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

Dear Sir,

Please find below some comments in connection with the abovementioned public discussion draft.

1. Comments

1. Can a farm be a permanent establishment? (proposed paragraph 3.1 of the Commentary)

In general, the clarification could be better drafted due to the fact that it may cause problems with respect to the principal and accessory definitions related to immovable property included in Article 6 *vis a vis* some specific terms related to immovable property contained in Article 5 (2). In particular, since some DTTs include both asymmetrical concepts in the PE Article 5 (2) in comparison with the definitions of immovable property of Article 6 the example could be drafted in a broader way to include other categories of immovable property (i.e. farm, livestock, forestry).

The clarification could refer to overlaps in other PE terms included in Article 5 (2) which are also found in Article 6, such as those related to mineral, oil or gas deposits or other natural resources. This is the case, for example, of the terms included the Chilean – Australian DTT in Article 5 (2) f) and g), which overlap the definitions contained in Article 6.

2. Comments

2. Meaning of “at the disposal of” (paragraph 4.2 of the Commentary)

The clarification could refer to the problems posed by the meaning of “at the disposal” by focusing on the requirement both from a Civil and Common law traditions. The word “disposal” has a precise meaning in Civil Law (uti, frui, possidere, **disponere)**. The commentary seems to determine a tax threshold for the constitution of a PE in the source State, which entails the presence for the use of a certain location in a business context. Hence, the contours could be better determined for tax administrations of developing countries to have a better understanding of the legal issues entailed in practical applications. In order to qualify the meaning of “at the disposal” in DTTs the “extent of the physical presence” could be better characterized in the OECD commentary by clearly establishing a conceptual legal basis. For example, the terms “at the disposal” could require a “significant performance of economic actions indicative of such

disposal" in the Source State, regardless if the actions are based in the legal exercise of a right granted to the user of the location.

Besides, it does not seem correct to confuse the interpretation of "at the disposal" by introducing the terms "intermittent or incidental", since they seem to address a temporal aspect in the recurrency of the activities". The core of the present discussion should be the term " at the disposal", which requires some significant or substantial exercise of physical presence for configuration of a PE. By introducing the temporal aspect in the determination of the term "at the disposal" the discussion encompasses another problem which corresponds to OECD, Article 5, Commentary Par. 6.1. Consequently, the legal problems entailed in the determination of the extent of the presence of an enterprise in the source state in a physical sense should not be intertwined with the problem of duration of the presence in a temporal sense.

3. Comments

3. Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)

The issues of temporality have been treated in the Commentary with no methodology in the context of the old and new forms in which business are carried according to their nature. For new forms of businesses tax planning for avoiding a minimum time threshold is not a problem. From a tax erosion viewpoint, even if the business is a one time occasion or is performed almost instantaneously there is a temporal dimension to be acknowledged.

States of source should be able to claim distributive rights by configuring the existence of a PE, if the other conditions are fulfilled. Hence, given the present forms in which businesses develop, the concept of permanent establishment in its temporal sense should not find exceptions as a function of the frequency or periodicity of the carrying out of the activities carried out in the place of business. In practice, the fact that activities are carried uncontinously, intermittently, not recurrently, infrequently, not periodically should not be a relevant condition to restrain the constitution of a PE.

Given the above, the present discussion should not be focused in finding a reasonable extension of time which could be regarded as a benchmark criteria, such as, the arbitrary 6 months time included in the discussion. A reasonable temporal threshold could only work as a benchmark if it could have a general application both for source and resident State and be tested in the old economy and the new economy. We suggest that a qualitative duration criteria, regardless of quantitative "shortness or longness" in terms of temporal extent, is the only plausible solution for an international consensus. Provided that the minimum duration criteria is able to support the generation of an economic link in the territory of the source State, it is irrelevant whether the operations take 0.1 seconds or 6 months. Therefore, a qualitative criteria should be maintained as an undetermined concept, to be filled by experience, which could work as a *de minimis* duration threshold.

4. Comments

8. Main contractor who subcontracts all aspects of a contract (paragraphs 10 and 19 of the Commentary)

The issues concerning the use of subcontractors require more clarification for tax administrations of developing countries to understand the correct interpretation in application of Article 5 and 7. This is specially critical in case of immaterial services rendered by subcontractors.

The use of subcontractors should be analyzed more methodologically and general examples could be provided so that the principles could be applicable in the different scenarios of article 5 for the configuration of a PE and Article 7 for the attribution of profits. The following are problems of applications which have not been solved in conformity with international principles by the tax administration in Chile according to letter rulings issued during 2010 and 2011: a) A resident state enterprise of Country R is acting totally or partially through a services subcontractor located in a source state Country S; b) A resident state enterprise of Country R is acting through a subcontractor located in a third state Country T for works performed in source state Country S; c) A resident state enterprise of Country R is acting through its PE located in third state Country T for works performed in source state Country S which could conform a Sub PE.

According to erroneous arguments presented by the Chilean IRS in private letter rulings it has been determined that for the principles of Article 5 and 7 to be applicable, bussiness profits derived by the principal (contractor) from commercial operations entailing services or goods which are rendered by a subordinate (subcontractor) should be classified under Article 21 of the relevant DTT. The former, since business profits under Article 5 and 7 must derive from the exercise of activities performed by the same enterprise generating the profits, with its own human and material resources, which ought to own, in order to be considered as business profits of the same enterprise. By this mean, the Chilean administration has tried to obtain a right to tax the activities at source recharacterizing the activities under the modified distributive rule of Article 21 contained in some DTTs.

5. Comments

12. Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)

The terms included in Article 5, 4) letters a) to e) of the OECD Model Tax Convention and the imprecise explanation contained in the relevant OECD Commentary, paragraphs 21 to 24, are still not adequate in relation to the “preparatory or auxiliary test” to be applied as *ultima ratio* for deciding the scope of the restrictions entailed in the PE negative list.

In particular, the explanations contained in OECD Commentary, Article 5, paragraphs 21, 23 and 24 contain a confusing mixture of both legal and economic concepts, which have been drafted in a way which produces conflicts of interpretation. This is clear by reading the triple operative criteria set forth from an economic viewpoint in paragraph 23 of the OCDE Commentary, which results in some important activities to be eventually dismissed from the negative list if strictly followed. Conversely, looking at the double operative criteria set forth from a legal viewpoint in paragraph 24 of the OCDE Commentary the same activities could be included in the negative list.

In order to give a precise example of activities of utmost importance which require absolute clarity of treatment from a conceptual and practical viewpoint the following Table summarizes

the practical outcomes for the tax treatment of Research, Development and Innovation (R & D & I) according to the definitions which these activities have in the OECD Frascati Manual[1] and OECD Oslo Manual[2], in spite of a strict use of both legal and economic criteria described in paragraphs 21 to 24 of the OECD Commentary to article 5 (4).

Concept Interpretation		
DTT Business Profits OECD Article 5, 4), e)	Triple Economic Criteria OECD Commentary, Art. 5, par 23	Dual Legal Criteria OECD Commentary, Art. 5, par 24
Preparatory: Latin praeparare, from prae 'before' + parare 'make ready'. Prepare: Verb 1 make ready for use or consideration. 2 make or get ready to do or deal with something3.	Axiomatic Productivity Proximate Profitability Certain Allocability Only R & D & I categories of fundamental research and applied research qualify for PE Negative List. Development and Innovation could have proximate profitability and certain allocability, failing the threshold of being preparatory.	Essential: Adjective.1 fundamental; central. 2 absolutely necessary. Categories of R & D & I such as fundamental research and applied research could be distinguished as not being fundamental operations and qualify for PE Negative List. Development and Innovation activities could qualify as essential operations for the business being excluded.
Auxiliary: Latin auxiliarius, from auxilium 'help'. Adjective, providing supplementary or additional help and support.	Axiomatic Productivity Remote Profitability Uncertain Allocability Arguably, R & D & I could match the criterion of being auxiliary in the sense of providing low margins of additional productivity, remote profitability and uncertain allocability, in order to be qualified for the PE Negative List.	Significant: Adjective 1 extensive or important enough to merit attention. 2 having an unstated meaning; indicative of something. All R & D & I as fundamental research, applied research, development and innovation would fall out the PE Negative List considered as activities entailing some extent of significant auxiliary support for the business activities of the enterprise as a whole.

In light of the information contained in the Table the operative criteria contained in OECD Commentary, Article 5, paragraphs 21, 23 and 24 seems to be a confusing guidance in an area of whose conceptual and practical treatment should clarified for tax purposes and be in line with other important definitional scientific documents such as the OECD Frascati Manual and OECD

[1] Frascati Manual, The Measurement of Scientific and Technological Activities, Proposed Standard Practice for Surveys on Research and Experimental Development, OECD, 1993, pp. 18. Frascati Manual, OECD, 2002.
[2] OECD, The Measurement of Scientific and Technological Activities Proposed Guidelines for Collecting and Interpreting Technological innovation Data, Oslo Manual, 1992, hereinafter Oslo Manual. 3rd edition of the OECD Oslo manual published 27 Oct 2005.
[3] Oxford University Dictionary and Black's Dictionary.

Oslo Manual. Hence we suggest that a new commentary is drafted in order to clarify the criteria behind the “preparatory and accessory test”, in particular looking forward to R & D & I activities contained in Article 5, 4, letter e) and f) of OECD Model.

6. Comments

19. Meaning of “to conclude contracts in the name of the enterprise” (paragraph 32.1 of the Commentary)

The clarification intends to cover the situation of the Agency PE by means of two different figures of commercial intermediation dealing with the contractual figure of the civil and / or commercial Mandate. These intermediations may be performed by a person acting with or without the element of representation. In the first case, the mandatary acts *in nomine alieno,* in the name and on behalf of the mandator. In the second case, the mandatary acts *in nomine propio* and does not disclose the name of the mandatory, who is the principle titleholder to the rights and obligations provisionally created in the patrimony of the mandatary, who is obliged to transfer them thereafter.

Although attention has been put in the elements of representation, the recurrency and the independency in executing the targeted contract, it would be also important to clarify the practical situation of the flows of moneys between the Mandator, Mandatary and Third Parties engaged in international transactions in the context of DTTs, for tax administrations of developing countries to have more clarity. Some of these payments may flow between the resident State R of the mandator (principal) and source State S of the mandatary (Agent) for accessory or principal contracts closed with Third Parties located in the same State S of source or even in Third Countries.

The following examples could be addressed to attain uniformity of treatment across jurisdictions from an international tax perspective: a) Advancement of moneys by the mandator to the mandatary in order to execute the target contract; b) Reimbursement of expenses from the mandator to the mandatory for accessory payments made necessary for the execution of the target contract; c) Remuneration (commission) of the mandatory paid by the mandator for the services rendered; d) Payment made by mandatory to third parties in fulfillment of accessory or principal target contract; and e) contract or tort liability payments.

We would like to thank for the opportunity given by the OECD to submit these commentaries.

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