee as well.

The power of disposal should therefore only be assumed when the employee can and does exclude others (e.g. the management of the newly acquired subsidiary) from “her” place of business. This implies that the employee is still under control of her company and therefore not integrated in the chain of control of the acquired subsidiary. Otherwise the management of the newly acquired subsidiary could command the employee and she (and her company) would lose the power of disposal over her office.

### 3.3 Conclusion

The activity of the employee should only form a fixed place of business PE when the office equipment fulfills some kind of substance requirements and when the employee can exclude others from her office.

### 3.4 Proposal

We propose that the example should only constitute a PE under the strict criteria as described above. This should be made clear in the Proposed Changes.

Further, the example should be used to discuss the impact of the activities of the employee with respect to the qualification as a secondment or service PE.

Otherwise the example constitutes the danger that each secondment or service activity performed between affiliated entities can constitute a “fixed place of business PE”.

## 4 Example in section 4.7 of the Annex to the Proposed Changes

### 4.1 Text of the example

4.7 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its his main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

### 4.2 Analysis under the criteria above

#### 4.2.1 Local requirement

A fixed place of business could be the single wall painted by the painter. If the painted wall would constitute a place of business this would not be a really fixed place but “moving” through the building during the two years of work.

The whole building can constitute a fixed place of business through which the painter carries on his business. This cannot be the case since the painter is performing his business only at the single wall (although on a concurrent basis) and not in the whole building.

Additionally, the potential place of business (the wall) does not meet any substance requirements with regard to business equipment.

This is also a good example to show that the wall is only the object of the business of the painter and not a fixed place by which the business of the painter is carried on.

We do not see a fixed place of business in this example and the local requirement for a “fixed place of business PE” under all identified criteria is not met.

#### 4.2.2 Temporal requirement

The temporal requirement for a “fixed place of business PE” is met by assumption and will not be further discussed.

#### 4.2.3 Legal requirement

The painter has no power of disposal over the office building, beside the contractual obligation to do its work at the client’s office. In the example the client can most likely cancel the contract of the painter or at least interrupt the painter’s work due to business requirements. A contractual obligation should not be mixed up with a power of disposal.

By no way will the painter be able to exclude his client from the usage of its office building.

Thus, the painter has no power of disposal over this place of business and the legal requirement for a “fixed place of business PE” is not met.

#### 4.2.4 Conclusion

The activities of the painter can not constitute a PE since the local and the legal requirements are not met.

According to the requirements above this example will not constitute a PE.

Additionally, it will be hard to allocate profits to the activities of the painter under the separate entity approach. You would have to answer the question how a person painting a wall (which is an object of its client) can constitute a separate entity.

The allocation of profits could previously be solved by the application of the indirect method. Thus, you could rather easily allocate the painter’s overall profits to the PE by the application of a time based allocation key. This is not possible under the application of the separate entity approach.

### 4.3 Proposal

The example should be deleted from the Proposed Changes or discussed regarding service/construction PEs. Reference should be made that the obligation to fulfill a contract can not constitute a power of disposal.

## 5 Example in section 4.2 of the Annex to the Proposed Changes

### 5.1 Text of the example

4.2.... thus, for instance, 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 (see also paragraph 42 below). It is also important to remember that even if a place is a place of business through which the activities of an enterprise are partly carried on, that place will be deemed not to be a permanent establishment if the only business activities carried on at that place are those listed in paragraph 4. [the rest of existing paragraph 4.2 is moved to new paragraphs 4.3 and 4.4]

### 5.2 Analysis under the criteria above

#### 5.2.1 Local requirement

A typical<sup>3</sup> contract manufacturer is active at its **own** plant and is performing its own enterprise on its own (although limited) risk. His own (and maybe single) enterprise is to fulfill its contractual obligations towards its entrepreneur.

Thus, the contract manufacturer does not carry on the business of its entrepreneur, but its **own enterprise**.

The plant of the contract manufacturer can therefore not constitute a fixed place of business by which the enterprise **of the entrepreneur** is carried on.

The local requirement for a “fixed place of business PE” is not met in the sample above.

#### 5.2.2 Temporal requirement

The temporal requirement for a “fixed place of business PE” is met by assumption and will not be further discussed.

#### 5.2.3 Legal requirement

It goes hand in hand with the findings above that the plant of the contract manufacturer is not at the disposal of the entrepreneur. The owner of the plant is the contract manufacturer. The entrepreneur

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<sup>3</sup> The analysis could differ, when the contract manufacturer is active in a plant and producing with equipment both owned by its entrepreneur.

has no legal rights<sup>4</sup> to use the plant of the contract manufacturer or exclude anybody from the usage of the plant of the contract manufacturer.

If the logic of the painter example would apply here as well, you should rather pose the question whether and under which preconditions the activities of the contract manufacturer could constitute a PE at the entrepreneur's premises (e.g. by delivering the produced goods), since the contract manufacturer is fulfilling a contractual obligation towards its entrepreneur.

The legal requirement for a "fixed place of business PE" is not met.

#### 5.2.4 Conclusion

A typical contract manufacturer will perform its own enterprise. It will therefore never carry on the business of its entrepreneur. Its plant can therefore not constitute a fixed place of business and herewith a PE of its entrepreneur.

The discussion about the power of disposal in the example (sec. 20 of the Proposed Changes) is illustrative but should only be secondary in the contract manufacturer context.

#### 5.2.5 Proposal

We propose to include a very decisive statement in the commentary, that a typical contract manufacturer is performing its **own** business and does therefore never constitute a PE of its entrepreneur. A PE at the premises of another legal entity should only be constituted in very exceptional cases (e.g. abuse) and under objective criteria. Therefore any other reference with regard to contract manufacturing can be deleted in the Proposed Changes.

The potential implications of contract manufacturing constituting a PE of their entrepreneur would really endanger the purpose of the OMC which render relief of double taxation to separate legal entities. If contract manufactures as separate legal entities could be requalified as PE of their entrepreneurs any legal entity (affiliated or not) could be requalified as well. Following the logic in the example above the relevant criteria would be the contractual context (power of disposal) between both parties of the contract.

### 5.3 Final Conclusion/Proposal

The 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.

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<sup>4</sup> There might be legal rights resulting from a potential shareholdership of the entrepreneur. These rights should not impact the discussion above.

We therefore 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 propose to revise or delete 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 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.

Dr. Arwed Crüger

Kai-Udo Schwinger

Head of Transfer Pricing

Manager Transfer Pricing