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17 February 2012

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Re: *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention – Public Discussion Draft*

Dear Ms. Perez-Navarro:

On behalf of Tax Executives Institute, I am pleased to respond to the OECD's request for comments on proposed changes to the official commentary to Article 5 of the OECD Model Tax Convention. Article 5 (Permanent Establishment) of the Convention includes the definition of the treaty concept of a permanent establishment (PE), which is primarily used to allocate taxing rights when an enterprise of one State derives business profits from another State. The OECD's Committee on Fiscal Affairs (CFA), through a subgroup of its Working Party No. 1 on Tax Conventions and Related Questions, has examined various questions related to the interpretation and application of the definition of a PE. This examination culminated in the release of a discussion draft regarding the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (the Discussion Draft) on 12 October 2011. The Discussion Draft proposes several modifications to the official Commentary on Article 5 of the OECD Model Tax Convention (Commentary) interpreting the PE concept, and invites public comments on the proposed modifications.

In general, Tax Executives Institute is concerned that, while there is much to be commended in the Discussion Draft, some parts of the proposed changes to the Commentary may regrettably increase uncertainty and thereby exacerbate the number, scope, and degree of controversies between taxpayers and taxing authorities as well as among taxing authorities themselves.

TEI Background

Tax Executives Institute was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in North America, Europe, and Asia. As the preeminent association of business tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent 3,000 of the largest companies in the United States, Canada, Europe, and Asia.

Discussion Draft Background

The Discussion Draft addresses 25 separate issues related to the PE definition that were previously identified by the CFA, including its work on business restructurings and in comments from the OECD Business and Industry Advisory Committee (BIAC). The Discussion Draft recommends changes to the Commentary for most of these 25 issues. The Annex to the Discussion Draft contains a comprehensive list of all the recommended changes to the Commentary.[1]

General Comments on the Discussion Draft

TEI commends the OECD for issuing its Discussion Draft for public consultation. We believe that the proposals represent an important step in applying the PE concept to today's global business environment and facilitating cross-border commerce. Whether a PE exists or not remains one of the most important determinations under most bilateral tax conventions and the OECD has led the way in providing guidance in this area. The Discussion Draft contains helpful statements on the role of taxpayers and tax authorities as well of the application of the PE concept under the OECD Model Tax Convention. TEI supports the OECD's attempts to foster a harmonised interpretation and application of the PE concept and to discourage OECD Members States from making reservations on certain issues. Consistently interpreted and applied international tax rules are in the interest of tax authorities and taxpayers; they will minimize discrepancies, reduce controversies and promote cross-border trade.

There are, however, aspects of the Discussion Draft with which we disagree. These areas are discussed in detail below. Before turning to the Discussion Draft on an issue-by-issue basis, we offer the following observations:

- The Discussion Draft does not offer a comprehensive approach to the PE concept. In TEI's view, such an approach would focus on (i) clarifying the determination of a fixed place of business, (ii) issues related to dependent agents concluding contracts, and (iii) clear exceptions for

[1] Organisation for Economic Co-operation and Development, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention*, (12 October 2011), 44-59 (*hereinafter* "Discussion Draft").

preparatory and auxiliary activities. Unhelpfully, certain portions of the Discussion Draft lend support to the notion of an "activity" or "services" PE, which would lead to unnecessary controversy.

- Electronic commerce, as well as non-traditional work relationships (such as "working from home"), have been addressed in the Discussion Draft, but again not through a consistent comprehensive approach. Rather, the draft proceeds on an "issue by issue" basis.

- The proposed changes in the Discussion Draft could lead to unintended results (such as when combining issue number two regarding the meaning of "at the disposal of" and issue number three regarding certain business restructurings). We recommend that the OECD expressly address the consequences of the interaction of the proposed changes and their intentional and potential unintended consequences.

Comments Relevant to Specific Issues in the Discussion Draft

The following comments address Discussion Draft issues of particular relevance to TEI and its members. No inference should be drawn from the failure to address other issues.

1. Issue #2: Meaning of "at the disposal of" (paragraph 4.2 of the Commentary)[2]

Paragraphs 4 to 4.2 of the Commentary explain that a place of business may constitute a PE of a business enterprise if that place is "at the disposal" of the enterprise. The concept of "at the disposal" is not found in the definition of a PE in Article 5, but instead is set forth in paragraph 4 of the commentary to explain the concept of "place of business." The proposed changes to the Commentary clarify that, when examining whether a location is at the disposal of an enterprise, the extent of the presence of the enterprise in that location and the activities it performs there are relevant. For example, when an enterprise has an exclusive legal right to use a particular location to carry on its activities and that location is only used for such activities, or when it performs activities on a continuous and regular basis for an extended period of time at a location that belongs to another enterprise or that is used by a number of enterprises, that location is considered to be at the first enterprise's disposal. The Discussion Draft explains, however, that this should not be the case where the enterprise's presence in a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise or where an enterprise does not have a right to be present at a location and in fact does not use that location.

In general, TEI believes that the proposed changes signal a move away from the requirement under the general PE definition in paragraph 1 of Article 5 that there be a "fixed place of business" of an enterprise and toward finding that an activity being carried on somewhere in the source country for an extended (but undefined) period of time constitutes a PE. In other words, the changes may sanction the creation of an activity or services PE, permitting the PE determination to

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2 *Id*. at 8-10.

be based upon services rendered. Regrettably, such a development would discourage cross-border economic activity without efficiently increasing tax revenue.[3]

On the other hand, absent a more comprehensive approach to the PE concept, we believe an expansion of the list of exceptions to the PE definition is an acceptable approach for guiding multi-national enterprises (MNEs) on permitted activities. For example, the language in paragraph 4.2 concluding that the location of a supplier or contract manufacturer will not be deemed to be at the disposal of the enterprise that receives the goods is helpful.[4]

TEI believes the Discussion Draft requires further clarification in respect of the level of permitted services. In particular, the example discussed in paragraphs 13 and 14 regarding a consultant conducting training for 20 months at a client's location does not provide a rationale for its conclusion that the activity creates a PE.[5] While many MNEs provide training, they would not consider themselves to have a PE in each location where the training takes place. For example, would the conclusion be the same if the training contract did not specify where on the client's premises the training was to take place, such that there was no place that could be considered "at the disposal" of the consultant? What if the training took place at a third party's premises (such as a hotel), but nevertheless case the training took place for 20 months? Alternatively, what if the training were for 7 or 13 months? Additional explanation of the significance of these facts in the example, and for services generally, would be welcome.

Finally, TEI believes that the Commentary should clarify that procurement activities, even if they are extensive enough to require that the supplier's premises be "at the disposal" of the foreign enterprise, or require personnel of the enterprise to be at the supplier's premises for extended periods, do not constitute a PE, in accordance with subparagraph 4(d) of Article 5 (regarding an exception to the definition of a PE for the maintenance of a fixed place of business solely for the purpose of purchasing goods). Mere procurement activities should not constitute a PE because they are not generally the "business" of the enterprise and, further, it is likely that little or no income of the enterprise would be allocable to such activities.

2. Issue #3: Can the premises of a (converted) local entity constitute a permanent establishment of a foreign enterprise under paragraph 1? (paragraph 4.2 of the Commentary)[6]

The Discussion Draft notes that business restructurings may lead to assets being held, risks being managed, or activities being performed by a converted local entity for the account of a foreign enterprise. This raises the issue whether, and if so in which circumstances, the premises of the converted local entity in which these activities take place may constitute a fixed place of

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3 If such a change is being considered it should be effected expressly in Article 5 itself and not by an interpretational adjustment to the Commentary.

4 Discussion Draft at 9.

5 *Id*. at 10.

6 *Id*. at 11-12.

business of the foreign enterprise. The Discussion Draft also provides a contract manufacturing example where a resident of one state (CARCO) sets up a subsidiary (SUBCAR) resident in another state to assemble cars from parts owned and supplied by CARCO and imported to SUBCAR's state of residence by CARCO.[7] The example states that the parts and automobiles will be the property of CARCO throughout the manufacturing process.

The Discussion Draft concludes that CARCO does not have a PE as a result of the arrangement. Further, the Discussion Draft notes that the conclusion in the CARCO example should not depend on whether the arrangement arose from a business restructuring that results in a "converted" entity. TEI agrees with these conclusions. We would recommend, however, that the rationale for the "no-PE" conclusion in the example be expanded so the principles present are more apparent to taxpayers and tax authorities in other circumstances.[8]

3. Issue #4: Home office as a PE (proposed new paragraphs 4.8 and 4.9)[9]

This issue addresses when an individual's home office (*i.e.*, an office located in an individual's residence) constitutes a PE of the individual's employer. The Discussion Draft would add new paragraphs 4.8 and 4.9 to the Commentary to clarify when an employee's home office will be considered "at the disposal" of the employer and therefore potentially a PE. The new paragraphs note that even though part of an enterprise's business is carried on through an individual's home office, it "should not lead to the automatic conclusion that that location is at the disposal of the enterprise simply because that location is at the disposal of an individual (e.g., an employee) that works for the enterprise."[10] The proposed new paragraphs continue that whether a home office will constitute a PE is a "facts and circumstances" determination, but note that if a home office is used "on a regular and continuous basis" and it is clear that the enterprise "has required the individual to work from home (e.g., by not providing an office . . . in circumstances where the nature of the employment clearly requires an office)" then the home office "may" be considered to be at the disposal of the enterprise.[11]

TEI supports the inclusion of the proposed language in the Commentary in light of the increasing frequency of employees working from home (or elsewhere out of the office) both full and part time. Further, cross-border telecommuting has become increasingly common. Nevertheless, proposed new paragraph 4.9 states that "the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue" because the

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7 *Id*. at 11.

8 Paragraph 20 of the Discussion Draft merely states that a "key factor was that the premises of SUBCAR were not used by CARCO itself and could not be viewed as being at the disposal of CARCO." *Id*. We note that this factor alone should not create a PE. CARCO must be carrying on its business at SUBCAR's premises for CARCO to have a PE. It appears that the conclusion in the Discussion Draft is the same, *i.e.*, that SUBCAR is carrying on its own business and not the business of CARCO.

9 *Id*. at 12-13.

10 *Id*. at 12.

11 *Id*.

"vast majority of employees reside in a State" where their employer has a fixed place of business.[12] Even if the statement is true, it is not helpful when cross-border commuting is the issue in point. TEI believes a clear and broad exemption for work outside the office and in home offices is desirable from the perspective of MNEs as well as employees.

We have other concerns about the proposed new paragraphs. For example, in what circumstances does employment "clearly require an office?" Also, what if the non-resident consultant carrying on much of the business is an employee of a non-resident enterprise, rather than a self-employed person running her own business?

Fundamentally, it would be a rare event for an employee's home office to be considered "at the disposal" of the employer from a practical or legal perspective. Thus, TEI recommends that the proposed new paragraphs 4.8 and 4.9 be amended to recognize that even in cases where an employee works from home continuously, the home is not necessarily at the disposal of the employer. Accordingly, it should constitute a PE of the employer only in rare circumstances (*e.g.*, where the employer has access to the employee's home via the employment contract, the employee is regularly conducting business with customers at the home, or the employee represents to the public that the home office is a place of business of the enterprise).[13]

Should such a change to paragraphs 4.8 and 4.9 prove unacceptable, TEI recommends that, at a minimum, the OECD provide additional details in the four examples presented in paragraph 26 of the Discussion Draft. For example, TEI believes that only the facts in example 3 could support the conclusion that an employee's home office constitutes a fixed place of business of the business enterprise, and even then only in very limited circumstances. Even if the home office in the example constituted a fixed place of business of the enterprise, TEI believes a proper interpretation of the PE definition would only consider the activities carried out at such a place to determine whether there is a PE of the enterprise, and no "force of attraction" principle should be applied to the activities carried out at the construction sites, each of which would need to be analysed separately for the PE determination. In addition, since the activities carried out at the home office are likely to be preparatory or auxiliary, the facts of example 3 do not necessarily lead to the conclusion that the enterprise has a PE at the home office. In sum, the OECD should provide its view on the creation of a PE in each of the four examples and the rationale for that conclusion; it should also expand the discussion of when employment "clearly requires an office."

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12 *Id.*

13 Employees providing services to an employer represent an input cost to the employer; *i.e.*, a procurement cost. While all employee activities contribute to the profitability of an enterprise, in most cases there will be no profit specifically attributable to such procurement activity. Thus, requiring an enterprise to file a foreign tax return and deal with other compliance issues when it would have little or no corporate tax to pay is impractical and should be avoided, especially in the context of a "cross-border home office."

4. Issue #6: Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)[14]

The Discussion Draft acknowledges business concerns about the uncertainty surrounding the period of time necessary for a location to constitute a PE. The second sentence of paragraph six of the Commentary states that a "place of business may . . . constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time."[15] It is unclear, however, what aspects of the "nature of the business" distinguishes (i) a place of business that exists for a very short period of time that constitutes a PE, from (ii) a place of business that exists for a very short period of time that does not constitute a PE.

The Discussion Draft proposes two clarifying examples that address (i) activities of a recurrent nature and (ii) a business carried on for a short duration, each of which would meet the time requirement for a PE.[16] TEI welcomes these clarifying examples, including the indication in both examples that it will not always be the case that a PE exists ("it *could be* considered that the time requirement for a permanent establishment is met" (emphasis added)).

Regrettably, these clarifying examples do not address recurrent circumstances where the activity relates to something other than the direct production of income for the enterprise (such as the annual sales fair in the example). For example, under the terms of a sales agreement an engineer may be required to visit a foreign customer on a recurring basis to ensure the proper operation of a product manufactured by his employer. Often such services are provided at no additional cost. This "recurring" activity should not constitute a PE of the engineer's employer and, even if it did, it arguably does not generate any "business profits" taxable in the foreign jurisdiction. A strict reading of the proposed changes, however, might require the enterprise to comply with the foreign jurisdiction's tax reporting rules even though no tax is likely due. TEI recommends that the proposed changes to the Commentary provide that recurrent activity, in and of itself, does not necessarily indicate the existence of a PE absent other facts (such as income-generating activity).

In the example of attendance at a recurrent sales fair, it is unclear at what point the recurrent (but less than six month) presence of the non-resident in a state becomes a PE. While it may seem clear that a presence for 5 weeks a year every year for 15 consecutive years might constitute a PE, this determination is based on hindsight and provides little guidance for taxpayers and tax administrators in year three of the time span. Does the PE determination depend on the intention of the business enterprise, or perhaps the certainty of its conducting business in the following year or years? TEI recommends including in the example the fact that the non-resident enterprise had negotiated a rental agreement that allocates it a fixed, multiple-year right to use a stand at the sales fair, with a total rental period of some minimum time (*e.g.*, 6 to 12 months of use

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14 Discussion Draft at 14-17.

15 *Id*. at 16.

16 *Id*. at 16-17.

within the span of the contract), to show that a PE is created. As modified, the example would provide more certainty in the application of Article 5, confirming that multiple rental contracts between parties that are periodically renegotiated should not create a fixed place of business, so long as the contracts do not individually reach the stated minimum period of time and the do not contain automatic renewal provisions or options.

Finally, the examples in the Discussion Draft seemingly blend both meanings of the word "permanent" – temporal and constitutional – into one, with the result that clarity is lost (outside of fact patterns that closely resemble those in the added examples). To provide certainty, reduce disputes between taxpayers and tax authorities, and decrease administrative burdens, the OECD should develop a *de minimis* rule (both temporal and constitutional) under which a PE would not exist if a business enterprise conducted activity for a sufficiently short period of time.

5. Issue #7: Presence of foreign enterprise's personnel in the host country (paragraph 10 of the Commentary)[17]

This issue concerns the circumstances under which the presence in a country of personnel of a foreign enterprise may constitute a PE in that country. The Discussion Draft explains that this issue arises in cases where an employee may be formally employed by one entity but "economically" employed by another, consistent with the criteria set forth in paragraphs 8.13 through 8.15 of the Commentary on Article 15 of the OECD Model Tax Convention. The most common situation where this issue arises is when an employee of a company in a multinational group is seconded to another company of the same group without a formal contract between the two enterprises or a change in the employee's personal employment contract, but nevertheless a "cost-plus" charge is paid to the first company to avoid transfer pricing issues. According to the Discussion Draft, the first company is at risk of having a PE at the premises of the second company where the seconded employee works.

The proposed changes in the Discussion Draft state that within a multinational group employees are frequently seconded from one enterprise to another. For administrative reasons, however, such as the need to preserve seniority or pension rights, there may be no change to the employment contract, even though the employee is carrying on the business activities of secondee company. The Discussion Draft therefore notes that the analysis in paragraphs 8.13 to 8.15 of the Commentary on Article 15 is relevant in distinguishing these cases from cases where the employee is carrying on the foreign enterprise's own business (as opposed to the business of the related company).

TEI appreciates the clarification that Article 5 and Article 15 should be read together and interpreted consistently. Hence, the formal employment relationship between an employee and an enterprise is not determinative of which enterprise's business the employee is carrying out. We are concerned, however, that the proposed changes to paragraph 10 of the Commentary are ambiguous and could be misinterpreted. First, the wording suggests that the activities of a dependent agent of a non-resident enterprise carried on at the agent's premises could be deemed to be at the disposal

[17] *Id*. at 18-20.

of the enterprise and therefore create a PE, even where the dependent agent does not conclude contracts for the enterprise. Second, the wording suggests that if the employees of the foreign enterprise are performing that enterprise's own business activities, or are clearly carrying on their employer's business activity and not that of a related resident enterprise, such activity necessarily constitutes a PE of the foreign enterprise, without regard to whether such activity constitutes a "fixed place of business" or a deemed PE (as provided in certain bilateral tax conventions) under the general definition in paragraph 1 of Article 5. TEI recommends clarifying the revised language of paragraph 10 of the commentary to dispel these concerns.

6. Issue #8: Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)[18]

To address whether an enterprise (contractor) that has undertaken the performance of a "comprehensive project" has a PE if it subcontracts all aspects of that contract to other enterprises (subcontractors), the Discussion Draft proposes the following new paragraph 10.1 to the Commentary:

> 10.1 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.[19]

In addition, the Discussion Draft would add a new sentence to paragraph 19 of the Commentary, providing that in the case of a general contractor on a comprehensive project that subcontracts all or part of the project to subcontractors to work on the building site, "the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where the general contractor has overall responsibility for the site and the site is made available to that general contractor for the purposes of carrying on its construction business."[20]

While it appears that the hotel owner in new paragraph 10.1 to the Commentary has a PE (although this is not stated explicitly), no rationale for that conclusion is provided. To increase

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18 *Id*. at 20-22.

19 *Id*. at 21.

20 *Id*.

clarity, TEI recommends that language be added to clarify the reasons for concluding that the hotel owner has a PE (*e.g.*, is it because the enterprise both (a) has a fixed place of business through its ownership of the hotel, and (b) carries on its business through that fixed place by renting rooms over the internet, even though subcontractors carry out all the physical activity at the site? Or is there some other rationale?).

Further, it is unclear whether the added sentence in paragraph 19 reaches the correct conclusion that the general contractor has a PE. While the work site may be "at the disposal" of the general contractor, the general definition of a PE in Article 5 requires not only a "fixed place of business" but also that the enterprise actually conduct its business "through" that fixed place. Thus the question is does a general contractor that contracts out all of the work at a particular site in fact conduct its business through that site, especially when the general contractor neither owns the site nor conducts any physical activity there? Or, alternatively, is the place where the general contractor conducts its business the place where it negotiated the contracts with its subcontractors? Additional discussion of this point would be helpful.

In addition, we question whether the conclusions expressed above are appropriate in circumstances where a general contractor chooses to subcontract activity in a particular country to support a specific customer contract rather than engaging in business in that country itself. For example, a supplier to a multinational customer may be required to provide goods or services in a country where the supplier does not carry on business. The supplier may subcontract, for example, the installation or maintenance services in that jurisdiction to a local subcontractor. In these circumstances, the customer may still look to the general contractor for overall responsibility or performance of the contract since it does not have a direct relationship or contract with the subcontractor. In our view, if all or substantially all of the risks and requirements of the customer contract are passed on to the subcontractor in the subcontracting agreement so that the subcontractor effectively assumes these risks and requirements, then we believe the subcontracting relationship should not constitute a PE of the general contractor. Thus, TEI recommends the Commentary clarify that a subcontracting relationship does not constitute a PE of the general contractor where the subcontractor assumes the risks and requirements of the general contractor, and the general contractor does not otherwise carry on business in that country

7. Issue #9: Application of paragraph 3 to joint venture and partnership activities (paragraphs 10 and 19 of the Commentary)[21]

This section of the Discussion Draft addresses how paragraph 3 of Article 5, which states that a building site or construction or installation project will constitute a PE only if it lasts more than 12 months, applies when a construction site lasts longer than 12 months but no taxpayer is on site for more than 12 months, and in particular in the context of partnerships. Specifically, the Discussion Draft proposes new paragraphs 10.3 and 10.4 to the Commentary that, among other things, make clear that if two separate enterprises "simply agree to each carry on a separate part of the same project and . . . not jointly carry on business activities and share the profits thereof" then

[21] *Id*. at 22-24.

it "would be difficult to consider that a separate enterprise has been set up."[22] In that case, paragraph 56 of the Discussion Draft makes clear that whether there is a PE under paragraph 3 of Article 5 should "be determined independently for each company."[23] In addition, new paragraph 10.3 clarifies that when two enterprises collaborate on the same project, "whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State."[24]

TEI agrees with these proposed additions to the Commentary, which clarify how to apply the time based test in paragraph 3 to parties in a joint venture that does not amount to a partnership, and how the determination whether a partnership is formed by referring to local law. One potential issue, however, is whether these changes to paragraph 3 can, or should, apply outside the context of construction sites. TEI recommends that the OECD confirm that this determination should generally apply when assessing temporal limits for joint ventures and partnerships.

In addition, TEI is concerned that only the elements of the discussion leading to a PE have been enshrined in the proposed changes to the Commentary, while comments vitiating the existence of a PE have been consigned to the background discussion. TEI recommends that the elements of the background discussion regarding a "no-PE" determination be included in the changes to the official Commentary. We also suggest that the Commentary reflect that, for a sub-contractor to another party or joint venture that has a construction or installation site in a second country, the threshold for determining whether the subcontractor has a PE in a second country should be assessed separately based on the level of the subcontractor's activities.

8. Issue #10: Meaning of "place of management" (paragraph 12 of the Commentary)[25]

This issue addresses whether and in what circumstances a company that is a member of a corporate group may constitute a "place of management" of another company of the group and thus potentially constitute a PE of the other company under subparagraph 2(a) of Article 5. For example, if a parent company located in one state provides all of the accounting, legal services, and human resource functions of its subsidiary located in another state, does the performance of these services by the parent company constitute a PE of the subsidiary as a "place of management?" The Discussion Draft proposes changes to paragraph 12 of the Commentary to clarify that the list of examples in paragraph 2 of Article 5 (*e.g.*, a place of management, a branch, an office, etc.) must be interpreted in light of the general definition of PE in paragraph 1, and that therefore the examples in paragraph 2 are not "automatically" PEs.

TEI agrees that the examples in Article 5(2), including a place of management, should constitute a PE only if they meet the full requirements of paragraph 1, such that the places listed in

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22 *Id*. at 22.

23 *Id*. at 23.

24 *Id*. at 22.

25 *Id*. at 24-25.

paragraph 2 are merely a subset of illustrative examples of what may be covered by paragraph 1. Further, TEI believes that the examples in paragraph 2 should be read in the context of paragraph 4, which exempts certain activities and places of business from the definition of a PE altogether. TEI recommends adding the following phrase to the end of the proposed revision to paragraph 12 of the Commentary: "and are not exempted by virtue of the operation of paragraph 4."

Finally, paragraph 61 of the Discussion Draft, which addresses the example in paragraph 59 regarding centralized accounting, legal, and human resource services of a multinational group,[26] misapprehends the issue in the example. According to that paragraph, the "real issue" underlying the example is the meaning of the phrase "at the disposal," *i.e.*, whether the premises of the headquarters company performing the centralized services is at the disposal of its subsidiary. While this question might also be an issue in the example in paragraph 59, TEI submits that the correct area of focus is not whether a fixed place of business is "at the disposal" of an enterprise (*i.e.*, the subsidiary), but rather whether the business of the enterprise is "carried on" "through" that fixed place, in accord with the general definition of a PE in Article 5(1). Specifically, whether or not the premises of the headquarters company is "at the disposal" of the subsidiary, it seems difficult to conclude that accounting, legal and human resource activities constitute the "business" of the subsidiary being carried on through the headquarters company's premises. TEI suggests replacing the phrase "at the disposal" with "through which" in paragraph 61 of the Discussion Draft. Alternatively, an additional sentence could be included that reads as follows: "Through the subsequent consultation process, the Working Group acknowledges that the meaning of 'at the disposal' is not the appropriate focus in this example; the correct focus is whether the business of the enterprise is actually carried on in the relevant State. Applying such a test in this example it is clear that BCO does not carry on any business in State S, and, for this reason, has no permanent establishment in State S."

9. Issue #11: Additional work on a construction site (proposed new paragraph 19.1 of the Commentary)[27]

The discussion under this issue provides additional clarification on to what extent additional work performed on a construction site counts for purposes of the application of the 12 month time requirement of paragraph 3 of Article 5 for construction sites to constitute a PE. The Discussion Draft clarifies that a "testing" period related to the completion of a construction site should be included in the general 12-month period for determining construction site PEs, but that in practice delivery of a building or facilities should generally constitute the end of the period of work for purposes of the 12 month time period and that work done pursuant to a guarantee to make repairs would normally not be included in the original period.

TEI does not have any comments specific to this issue, but asks whether the OECD considers the principles embodied in these changes to apply outside the construction context (*e.g.*, to software development) and, if so, we request an explanation of how and in what circumstances.

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26 *Id*. at 24.

27 *Id*. at 25-26.

10. Issue #12: Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)[28]

The Discussion Draft explains that an issue was raised whether the activities that are mentioned in subparagraphs 4(a) through (d) of Article 5,[29] are "automatic exceptions" to the definition of a PE, or whether these exceptions are conditional on the activities being of a preparatory or auxiliary nature, as required in subparagraphs 4(e) and (f). The Discussion Draft proposes changes to paragraph 21 of the Commentary to address this issue and concludes that the activities in subparagraphs 4(a) through (d) are not subject to the extra requirement that they be of a preparatory or auxiliary nature.

TEI agrees with these proposed changes. We note, however, that although paragraph 76 of the Discussion Draft states that that "the Commentary should be amended to clarify that subparagraphs a) to d) were not subject to the extra condition that the activities referred to therein be of a preparatory or auxiliary nature,"[30] paragraph 21 of the modified Commentary continues to provide that, in reference to subparagraphs 4(a) through (d), "The common feature of these activities is that they are, in general, preparatory or auxiliary activities."[31] TEI recommends that this sentence be eliminated from paragraph 21 of the Commentary.

11. Issue #13: Relationship between delivery and the sale of goods in subparagraph 4(a) (paragraphs 22 and 27.1 of the Commentary)[32]

Whether the exception in subparagraph 4(a) of Article 5, relating to "the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise," applies to goods or merchandise to be sold from abroad is addressed under this issue. The Discussion Draft notes that based on the wording of subparagraphs 4(a) and (b), which refer to the use of facilities or maintenance of a stock of goods or merchandise "solely" for the purpose of storage, display, or delivery, a place used for display or delivery that was also used for making sales would not be covered by these subparagraphs and could constitute a PE. The Discussion Draft states, however, that the wording of subparagraph 4(a) did not support the suggestion that the application of that subparagraph depends on whether the goods or merchandise stored, displayed, or delivered had already been sold. Clarifying changes were made to the Commentary to reflect these conclusions.

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28 *Id*. at 26-28.

29 These activities are: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; and (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise.

30 Discussion Draft at 28.

31 *Id*. at 27.

32 *Id*. at 28-30.

TEI generally agrees with the proposed clarifications to the Commentary. We recommend, however, that certain changes be made to the additional sentence in paragraph 27.1 that begins "The same approach applies where an enterprise that maintains in a Contracting State one or more fixed places of business . . . ." Specifically, we propose that the sentence read as follows: "The same approach applies *so that*, where an enterprise that maintains in a Contracting State one or more fixed places of business within the meaning of subparagraphs a) to e) ~~is~~, *it may* also *be* deemed, through the application of paragraph 5, to have a permanent establishment in the same State~~;~~ in ~~that~~ case ~~of~~ the activities *carried out in such separate fixed places of business* ~~that resulted in that deemed permanent establishment~~ are not separated organisationally ~~from these fixed places of business, it could not be argued that the enterprise is solely engaged in a preparatory or auxiliary activity at these places~~." We believe these changes, while not altering the essential meaning of the new sentence, simplify its wording and will avoid a potential misinterpretation of the change that it should always be the case that activities linked in separate fixed places of business create a PE, even if they together do not rise to more than preparatory and auxiliary functions.

12. Issue #14: Does a development property constitute a PE? (paragraph 22 of the Commentary); and Issue #15: Do "goods or merchandise" cover digital products or data? (paragraph 22 of the Commentary)[33]

The Discussion Draft explains that a question was raised whether, in a situation where a developer develops and sells immovable property, the property would constitute a PE notwithstanding the fact that the business of the developer is to sell that property (Issue #14). Another question is whether the reference to "goods or merchandise" in subparagraphs 4(a), (b), and (c) apply to digital products or, more generally, data (Issue #15)?

To address these issues, the Discussion Draft proposes clarifying that the words "goods" and "merchandise" for purposes of the exemptions to the definition of a PE in subparagraphs 4(a) through (c) "refer to tangible property that can be stored, displayed and delivered and would not cover, for example, immovable property and data (although the subparagraphs would cover tangible products that include data such as CDs and DVDs)."[34] The Discussion Draft also notes that whether activities carried on through servers would qualify for the exemptions in paragraph 4 of Article 5 was addressed in paragraphs 42.7 through 42.9 of the Commentary, which are not part of the Discussion Draft.[35] Those paragraphs generally provide that this determination depends on the nature of the business enterprise, such that "core functions" carried out on servers owned by an enterprise would not always be considered "preparatory or auxiliary" and thus could constitute a PE of the enterprise (depending on the facts and circumstances).

TEI agrees with the proposed clarification. We question, however, whether the current explanation in paragraphs 42.7 through 42.9 of the Commentary remains sufficient given the changes to the Commentary in Issue #12 above. Paragraphs 42.7 through 42.9 of the Commentary

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33 *Id*. at 30-31.

34 *Id*. at 30.

35 *Id*. at 31.

consistently refer to the activities in paragraph 4 as being of a "preparatory or auxiliary" nature even though the clarifications in the Discussion Draft make clear that this extra requirement does not apply to subparagraphs (a) through (d). Therefore, TEI believes paragraphs 42.7 through 42.9 are outdated and need revision to make them consistent with the proposed changes to the Commentary in the Discussion Draft, especially as e-commerce and "cloud computing" trends accelerate.

Finally, whether or not the OECD agrees with the foregoing recommendations, the OECD should at a minimum clarify that when one enterprise provides data storage services to a second enterprise, the data of the second enterprise stored on the server of the first enterprise does not create a PE of the second enterprise in the state of the first enterprise.

13. Issue #16: Carrying on various activities listed alternatively in subparagraphs 4(a) and (b) (paragraph 22 of the Commentary)[36]

The Discussion Draft asks to what extent do the specific exceptions in subparagraphs 4(a) and (b) apply if various activities listed alternatively in these subparagraphs are carried out at the same location and these activities, taken together, go beyond the preparatory or auxiliary threshold to preclude the application of subparagraph (f)? The Discussion Draft notes that this issue, which relates to the fact that subparagraphs 4(a) and (b) refer alternatively to storage, display, "or" delivery, was a relatively minor drafting issue and concludes that the phrase "storage, display or delivery" in subparagraphs 4(a) and (b) should be interpreted as "storage, display and/or delivery" and that this should be clarified in the Commentary.

TEI agrees with the clarification that activities that do not constitute a PE standing alone should not constitute a PE when undertaken together.

14. Issue #17: Negotiation of import contracts as an activity of a preparatory or auxiliary nature (paragraphs 24 and 25 of the Commentary)[37]

The Discussion Draft proposes the following addition to the Commentary regarding the negotiation of import contracts, which clarifies what constitutes activities of a "preparatory or auxiliary" nature under the general exception for such activities to the definition of a PE in subparagraph 4(e) of Article 5:

> 24.2 Similarly, where an enterprise that sells goods worldwide establishes an office in one State, and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State (*e.g.* by participating in decisions related to the type, quality or quantity of products covered by these contracts) even if they do not exercise an authority to conclude contracts in the name of their employer, such

36 *Id*. at 32.

37 *Id*. at 33-34.

> activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment.

For most MNEs, it is not practical or feasible to determine who is involved in a contract negotiation or where such negotiations take place. For example, for the largest and most complex contracts, hundreds of people may be involved and contract negotiation may cover months or even years; therefore, it would be impractical (if not impossible) to track down who was involved, where the various negotiating meetings were held, *etc*. In addition, the criteria for determining whether an employee took an "active part" in the negotiation (*i.e.*, participating in decisions related to the type, quality or quantity of products covered by these contracts) is too broad, for example, this could include technical engineers providing input into a product or service being sold or an accountant providing a business case analysis that impacts the quantity of products sold. For these reasons, the exercise of authority to conclude contracts should remain the primary determination of the existence of a PE, both for clarity and ease of administration. Therefore, TEI recommends deleting this new paragraph from the Discussion Draft. Alternatively, TEI recommends clarifying the Discussion Draft to state that if the activity described in the new paragraph is carried on by a separate local subsidiary acting in the ordinary course of its business of providing services locally, the subsidiary's activities will not constitute the activity of a dependent agent carrying on the activity of the selling enterprise.

15. Issue #18: Fragmentation of activities (paragraph 27.1 of the Commentary)[38]

This issue addresses the fragmentation of an enterprise's activities between different places of business, which is currently addressed in paragraph 27.1 of the Commentary. The Discussion Draft concludes that no changes are necessary to the Commentary. TEI agrees with this conclusion.

TEI disagrees, however, with the suggestion in paragraphs 105 and 106 of the Discussion Draft that a "stripped" enterprise must be looked at through the lens of a legislative or judicial anti-abuse provision. There is no doubt that a MNE may establish its operations in a particular jurisdiction as "risk-stripped" enterprises. If the amount of risk stripped from the enterprise is reflected in the remuneration to these enterprises under arm's-length transfer pricing principles, there is no need to apply legislative or judicial anti-abuse doctrines.

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38 *Id*. at 34-35.

16. Issue #19: Meaning of "to conclude contracts in the name of the enterprise" (paragraph 32.1 of the Commentary)[39]

Issue #19 of the Discussion Draft addresses the question of whether the phrase "to conclude contracts in the name of the enterprise" only refers to cases where the principal is legally bound vis-à-vis the third party, under agency law, by reason of the contract concluded by the agent, or whether it is sufficient that the foreign principal is economically bound by the contracts concluded by the person acting for it in order for a PE to exist as long as the other conditions are met?

The Discussion Draft proposes to modify paragraph 32.1 of the Commentary by adding the last sentence below (in italics):

> 32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. *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.*

Because the question presented in Issue #19 (paragraph 107 of the Discussion Draft) appears to make a distinction between an enterprise that is legally bound and one that is economically bound by a contract concluded by its agent, TEI recommends that the word "legally" be inserted before "bound" in the italicized sentence above to make clear that this is a legal, and not economic, determination. To the extent the additional sentence is intended to address "economically" binding contracts, TEI suggests that such an addition would be ill-advised and would lead to more disputes between taxpayers and tax authorities. If this is the intention, it should be clearly stated in the changes to the Commentary; in addition, more explanation, with examples, is necessary to illustrate when an enterprise may be "economically," but not legally, bound to a contract.

17. Issue #20: Is paragraph 5 restricted to situations where sales are concluded? (paragraph 33 of the Commentary)[40]

One of the conditions for determining that an agency PE exists is that the agent have authority to conclude contracts in the name of the foreign enterprise. A question was raised whether this means that the possible application of paragraph 5 to business restructurings is

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39 *Id*. at 35-37.

40 *Id*. at 37-38.

restricted to situations in which a full-fledged distributor is converted into a commissionnaire or other sales agent that has and habitually exercises an authority to conclude contracts. Where a local manufacturer is converted into a contract or toll manufacturer or where a full-fledged research operation is converted into contract research, the converted local entity will not, in general, have an authority to conclude contracts with third parties.

To address these issues, the Discussion Draft suggests adding the last sentence of the following to paragraph 33 of the Commentary (in italics):

> 33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. *The types of contracts referred to in paragraph 5 are not restricted, however, to contracts for the sale of goods: the paragraph would cover, for example, a situation where a person has and habitually exercises an authority to conclude leasing contracts or contracts for services*.[41]

The Discussion Draft explains that the italicized sentence was intended to clarify that the word "contracts" did not refer exclusively to contracts for the sale of goods. TEI agrees that the word "contracts" in paragraph 5 of Article 5 should not be limited to the sale of goods and thus the clarification is welcome. We recommend, however, that the phrase "revenue generating contracts" be inserted before "for example" so the final sentence reads, in part, "The types of contracts referred to in paragraph 5 are not restricted, however, to contracts for the sale of goods: the paragraph would cover revenue-generating contracts, for example . . . ." This would clarify that the authority to enter into purchase contracts, for example, would not constitute a PE, which we believe is consistent with paragraph 5 and Article 5 generally.

18. Issue #22: Assumption of entrepreneurial risk as a factor indicating independence[42]

The Discussion Draft states in issue #22 that, as indicated in paragraph 38 of the Commentary, an important criterion for determining whether an agent is of an independent status is whether the entrepreneurial risk is borne by the agent or by the enterprise whose behalf the agent is acting. In prior efforts, Working Party No. 1 considered adding a paragraph to the Commentary clarifying the meaning of "entrepreneurial risk." The Discussion Draft, however, states that it was not considered necessary to attempt to clarify the concept of "entrepreneurial risk," which was used in only one of many factors put forward in paragraphs 38 to 38.6 of the Commentary for determining whether or not a person was an agent of an independent status.

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41 *Id*. at 38.

42 *Id*. at 39.

TEI agrees that it is not necessary to clarify the concept of entrepreneurial risk and questions whether it would be possible to do so in a helpful and practical manner.

Conclusion

TEI appreciates this opportunity to present its views on the OECD's Discussion Draft concerning changes to the Commentary to Article 5 of the OECD Model Tax Convention. These comments were prepared under the aegis of TEI's European Direct Tax Committee whose Chair is Anna M. L. Theeuwes. If you have any questions about the submission please contact Ms. Theeuwes at +31 70 377 3199 (or an.m.l.theeuwes@shell.com), or Benjamin R. Shreck of TEI's legal staff at +1 202 638 5601 (or bshreck@tei.org).

Respectfully Submitted,

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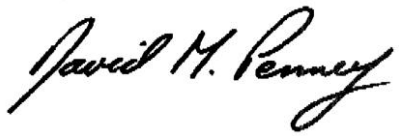

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