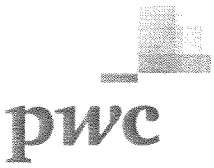

Private & Confidential

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10 February 2012

CT06/RSC

Dear Grace

Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention.

This submission is made in response to the request for comments in the public Discussion Draft issued by the OECD on the above topic on 12 October 2011.

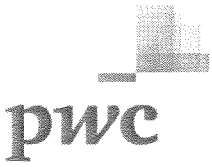
As a general matter, we strongly support the OECD's work on the interpretation and application of the definition of permanent establishment with a view to improving the Commentary to the OECD Model Tax Convention. We consider that many of the changes proposed in the public Discussion Draft will help with this goal.

Our comments on the Draft are set out below.

Meaning of "to conclude contracts in the name of the enterprise".

In connection with the dependent agent rule, it is proposed that a clarification should be inserted into the Commentary on Article 5 as follows: "For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract."

Given the opening words ("For example...") we assume that the intention behind this change is solely to amplify the previous sentence and make it clear that the acts of agents for undisclosed principals may fall within the scope of Article 5. However, the actual wording of the new text lends itself to a very broad interpretation. Wider (and wilder) interpretations of the text might potentially also be encouraged by the discussion of being "economically bound" in the Discussion Draft document in the context of commissionaire arrangements and the reference to "bound" which appears in the proposed new text. It is therefore important to clarify beyond doubt what this new text is dealing with. If contrary to our reading, the new text is intended to sanction some kind of "economically bound" interpretation of Article 5 (5), we would consider that to be a wholly undesirable (and practically inoperable) change to the Commentary and one that first requires very much further explanation and consideration. For example, transfer pricing methods based on cost plus and targeted gross/net margin (which have been extensively accepted and used by taxpayers and tax authorities for many



years) could well become embroiled in disputes relating to the "economically bound" concept. This would undermine the global transfer pricing framework in which the OECD has invested such significant resources over many years. However, for the reason given, (and also on the basis that so fundamental a change could not realistically be effected by the insertion of a mere example) we are assuming this is not intended. This would mean that any "opportunistic" reading of the Commentary to such an effect would be wholly unsupported by reference to the OECD Model Tax Convention and Commentary.

There is a wider point to be made in this context: Where the discussion in an OECD Discussion Draft ranges over a number of issues (in the present case including commissionaire arrangements, the notion of "economically bound", contracts that do not make commercial sense, etc) it would be helpful for the discussion to make clearer which particular points of those discussed are intended to be addressed in proposed changes to the OECD Model Treaty or Commentary and which are discarded or ignored. This is important because otherwise the general background discussion may be taken as automatically colouring or giving meaning to the specific recommendations made. The point is relevant to the discussion throughout the Discussion Draft of 12 October 2011.

Time requirements for the existence of a PE.

The Commentary identifies two exceptions which represent a departure from the general practice of a six month time threshold for a PE to be created. These exceptions are (1) where there are recurrent activities of less than a six month duration but over an extended period and (2) where the activity concerned, though lasting less than six months, constitutes a business in itself which is carried on exclusively in the host country. It is now proposed to add examples illustrating each of these exceptions. These exceptions from the general practice of a six month threshold have in the past led to concerns over the uncertainty they create. Our main concern is that the examples now proposed may add to that uncertainty. The two examples (annually recurrent five week presence at an international fair and a four month operation of a restaurant during filming on location) potentially raise a number of further questions. For example, if presence by short visits to the host country is to count in the way proposed, from what point should the permanent establishment threshold be regarded as crossed? The point is particularly relevant given that we would expect that, in many situations, there would be little certainty over the extent of future visits at any time. The concern is therefore that the exception provided for – as illustrated by the proposed example – can be applied only in a retrospective manner, putting the taxpayer in an obviously difficult position.

With regard to the second example which it is recommended should be inserted into the Commentary, the underlying point of principle relies heavily on being able to identify a "business" which is carried on "exclusively" in the host country. Our concerns relate to the interpretation of "business". The example suggests that in construing the relevant "business" it is appropriate to look only at the actual business of the relevant enterprise such that if this is also carried on outside the host state the test will not be met. It would be helpful to clarify this point further so as to preclude the possibility that elements or distinct functions carried on as part of the wider business of an enterprise could be regarded as in themselves sufficient to constitute a "business" for the purposes of this exemption to the normal six month approach.

Meaning of "at the disposal of".

The existing Commentary requires a place of business to be "at the disposal of" the enterprise before a permanent establishment may be created under the fixed place of business test. However, the reference to "at the disposal of" appears only in the Commentary, not the text of the article itself. The aim of the phrase is to help explain the "place of business" requirement. There has in recent years been much discussion as to whether the "at the disposal of" test is helpful and clear. In particular, an example in the existing Commentary relating to a painter who, for two years, spent three days a week in a large office building of its main client is stated as giving rise to a permanent establishment on the basis of the presence of the painter in that office. It has been objected that the existence of this example makes it hard to understand the "at the disposal of" concept beyond meaning simply a test as to whether there is ongoing presence or use of a place.

It is now proposed to insert a lengthy clarification of the "at the disposal of" test. It is emphasised that whether a location may be considered to be at the disposal of an enterprise will depend on the extent of the presence of an enterprise at that location and the activities that it performs there. It is clarified that 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. The "at the disposal of" test is also met where an enterprise performs its activities on a "continuous and regular basis" during an extended period of time at a location belonging to another enterprise. It is also clarified that intermittent or incidental presence may not be sufficient, and that where an enterprise does not have a right to be present at a location and does not use the location itself, then that location would not be regarded as being at the disposal of the enterprise.

Whilst this expanded Commentary is clearly helpful, it is not clear that the concept is entirely clarified. One of the difficulties with the expanded Commentary is that it leaves the strong impression that an enterprise that carries on a business that by its very nature requires the physical presence of the enterprise's employees in the premises of its clients or customers for some extended period will quite likely be found to have created a PE of its own in those premises.

Although the Working Group appears to have rejected BIAC's suggestion for a non-exclusive list of criteria to clarify the meaning of "at the disposal of", we believe some additional clarification of its meaning is needed. We suggest the Commentary provide further guidance regarding an enterprise's physical control over, and identification with, a third party's premises. More specifically, we suggest that where, as the Commentary describes , "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" those activities should not create a PE for the enterprise unless they are carried out in circumstances where the enterprise has a level of physical control or authority over the location that gives it the freedom to conduct its own business at that location and where it has identified itself in the relevant marketplace as conducting its business through those premises.

Canadian jurisprudence provides an example of how these criteria might be applied. For example, in *Dudney v. The Queen* 2000 D.T.C. 6169 (FCA), affirming 99 D.T.C. 127 (TCC), the court found that a U.S. resident consultant, Mr. Dudney, did not have a fixed base (which the court said had the same meaning as " permanent establishment") at the premises of a Canadian client at which he provided his services over an extended period. The Federal Court of Appeal stated that "Although Mr. Dudney had access to the offices of PanCan and he had the right to use them, he could do so only during PanCan's office hours and only for the purpose of performing services for PanCan that were required by his

contract. He had no right to use PanCan's offices as a base for the operation of his own business. He could not and did not use PanCan's offices as his own. "

The Federal Court of Appeal agreed that the Tax Court had considered the correct factors in making its decision. These factors are evident in the following passage from the Tax Court decision wherein it is stated, "The Appellant had no control over the premises in which he worked, nor was he identified with them in any way...The Appellant had no freedom to come and go from the building where he worked except during normal business hours, and he could not do any work there, except that done under the contract for PanCan. Any other company wishing to use his services would not be able to find him there, as he was not identified anywhere as working at that location. He had no space in the building that was his exclusively, and in fact the location at which he did his work changed from time to time at the sole discretion of the PanCan personnel."

We submit that the factors considered in *Dudney* – primarily physical control over access and use, and identification of the premises in the marketplace – are critical in distinguishing the difference between an enterprise that provides services or other activities at the business premises of a third party and an enterprise that makes the premises of a third party its own business premises.

Main contractor who subcontracts all aspects of a contract

The Discussion Draft recommends changes to clarify that an enterprise may be regarded as carrying on its own business through subcontractors, acting alone or together with employees of the enterprise. This would seem to lead potentially to a very wide expansion of the PE rules (going well beyond the real property and construction site examples given) save for the fact that the enterprise entering into the subcontracting arrangement with the subcontractor would, for a PE to exist, still need to meet all the conditions of Art 5 (1). Thus, a subcontractor would create a PE of the enterprise only if, as is clarified in the proposed change to the Commentary, it performs 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". The OECD text gives examples of an enterprise running a small hotel and sub-contracting the onsite running of the hotel to a company paid on a cost plus basis and a building contractors subcontracting part of the project to a subcontractor – in both cases, the subcontractor is to be regarded as carrying on the business of the enterprise.

The point of principle of having the acts of an independent third party regarded as those of a principal for the purposes of the Art 5(1) rule is troubling. We are concerned that the "protection" derived from the words quoted in the above paragraph will not in practice be sufficient to mean this rule will have a low impact in future. There is a certain subtlety in treating the acts of an independent third party sub-contractor as the acts of the enterprise or "principal" which procures the sub-contracting arrangement, while respecting the sub-contractor's own place of business as not being at the disposal of that enterprise or principal. Based on our experience of the actual operation of the relevant rules, we consider it very likely that this deeming principle will in practice lead to a significant widening of challenges aimed at extending the reach of taxing rights (e.g. in relation to franchise fees paid to an overseas franchisor).

Further, it is not unusual for a sub-contractor (such as an IT services provider) to carry on its work at its own place of business but to have access from time to time to the customer's place of business with that access to the customer's office facilities provided for in the central contract. Cases testing the borderline of what seems to be the intended PE threshold in this situation are therefore likely to be common.

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As a matter of principle, we do not see why work sub-contracted to, and carried out by, a local entity should create a permanent establishment of the main contractor assuming that the local entity does not fall within the dependent agent test. Overall, it seems appropriate to deal with this matter as a transfer pricing, and not a PE, issue.

Discussion of Independent Agent Status

We appreciate that it is in practice unlikely that the decision of the OECD not to provide further material guidance on this test will be reversed. However, we remain of the view that the existing guidance in the Commentary is certainly in need of further clarification and it is not clear how, and when, this can be done if not within the bounds of the current project.

Yours sincerely
For and on behalf of PwC

Richard Collier