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

Response from IBFD Research Staff[1]

I Introduction

The research staff of the IBFD welcomes this opportunity to comment on the discussion draft dealing with many issues relating to the interpretation of the concept of permanent establishment (hereafter referred to as PE), as published by the OECD on 12 October 2011. We hope that the following comments will provide a useful contribution to the work of the OECD in this respect and will gladly provide further clarification of any of the points raised.

This response to the OECD's discussion draft consists of two parts. Part II contains a number of general remarks on the concept of PE as dealt with in the text and commentaries of the current OECD Model Tax Convention (OECD Model). Part III contains a direct response to a selected number of 11 out of the 25 (!) issues dealt with in this discussion draft.

II Concept of PE in the current OECD Model

(i) General considerations

The research staff is happy that the OECD has provided a document attempting to deal with interpretation issues regarding one of the corner-stones of tax treaties: the notion of PE, which is crucial to the allocation of the taxation rights regarding cross border business activities.

The large number of 25 points raised in the document, shows that apparently many issues have been raised in practise. This cannot come as a surprise in view of the globalization and changes in business models over the last decades. It had also already become apparent from the increasing case law regarding PE's and from the general report as well as the country reports prepared and published for the 2009 IFA Congress. In our view these developments pointed out that currently there is not enough clarity regarding both the definition of the basic concept in paragraph 1, and other provisions of article 5 of the Model and its related commentaries.

[1] The authors of this response were: Jan de Goede, Daljit Kaur, Bart Kosters, and Andreas Perdelwitz.

In view of that, we would like to make some more general observations, before dealing in Part III with a selected number of issues of interpretation as dealt with in the discussion draft.

First of all , we note that the notion of PE has already been used for a very long time in tax treaties. It reflects the so-called supply-based theory, which requires a physical nexus between the non-resident enterprise and the country from where the business income is derived for the latter to be entitled to tax (part of) the profits derived from that country. Apparently, in the past the fundamentally different supply-demand theory (under which the mere use of the market in the other country would already justify taxation in the source state, even without any physical presence there) was not considered a proper basis for the allocation of taxing rights regarding business profits in either the OECD or the UN Model.

It is also worth noting that besides this theoretical starting point and various other economic and legal considerations, practical enforcement aspects played an important role in defining the concept of PE. The concept effectively represents the minimum threshold level of activities required to be carried on in the source state.

In these comments we limit ourselves to the discussion and interpretation of the concept of PE as derived from the first theory and do not go into the far broader issue of alternative approaches to the allocation of business profits between residence and source country on which according to an OECD report of 2004[2], no general agreement could be reached. It seems that currently there is more debate on the appropriateness of the current concept for the allocation of taxing rights, but no general agreement is feasible yet.

Limiting ourselves to the current concept, it is striking to note that the text of the article dealing with PE's (article 5 in both the OECD and the UN Model) has hardly been changed since the 1963 OECD Model. However, numerous changes were made during that period to the commentaries. These do not seem to only include limited clarifications needed due to for instance changes in business models, but also seem to contain substantive new interpretations of (part of) the six key features of the definition of PE as expressed in paragraph 1 of article 5.

These key features are :

- a tangible place in the other state

- at the disposal of the enterprise

- fixed in geographical sense

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[2] See 2004 OECD Report "Are the current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?".

- fixed in temporal sense (permanence)

- the business must be carried on

- through that fixed place.

Although previous changes to the commentaries and part of the 25 issues now addressed were and are useful in interpreting the PE notion in changed business circumstances, the question is warrented whether all these changes to the commentaries are still consistent with the original understanding of these key-elements. Due to these sometimes substantial changes, questions can be raised regarding the authority of the commentary in interpreting the same text regarding the notion of PE as included already for many years in the tax treaties. We have the impression that the limits of solving problems by changing the commentaries have not only been reached but have already even been exceeded, causing serious risks for legal certainty.

(ii) Legal certainty

As mentioned above, part of the abovementioned changes have even raised uncertainties as to the interpretation of some of the key-features of the PE concept (like the notion of being at the disposal, or the notion of fixed both in a geographical and in a temporal sense).

Due to the substantial increase of case law in many countries, the need has become apparent for clear concepts in the text of article 5 and for clear guidance in the commentaries within the limits put by the text of the provisions.

It should also be observed that a lot of relevant case law is produced by courts from countries not being a member of the OECD and thus not bound by or fully familiar with the long history of the PE concept as developed e.g. in the OECD Model and its commentaries. However, even in the case of countries which are not a member of the OECD, reference is regularly made by the relevant courts to both the OECD texts (which are many times identical to the UN Model) and commentaries. This increasing involvement of non-OECD countries further shows the need for more legal certainty which can only be reached by clear texts and guidance in the commentaries. In our view, the current document does not really provide such certainty required for taxpayers but only adds to the already large number of rather factual examples which many times have a limited scope.

As mentioned above, the aspect of practical enforcement was one of the important considerations underlying the PE definition. In view of that, we think that after so many years of permanence in the text of the wording of article 5, a number of issues need to be clarified by amendments to the various paragraphs of the text. As that is, unfortunately, not within the scope of the current draft report, we do not further elaborate on that now,

but refer to a recent article published on this topic[3] in which various suggestions for such amendments were made.

(iii) Balance in the allocation of taxing rights between state of residence and state of source

It may be noted that in view of the increased influence of new emerging economies, new OECD member states as well as the participation of a number of non-member states in the work of the OECD, an increasing focus on source state taxation may occur. The authors of this response do not want to take a position regarding the appropriate balance in the allocation of taxing rights between states of residence and states of source, but do want to emphasize that in their view any increase in taxing rights for the source states, should not be achieved by giving a broader interpretation to the existing wording of article 5 of the Model. If such shift is desirable, it should in view of the legal certainty and smooth practical implementation mentioned before, be clearly expressed by amendments to the text of article 5 itself. In this respect we refer to the recently introduced optional provision regarding services as included in point 42.23 of the commentaries on article 5 of the Model.

III Comments on Discussion Draft

We have decided not to comment on all the issues addressed in the discussion draft. Instead we have decided to focus on selected issues.

Issue 2: Meaning of "at the disposal of" (paragraph 4.2 of the Commentary)

Paragraph 4 of the Commentary states that a place of business may exist where there is a certain amount of space in the source state that is "at the disposal of" the foreign enterprise. A legal right is not required, but a mere presence is insufficient (paragraphs 4.1, 4.2 of the Commentary). The Commentary also provides that besides being owned or rented, there are other ways in which a place can be made available to or be "at the disposal of" the enterprise.

Whether or not a place is at the disposal of the enterprise is explained by way of examples in the Commentary. Such examples do not cover all the possible real-life scenarios that may exist and thus do not replace the need for the definition of "at the disposal of". As this principle is vital to the determination of a place of business, it should be included in the text of article 5 of the Model. It should also be explained by way of clear,

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[3] Jan de Goede ,Permanent Establishment: Relative Permanence (VAT in an EU and International Perspective, Essays in the honour of Han Kogels, pages 319-329, 2011, ISBN 978-90-8722-102-7)

normative rules in the Commentary, which can then be supplemented by the given examples. An example of a clear normative rule would be as follows:

"disposal requires control over the place in the sense that it can be accessed (at any time) without further permission of the person who made it available and that other people may be refused to use (parts of) the place".

The proposed revision is also unclear in what is meant by "continuous and regular basis during an extended period of time". The words "intermittent and incidental" are also used to indicate a negative situation, but as none of these terms have been explained in the Commentary, they can give rise to interpretive issues.

Issue 4: Home office as a PE (proposed new paragraphs 4.8.and 4.9.)

In addition to the proposed amendments regarding the interpretation of the notion of "at the disposal", the Working Group further suggests to add two paragraphs addressing the issue under which circumstances an employee's home office may constitute a permanent establishment for an enterprise. It appears reasonable that the starting point for the Working Group's suggestion is that the mere fact that an employee carries out work at home does not lead automatically to the conclusion that the home office is at the disposal of the employer. However, the further description of the Working Group under which a home office may be considered to be at the disposal of an enterprise does not provide for sufficient clarity.

While the current Commentary elaborates on a "right of use" test, the proposed revision introduces the notion of "continuous and regular basis" without further clarification. By doing so, the threshold of the PE-concept is lowered and broadened beyond its previous scope. Like it is considered in the example of the visiting salesman that the purchasing director's office is not at the salesman's enterprise disposal, the private home of an employee, e.g. the salesman is not at the disposal of the enterprise either, unless further requirements are met. In this respect, criteria which would indicate a "right to use" for the employer, are whether or not the employer reimburses expenses for the employee's home and whether or not the employer has a right to access the home in whatever way. The proposed criteria relating to a time element, whether the home office is used on a regular and continuous basis and whether the employer requires the employee to work from home are not suitable to identify a "right to use" for the employer. A rather stricter application of a "right to use" test would result in more certainty.

The example of the non-resident consultant carrying on most of her business activities in an office in her private home may indeed be considered a clear example where a home office constitutes a PE. However, this is based on the fact that the home is at the disposal of the

enterprise due to the specific feature that it is a single entrepreneur business and not because the enterprise has required the consultant to work from home. Further, the last two sentences of the proposed paragraph 4.9 ("the question whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue.") appear rather contradictory to the proposal to add two more paragraphs to the existing Commentary.

Issue5:.Shops on ships operated in international traffic (proposed paragraph 5.5 of the Commentary)

It is suggested to add a new paragraph 5.5 to the Commentary on article 5 to clarify that a shop which is located aboard a ship that is operated in international traffic would normally not constitute a permanent establishment.

We can agree to the principle laid down in issue 5. However, it seems useful to clarify in the suggested new paragraph 5.5 what is meant in this case with the wording "the operation of the boat is restricted to a particular area that has commercial and geographical coherence." We wonder how in the case of a ship operating in international traffic the condition of commercial and geographical coherence can be satisfied in a single Contracting State.

It would also be good that issue 5 would address whether in this situation it would be possible to have activities of a recurrent nature in a Contracting State.

Further, we feel that it would be useful to also explicitly address the situation where an enterprise of a Contracting State operates a shop aboard a ship which is operated exclusively in the other Contracting State. It is our understanding that in this situation the identification of a permanent establishment is equally relevant.

Issue 6: Time requirement for the existence of a permanent establishment (proposed paragraph 6 of the Commentary)

Issue 6 aims at clarifying when recurrent activities would lead to the presence of a permanent establishment. The Working Group proposes some changes to the Commentary to article 5. We feel that the examples in the proposed paragraphs 6.1 and 6.2 lead to a number of questions.

As to the recurrent activities included in the proposed paragraph 6.1 of the Commentary to article 5, the example mentions an individual who rents a stand at a commercial fair during five weeks each year for 15 consecutive years. It is then concluded that such a person will have a permanent establishment in the other Contracting State. The question is whether this is only the case as from year 15 or does the example imply

that retroactively the person should be deemed to have a permanent establishment as from the first year, which seems rather unpractical. Also, would the answer to the question on a PE be different if the person would be at the fair for just one week per year. When the duration per year would be shorter than the duration mentioned in the example, would this imply that more years of presence are required before a PE is deemed to exist? We feel that these questions should be dealt with in the Commentary. We also feel that the example given should be more realistic.

With respect to the example on the temporary restaurant in the suggested amended paragraph 6.2 of the Commentary to article 5, we feel that more clarification is required. Without any further elaboration on the topic, it is very strange that from the perspective of the source state, two identical situations are treated differently. In both cases, there is an activity (the temporary restaurant) connected to a one off event in the source state.

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

The Working Group proposes that an enterprise that has undertaken the performance of a comprehensive project must be considered to have a permanent establishment if it subcontracts all aspects of that contract to other enterprises. This concept shall not be limited to the scope of article 5 paragraph 3 but shall be applicable as well to the general rules under article 5 paragraph 1.

The suggested addition to the current paragraph 19 of the Commentary broadens the scope of article 5 paragraph 3 and the general principle of article 5 paragraph 1. While the general concept of article 5 effectively represents the minimum threshold level of activities required to be carried on in the source state, which requires also a certain presence in the source state. The proposal would mean that in the future this threshold is lowered from factual requirements such as a physical presence to a rather legal concept of contractual responsibilities and liabilities. After the amendments to the Commentary in 2003, by including on-site supervision activities carried out by other persons than the main contractor, this would constitute another case of broadening the scope of article 5 paragraph 3 by a mere change of the existing Commentary, not reflected in the wording of article 5. As already mentioned in the introduction, it should be considered to revise the wording of article 5, as done for example in the UN Model Convention, instead of continuously amending the Commentary.

In view of the unlikeness of scenarios where a main contractor completely subcontracts a construction project and not having any own employees present on the project site, we feel that the threshold prescribed by article 5 should not be further lowered to include these scenarios. Such cases could rather be considered in the light of paragraph 5 of article 5. The same holds true for the suggested new paragraph 10.1 of the Commentary.

The example given in the proposed paragraph 10.1 does not appear helpful in view of clarity, as it mingles aspects of the definition of a PE, e.g. fixed place of business and the carrying on of the business by the enterprise through the PE, with aspects relating to the allocation of profits where it refers to the remuneration of the subcontracted company being on a cost-plus basis.

We are further concerned about the question how the proposed amendment can be reconciled with the approach as expressed in the text of the existing paragraph 42.43 regarding the second alternative of the alternative paragraph relating to the provision of services. The second sentence of that paragraph stipulates that services performed by an individual on behalf of one enterprise will only be taken into account for another enterprise if the work of that individual is exercised under the supervision, direction or control of the last-mentioned enterprise.

Issue 11: Additional work on a construction site (proposed new paragraph 19.1 of the Commentary)

Paragraph 19 of the Commentary states that in calculating the duration of a construction site for the construction PE threshold, the site begins when the contractor begins work (including preparatory work), and ends when all the work on the site is completed or when the site is abandoned. The proposed paragraph 19.1 serves to provide that work undertaken on a site after the construction work is completed pursuant to a guarantee period would normally not be included in calculating the duration of the construction PE.

The proposed revision seems to leave open opportunities for abusive tax planning opportunities, in that contractors may try to rush through a construction project so as to cross-over into the guarantee period and thus avoid creating a construction PE. As such, we propose that the revision be clarified to state that the period of a construction PE ends only after delivery and acceptance of the project. This would ensure that the construction project meets the necessary requirements and standards of the client, and that the guarantee period is indeed a guarantee period and not part of the construction period.

In addition, paragraph 19.1 should go on to clarify that additional work on a construction site undertaken pursuant to a guarantee period could lead to the crystallisation of a separate construction PE if the repair works exceed the construction PE threshold.

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

The question concerns the issue whether the activities mentioned in subparagraphs a) to d) of paragraph 4 should be treated as automatic exceptions or whether these exceptions shall be subject to the conditions that the activities are of a preparatory or auxiliary nature. The issue was previously discussed in the 2004 report of the Business Profits TAG "Are the current treaty rules for taxing business profits appropriate for e-commerce?"[4] However, in the context of the 2004 report, the question was rather whether to abolish the exceptions in paragraph 4 a) to d) completely or whether to subject them to the overall conditions of being of preparatory or auxiliary nature. The Working Group chose the alternative under which the activities mentioned in subparagraphs a) to d) of paragraph 4 should be treated as automatic exceptions, i.e. a fixed place of business, where only such activities are carried out is deemed not to constitute a permanent establishment.

The result is convincing and may be considered a welcoming clarification. The decision of the Working Group is strongly supported by the actual wording of paragraph 4 a) to d). In the light of interpretation in respect of the wording, there is no room to subject the exceptions contained in paragraph 4 a) to d) to an additional condition or limitation. The wording of paragraph 4 suggests a sort of hierarchy between subparagraphs a) to f). Whilst subparagraphs a) to d) mention specific activities, which are supposed to be exercised solely for the benefit of the enterprise and not for the benefit of third parties, subparagraph e) provides for a general clause applicable to any other activity not mentioned in the foregoing subparagraphs, as it would not be possible to provide an exhaustive list of activities. Such activities, however, must be of preparatory or auxiliary nature. Subparagraph f) finally provides for an overall limitation in case of a combination of activities mentioned in subparagraph a) to e) and applies to all foregoing subparagraphs. A contrario, following the alternative suggestion to apply the general limitation of subparagraph e) to the foregoing subparagraphs, would render them unnecessary and the text of paragraph 4 could simply be reduced to subparagraphs e) and f).

The rationale behind the requirement of activities being of a preparatory or auxiliary nature is the fear of loss in tax revenue due to a possible fragmentation of functions in the host state by an enterprise and taking advantage of the provided exceptions in paragraph 4. However, activities listed in subparagraphs a) to d) are activities which are commonly considered as activities of preparatory and auxiliary nature. While subparagraph a) contains the limitation that it applies only to goods and merchandise owned by the enterprise maintaining the facilities in question, subparagraph b) and c) seem merely of a declaratory character. The maintenance of a stock of goods fails to satisfy the requirements of the general definition set out in article 5 paragraph 1, as the stock is not there to be used by an enterprise for its activities, but is rather the object in which the enterprise trades or which it processes. Similarly, subparagraph c) applies to stock that is maintained on the premises of another enterprise for being processed. Likewise, neither the stock itself

[4] see note 2

nor the premises of the other enterprise constitute a permanent establishment of the enterprise owning the stock[5]. Finally, the issue of fragmentation of activities is sufficiently addressed by subparagraph f) which applies to combinations of all activities provided for in subparagraphs a) to e).

In sum, the suggested amendment by the Working Group is in line with the wording of paragraph 4. However, as apparently the current wording of letter e has caused differences of interpretation, an amended wording of paragraph 4 subparagraph e) , e.g. "...any other activity of a preparatory or auxiliary character not mentioned in subparagraphs a) to d)", would be more desirable and would serve increased certainty and simplicity.

Issue 13: Relationship between delivery and the sale of goods in subparagraph 4a) (paragraphs 22 and 27.1 of the Commentary)

The proposed addition, that subparagraphs a) and b) apply regardless of the fact whether the storage or delivery takes place prior to or after the conclusion of the underlying sales contract for goods or merchandise, provided that the goods or merchandise belong to the enterprise whilst they are at the relevant location, serves as well certainty and clarity. As long as the sales activities related to the underlying contract are not carried out from the facilities which are used for the storage and delivery of the respective goods and merchandise, the application of subparagraph a) and b) to such a scenario should remain unaffected. As the current wording of subparagraph a) and b) does not provide room for a different view as regards this matter, the proposed addition is a mere clarification.

However, in this specific context, it seems useful to mention in the proposed text that the underlying sales contracts are either being concluded abroad, or, if concluded within the same state, from a fixed place or through a person separated organisationally from these places. If the contracts are concluded for example by dependant agents within the same state where the goods referred to in subparagraphs a) and b) are situated, the issue relating to the fragmentation of cohesive business activities may arise.

Issue 17: Negotiation of import contracts as an activity of a preparatory or auxiliary activity (paragraphs 24 and 25 of the Commentary)

The issue is whether activities in the other Contracting State relating to involvement in the negotiation of contracts for the import of products or services into that State for the purpose of selling them to buyers in that

[5] see Vogel, Klaus/Lehner, Moris, Doppelbesteuerungsabkommen (DBA), 5th ed. (Munich: Beck, 2008), Art. 5, note 88.

state are of a preparatory or auxiliary character or whether they lead to the presence of a permanent establishment in that State.

Although we agree that in principle the active participation in negotiations of import contracts goes beyond activities of a preparatory and auxiliary character, we would like to see further clarification as to when the participation in negotiations is to be considered as an active participation (like e.g. participation in the decision making regarding the pricing)and more importantly under which circumstances the participation in such negotiations is not of an active nature. It is however also important to bear in mind the changes that were made to the Commentary to article 5 in the 2005 update as a consequence of the decision of the Italian Supreme Court in the so-called Philip Morris case[6].

Issue 18: Fragmentation of activities (paragraph 27.1 of the Commentary)

Issue 18 focuses on an enterprise which maintains several fixed places of business in the other Contracting State within the meaning of article 5, paragraph 4. The question is whether each fixed place of business can be viewed separately from each other locally and organisationally. The Working Group recommends that no changes are made to the Commentary.

We feel that as a rule fragmentation of activities could be tackled with anti-abuse rules. Some tax treaties containing a separate article with respect to activities on the continental shelf contain explicit anti-abuse provisions as to fragmentation of activities.

As has been the experience in some countries it may be difficult to apply domestic anti-abuse provisions under double taxation conventions. Therefore, it could be considered to lay down in the Commentary to article 5 a text which could be included in tax treaties dealing with fragmentation of activities or projects.

Issue 19: Meaning of "to conclude contracts in the name of the enterprise" (paragraph 32.1 of the Commentary)

Paragraph 32.1 of the Commentary states that the phrase "authority to conclude contracts in the name of the enterprise" does not only apply to agents who enter into contracts literally in the name of the principal; it applies equally to an agent who concludes contracts which are binding on the principal even if the contracts are not actually in the name of the principal.

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[6] Corte di Cassazione (Supreme Court) 25 May 2002, Case 7682.

The Commentary does not specifically address the treatment of commissionaire agents, and it appears that the proposed revision to paragraph 32.1 makes an attempt to do so. However, the proposed revision is insufficient and does not add clarity to the issue of whether commissionaire structures can create a PE for the principal.

As seen from recent Court judgements in civil law countries (Zimmer in France and Dell DUF in Norway), a form over substance approach seems to have been followed and the emphasis is on the wording used in the treaty. Under this approach, a commissionaire structure would not create a PE for the principal due to the fact that in those civil law systems, the contracts are not concluded by the commissionaire in the name of the principal, and thus are not legally binding on the principal.

For clarity and from the perspective of legal certainty, the term "to conclude contracts in the name of the enterprise" should in conformity with the explanation in the commentaries be replaced with the word "to conclude contracts that are binding on the enterprise". This would ensure that all types of agency which are capable of binding the principal (whether legally or economically), could lead to a PE for the principal if the other requirements of article 5 paragraph 5are met. The Commentary should also specifically address the commissionaire structure in civil law jurisdictions, and clarify whether and when they are from a treaty perspective considered capable of binding the principal.

Clarification is also required with respect to the meaning of the term "habitually" used in article 5 paragraph 5. Paragraph 33.1 of the Commentary provides that the term "habitually" reflects the degree of permanency requirement of article 5. Pursuant to the Commentary, in order to be "habitual";

- the presence of the agent should be more than transitory;
- the degree of frequency giving rise to a habitual activity depends on the nature of the contracts being concluded and the business of the principal; and
- the same type of factors considered in paragraph 6 of the Commentary would be relevant.

It is not clear what is meant by "transitory", and the dependency on the nature of business and contracts creates room for differing views and thus uncertainty. In addition, as mentioned in our comments to Issue 6 above, uncertainties also exist with regards to the factors considered to meet the PE time requirement in paragraph 6 of the Commentary. Thus, a clarification in both places in the commentaries and in the text of the Model itself seems desirable.