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Grace Perez-Navarro, Deputy Director
Centre for Tax Policy and Administration (CTPA)
Rue André Pascal F-75775 Paris
Cedex 16 France, CTPA

Sent by e-mail: grace.perez-navarro@oecd.org

Re: Consultation response to the Proposed Changes to the Commentary on Article 5 (Permanent Establishment) of the OECD Model Tax Convention

Dear Ms. Perez-Navarro,

The International Bar Association would like to take this opportunity to comment on the Proposed Changes to the Commentary on Article 5 (Permanent Establishment) of the OECD Model Tax Convention.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world's top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.

We are submitting our comments on behalf of the IBA Tax Committee which has 1037 members from around the world. This committee formed a Working Group to respond to this Consultation, and those Working Group members are named at the end of this cover letter. The Working Group consisted of tax partners in the law firms Garrigues (Spain), Sanchez Devanny (Mexico) Bennett Jones (Canada) and Hogan Lovells (France).

The comments made in this report are the personal opinions of the Working Group members and should not be taken as representing the views of their firms, employers or any other person or body of persons apart from the IBA Tax Committee of which they are a member.

The comments are enclosed with this letter.

Sincerely yours

/s/ 

Claire Kennedy
Co-Chair of the Working Group
IBA Tax Committee
Canada

/s/ 

Xenia Legendre
Co-Chair of the Working Group
IBA Tax Committee
France

Working Group Members:

Ramón López de Haro
Tax Partner
Garrigues
Spain

Abigail Blanco
Tax Partner
Garrigues
Spain

Albert Collado
Tax Partner
Garrigues
Spain

Ricardo León Santacruz,
Tax Partner
Sanchez Devanny
Mexico

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Preliminary Comments

The discussion Draft presented by the Committee has been structured around 25 questions, in respect of which, there is generally a description of the issue, a recommendation of the Working Group concerning the Commentary on Article 5 and a background explanation on the recommendation.

The tax section of the IBA wishes to congratulate the Committee and its subgroup of its Working Party 1 on Tax Conventions and Related Questions for the excellent Draft discussion paper on the interpretation and application of PE. We believe that this paper analyses in a thorough and comprehensive manner most controversial issues relating to the identification of PEs of tax resident entities carrying out business activities in foreign jurisdictions (i.e. other than those of which they are tax resident) and proposes some practical, useful amendments to the Commentary.

The IBA acknowledges, nevertheless, that some of the questions raised by the Committee in the discussion Draft address rather specific issues concerning particular industries or businesses (e.g. farming, construction, shops on ships operating in international traffic, fund management or insurance). While these topics raise important questions, the IBA has decided to focus its comments and suggestions on those questions of more general application at an international level.

Areas of discussions in which the IBA has decided to focus its comments

This letter outlines IBA´s comments and suggestions, in respect of three main areas of discussion:

1. Area 1 (Services Establishments): The definition of the key circumstances under which a service company operating with personnel working abroad may have PEs in different jurisdictions.

2. Area 2 (Business Restructuring): The impact of business restructuring within multinational groups on the potential triggering of a PE in local jurisdictions of the non-resident entity acting as principal.

3. Area 3 (Ancillary Activities): The performance by a taxpayer of activities considered individually as preparatory or of an auxiliary nature, which, in an aggregated basis, might constitute a PE.

Considering these three areas, the IBA invites the Committee to expand its comments to cover situations commonly addressed by businesses or to clarify or be more specific on certain comments.

Comments on Area 1: Definition of key circumstances under which a service company may have a PE in different jurisdictions

Service companies are usually confronted with the analysis about whether or not the services provided by their personnel in foreign jurisdictions constitute a PE. Facts and circumstances relating to said business activity may vary greatly from one case to another but, in general:

- The employees of the service provider are bound to travel and stay for a variable period of time in another jurisdiction (although they could be constantly travelling within said jurisdiction or other jurisdictions).

- The employees may work in the premises of the client (service recipient), including (for example) construction sites, the premises of a local affiliate of their multinational group, or at their own home in said jurisdiction (including hotels).

- Sometimes, the personnel may not even be under the payroll of the company responsible for the project (the "principal") but, rather under the payroll of the affiliate company (related) or a third party subcontractor.

Under these circumstances, while recognizing the thoroughness of the analysis made under question 2 relating to the meaning and interpretation of the concept "at the disposal of", the tax section of the IBA would favour a more direct approach to this matter, which could save uncertainty and attendant costs to taxpayers and tax administrations. In particular, it appears that some of the Commentary on "at the disposal of" and some of the examples provided are aimed at assessing the relative importance of the site in the foreign state in which activities are undertaken to the overall activity of the service provider in that foreign state.

Rather than extend the definition of "at the disposal of" to circumstances beyond what that term means, implying as it does an element of control, including the right to enter premises, the IBA encourages the Committee to emphasize that the current Commentary does provide alternative "services PE" language (¶ 42.23), which may be included in bilateral treaties by States. One IBA participant notes that Canada and the United States incorporated a services PE definition in the latest amendment to the Canada-US Income Tax Convention. The IBA is of the view that stretching the definition of "at the disposal of" to address what could be addressed by the adoption of a services PE provision by member States in their bilateral treaties ultimately compromises the clarity of the Article and thereby increases uncertainty for both taxpayers and tax administrations.

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The IBA suggests including in the Draft, within questions 2, 3, 4, 6 and 7, several comments addressing these issues, in the following way:

- **Question 2**

  - Description of the issue-Paragraph 10 of the Draft

    - The Draft mentions that too heavy a reliance on an exclusively facts and circumstances approach will inevitably lead to situations where neither tax authorities nor taxpayers will be in a position to determine in advance whether a PE exists. This complete lack of precision is not helpful in interpreting Art. 5 correctly, and arguably, is not a definition per se. At the very minimum, a non-exclusive list of criteria should be provided as to what constitutes "at the disposal". Similarly, safe harbour exceptions could be included.

      IBA considers that the referred lack of precision is in practice leading to cases in which the taxpayers feel unprotected to defend their position, before the too-broad interpretations often made by the Tax Administration of the concept "at the disposal"

    - As regards the example in paragraph 4.5 of the Commentaries (**painter example)**, IBA understands that it is a good example of circumstances where a services PE provision, suggested in 42.23, would properly address the situation and give taxing rights to the source State, assuming at least that the painter is a sole proprietor and the facts are otherwise as set out in the example. But it is IBA´s opinion that it is not at all clear that a client's site in the form of a building is "at the disposal of" the painter just because the painter performs the "most important functions of his business" at this site. As the Commentary suggests, the real issue is the economic significance of this work to the painter's enterprise and that is precisely what the services PE provision addresses. Of course, interpretive issues may be raised by such a provision and as the Commentary notes, there may be cases of abusive arrangements; however, the IBA prefers the objective measures of the alternate services PE tests to stretching the meaning of "at the disposal of" to cover situations as the one in the example. The IBA also notes that as the services economy grows, and indeed in many countries' outstrips the "goods economy", the taxation of service providers should be addressed more directly and with clearer rules for the benefit of all concerned with the efficient administration of taxation, namely the service provider and the tax authorities of the home and source States.

    - Finally, IBA suggests to clarify in the Commentaries that no PE may be deemed to exist in cases in which the principal has a fixed place, such as

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a "representation office", but does not develop a business activity in or from this fixed place but from the State in which the principal is resident.

- Recommendation of the Working group-Paragraph 11 of the Draft

In line with IBA´s previous suggestions, IBA proposes adding the following wording to the proposed modification of paragraph 4.2 of the commentaries (IBA's suggestions are included in bold letters)

"4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise.

Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a "place of business through which the business of [that] enterprise is wholly or partly carried on" will depend on the extent of the presence of an enterprise at that location and the activities that it performs there.

Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities that location is clearly at the disposal of the enterprise. This will also be the case where an enterprise performs business activities on a continuous and regular basis during an extended period of time at a location that belongs to another enterprise or that is used by a number of enterprises.

This will not be the case, however, where the enterprise's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise. ***A period or periods of time of presence of an enterprise at a location will be deemed incidental if the aggregated period last less than 183 days within a calendar year.***

Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier, 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 .

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This will not be the case, also, where the enterprise has a presence at a location, such as a representation office, but no activity of the enterprise is developed through this representation office, only than those of a representation nature.

- **Question 3**.

  - Background-Paragraph 20 of the Draft

    The IBA suggests mentioning in the Commentaries another situation that could be addressed under this question: the one arising from operative structures in which personnel from the local subsidiaries are functionally dependent in the day to day work of management employed by the foreign principal.

- **Question 4**

  - Background-Paragraph 27 of the Draft

    The IBA understands that the case of the home office of an employee, which will often arise in the case of a service provider, is another situation which could be better addressed by a services PE provision; the IBA urges the Committee to consider its comments in this light.

    Indeed, it is doubtful that any employee, other than one living in an official residence, considers his or her home to be a the disposal of his or her employer, which again implies a degree of control and a right of access, even if the employer subsidizes the rent or other operating costs of the home. If an enterprise has no physical location in a foreign State through which its business is wholly or partly carried on, other than the home office of an employee, then the real issue is the economic significance of those activities to the overall activities of the employer in that foreign State. In fact, the matter recalls the issue in the case of the painter, in respect of which we provided comments above and we respectfully suggest that the solution is the same.

- **Question 6**

  - Description of the issue-Paragraph 32 of the Draft

    The IBA generally agrees with the comments of the BIAC and also urges the adoption of minimum time frames.

    IBA acknowledges that recurrent activities are a special case and does not consider the short duration business example to be particularly helpful. In this regard, IBA respectfully suggests that a clarification is provided about what is a short duration business versus an activity of short duration that ought not to

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give rise to a PE. Again, many of these situations could be addressed by a services PE provision, which could include a minimum time element (like in the case of the updated US- Canada double tax treaty).

The IBA also proposes changes in paragraph 4.2 of the Commentary, as set out as regards question 2 above, to introduce a proposal of minimum time frame.

- **Question 7**

  - Presence of employees of a foreign company / 2. Manager employed by the manpower company-Paragraph 44 of the Draft

    It is mentioned in the Draft, as regards the case where an employee of a company that belonged to a multinational group was temporarily seconded to work for another company of the group, that in many cases, the secondment would be done without a formal contract between the two enterprises but, to avoid transfer pricing issues, a cost-plus charge might be paid to the first company. This could have the unfortunate consequence that the services rendered by the employee might be considered to be provided by the first company to the second company, which would create the risk that the first company would be found to have a PE in the premises of the second company where the employee would work.

    In IBA´s view, the fact that a cost-plus charge is paid to the formal employer should not determine by itself that the employee carries out in the other State a business activity for its formal employer in the premises of the second company: As stated in paragraphs 8.13 to 8.15 and in subsequent examples (e.g. 8.25), what it is truly relevant is whether or not the employee works under the supervision and direct control of the company where it has been seconded. In other words, the fact that the cost is recharged with a mark-up should be irrelevant for assessing whether or not the formal employer has a PE in the other country (this is merely a transfer pricing question).

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Comments on Area 2: Impact of business restructuring within multinational groups on the potential triggering of a PE in local jurisdictions of the non-resident entity acting as principal

As it has been acknowledged by the OECD in its papers (among others in its Report on the transfer pricing aspects of business restructurings within multinational groups, of 22 July 2010), since the mid-90's, multinational groups have implemented business restructurings, which often involve conversion of full-fledged distributors into limited-risk distributors or commissionaires for a foreign associated principal or conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a foreign associated principal (apart from the transfers of intangible property rights to a central entity), among various examples.

These restructurings imply therefore the de-localization of risks and assets, which lead to a significant reduction of the benefits allocable to the converted local entities / subsidiaries, which have transferred those risks and assets to the principal.

While the assessment / analysis of such business restructurings should mainly focus on whether the referred reallocation of profits is consistent with the arm's length principle, it has been observed that inspections of the Tax Authorities have often focused the analysis on the possibility that the business restructurings lead the new principal to have a PE in the jurisdictions where the converted distributors or manufacturer reside.

Although the IBA understands that this approach is completely acceptable (since it seems reasonable that the Tax Authorities verify that the reality -the substance of the restructuring and of the further facts- fits the wording of the documents of the Companies involved in the restructuring), it may be observed that, in general, the fact that a business restructuring has taken place leads to challenge structures, which would have not been challenged if the multinational groups would have organized their structures from the very beginning as they become after the business restructuring.

For example, in some jurisdictions it may be observed that, in general, toll manufacturers are not suspected of generating a PE for their principals (even in cases that those ones are subsidiaries of the principals), unless they have become as such as a consequence of a business restructuring (e.g. because they were fully fledged manufacturers before the restructuring). Additionally, it has been observed that, in general, toll manufacturers are not deemed to generate PE for their principals, when there is no relation between both parties, that is, when both parties are independent (except for what can be derived from the tolling activity).

The IBA suggests introducing the following comments on questions 2, 3, 8, 20 and 22, which pretend that these situations should be avoided and that activities should be analysed considering the real substance of the operative.

- **Question 2**

  - Recommendation of the Working Group-paragraph 11 of the Draft

    IBA suggests that the proposed new paragraph 4.2 of the Commentaries finalizes including that "***The conclusions would be the same even if the first company has converted into a contract or toll manufactured due to a Business Restructuring***".

    Additionally, IBA suggests that any reference to contract manufacturers is extended to toll manufacturers.

- **Question 3**

  - Contract manufacturing-Paragraph 17 of the Draft

    As regards the CARCOs example, the IBA would like to point out that it does not seem necessary for the analysis at stake to make reference to the payment of royalties by the toll manufacturer to the principal. Under some jurisdictions, it could be stated that the license of the right to use the manufacturing process is instrumental to the manufacturing service itself and therefore, no separate remuneration should be set. In any case, this issue does not seem to add any relevant fact to the question of whether or not the activity carried out by SUBCAR constitutes a PE of CARCO.

- **Question 8**

  - Recommendation of the Working Group-Paragraph 48 of the Draft

    It is suggested in the Draft that it is added a paragraph 10.1 immediately after new paragraph 10 of the Commentary on Article 5, explaining that "*An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met. In the context of paragraph 1, that will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise for reasons other than the mere fact that these subcontractors perform such work at that location (see paragraph 4.2 above). An example would be where an enterprise that owns a small hotel and rents out the hotel's rooms through the internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis"..*

    IBA suggests to the Committee to clarify the example outlined in this paragraph in order to ascertain whether or not the subcontracting of the on-

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site operation of the hotel (not the renting of hotel rooms) would trigger a permanent establishment of the enterprise.

- **Question 20**

  - Background- Paragraph 117 of the Draft

    The IBA agrees with the comments of this paragraph, but propose considering the possibility to introduce the following business case, which is intended to avoid discussions in cases where a local entity develops several activities for the same principal. The objective would be to clarify that, when each single activity carried out by the local entity is not deemed to generate per se a PE for its principal, then, the conclusion should not vary even if the analysis is made considering the performance of all the activities together.

    Case: Business restructuring under which a fully-fledged manufacturer turns into a contract manufacturer, which, at the same time, promotes the sale of goods of the principal. Remuneration:

    a) For the contract manufacturing: Cost + margin.

    b) For the promotion of goods: commission calculated as a percentage of sales.

    All proofs evidence that the contract manufacturer / agent have no powers to conclude contracts in the name of the principal, but it has been observed by IBA that in some cases, Tax Authorities have considered that, in a case like the one at hand:

    a) The principal did not have a fixed place of business in Spain.

    b) The subsidiary was not a dependent agent in the general sense of this concept, since it did not conclude contracts in the name of the principal and did not even negotiate the terms of the contracts.

    c) But, nevertheless, the subsidiary may be deemed to constitute a dependent agent of the principal because it promoted the sales of goods manufactured by the subsidiary, following the instructions given by the principal. It is a kind of "manufacturing dependent agent".

    Considering that this situation occurs in practice, IBA suggests adding in a new paragraph 36 (or at the end of paragraph 35) the following:

    "If it is concluded that the enterprise has not a permanent establishment within the meaning of paragraphs 1 and 2 (subject to provisions of paragraph 4) and, at the same time, it is concluded that there is not a

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dependent agent within the meaning of paragraph 5 (even if the agent exists, it has no authority to conclude contracts in the name of the enterprise), no different conclusion should be achieved because that agent acts, at the same time, as contract manufacturer of the goods sold by the principal.

For example: if an enterprise resident in State C is a contract manufacturer for an enterprise (the principal) resident in country S and the first enterprise is also an agent of the principal (for promoting the sales of the goods manufactured by the first enterprise for the principal), and it is concluded, after individually analysed both the contract manufacturing and the agency activities,

- that the principal has not a permanent establishment in State C within the meaning of paragraphs 1 and 2 of article 5, because it is evidenced that the principal does not develop a manufacturing activity in State C (see paragraph 4.2 above), and

- That the principal has not a permanent establishment in State C within the meaning of paragraph 5 of article 5, because the agent has not an authority to conclude contracts in the name of the principal,

Then the conclusion may not be different if both contract manufacturing and agency activities are developed by the same enterprise and both activities are jointly considered.

- **Question 22**

  - Recommendation of the Working Group-Paragraph 124 of the Draft

    The IBA suggests that, at the end of the Paragraph 124 of the Draft, it is added that the reduction of risks associated to a particular business activity in favour of another group company (principal) in the framework of a business restructuring would not necessarily mean that the stripped enterprise is to be viewed as "dependent" from its principal.

Comments on Area 3: Development by a tax payer of activities considered individually as preparatory or of an auxiliary nature, which, in an aggregated basis, might lead to generate a PE

It is common that single companies develop multiple activities in jurisdictions, in which they are not tax residents, which considered in an individual basis, would not deem to trigger a PE in these other jurisdictions, since those activities meet requirements of article 5 to be considered as preparatory or of an auxiliary nature.

The intention of the IBA is to set it clear that the conclusion will be the same if those activities are jointly considered. That is, the aggregation of auxiliary or preparatory activities does not generate a non-auxiliary or a non-preparatory activity in the sense that they cannot generate a fixed place of business or a dependent agent for the non-resident entity.

The IBA suggests introducing the following comments on questions 13, 16 and 18 in this regard.

- **Question 13**
  - Background-Paragraph 83 of the Draft

    IBA proposes to add that if the agent retains its true independent nature under 5(5), the non-fragmentation position expressed therein is not applicable.

- **Question 16**
  - Background-Paragraph 97 of the Draft

    IBA understands that the clarifications of the Draft in Paragraph 97 are quite interesting, as they reflect the reality of many kinds of transactions. However, it is IBA understanding that they may be falling short of the reality of certain cases, in which the development of ancillary activities must be supported by the necessary development of additional ancillary activities. The typical case is that of the activity of maintenance of stocks of goods for storage, display or delivery, which sometimes may be developed only with the previous fulfilment of legal requirements.

    Examples of these supporting ancillary activities include securing authorizations to allow for the importation of the goods into the jurisdiction where they will be stored, displayed or delivered; or to secure regulatory compliance for goods which are subject thereto.

    It should be set clear that said ancillary activities, which are prerequisites for the holding of goods for storage, display or delivery, should be considered of a preparatory or auxiliary nature. In this sense, if a country

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requires that a permit be secured to hold a given item or a process be followed to import the goods, which will be held for storage, display or delivery, it would make sense that the Working Group include such ancillary activities as activities which do not change the preparatory or auxiliary nature covered under these two subparagraph. The inclusion of this may permit avoiding future discussions about this subject.

- **Question 18**

  - Background-Paragraph 106 of the Draft

    The IBA suggests noting in the Commentaries that the fragmentation of an enterprise's activity, in the framework of a business restructuring may also concern situations in which:

    a) The fragmented activities are carried out by the same "converted" (stripped) local enterprise in different places of business

    b) Those activities are not considered auxiliary but, however, none of them constitute by themselves a permanent establishment of the principal (foreign entity); e.g.

    - Because the activities are not carried out by the foreign entity through a fixed place of business in the other state

    - Because the local (stripped) entity, even though it acts as a dependent agent, it does not have the authority to conclude contracts in the name of the principal

    Paragraph 27.1 seems to address situations of a fragmentation of activities only referring to exceptions of Article 5(4). However, the same conclusion should be reached regarding activities that, although not considered auxiliary, do not constitute individually a permanent establishment. The combination of said activities under the same stripped (converted) local company should not *per se* trigger the existence of the PE, unless jointly considered, they could be viewed as a full subcontracting of the enterprise's business operations: See comments under sections 8 and 20.

Finally, the IBA wishes to highlight that comments in **question 20**, mainly related to Area 2, also stress on this area in cases that, after a business restructuring, a subsidiary begins to supply several kinds of services for a principal; in this sense, the tax section of the IBA understands that:

- Where a subsidiary is, for example, a toll manufacturer for the principal, and it is concluded that it does not imply a fixed place of business for the principal,

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- where, at the same time the subsidiary is, for example, promoting the goods manufactured for the principal, with no powers to bind the principal, so that no dependent agent may be deemed to exist in the terms of article 5,

- Then no PE exists regardless the development of both activities by the same subsidiary.

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