OECD WORK ON THE PERMANENT ESTABLISHMENT DEFINITION

Over the last few years, Working Party No.1 of the OECD Committee of Fiscal Affairs has discussed various issues and practical examples related to the definition of permanent establishment found in Article 5 of the OECD Model Tax Convention.

The 2003 update

That work has already resulted in changes to the Commentary on Article 5 of the OECD Model Tax Convention. These changes were adopted by the OECD in January 2003 and dealt with:

- The application of the existing PE definition to e-commerce. A first draft on this issue was released for comments in October 1999. Based on the comments received, a revised draft was released for further comments on 3 March 2000. The changes were subsequently finalized by the Working Party No. 1 in September 2000 and approved by the Committee on Fiscal Affairs in December 2000.

- A number of technical issues related to the permanent establishment definition. Work on these had started in the early 1990s, when a Working group was set up to deal with a number of practical problems related to Article 5. The changes to the Commentary resulting from that work were presented at the San Francisco IFA Congress in 2001 and were put on the OECD web site in October 2001. They were subsequently revised in light of business comments and were finally adopted by the OECD in January 2003, when the 2003 update to the Model Tax Convention was approved A background report explaining the various changes was published in May 2003.

The 2005 update

The only changes related to the permanent establishment definition that will be made in the next update to the Model Tax Convention, which is scheduled to be published in the first part of 2005, deal with clarifications that business and some member countries have asked the OECD to make following a well-known court decision. These changes were released for comments in April 2004 and were slightly revised in September based on the comments received. The revised version, in which the most recent changes are underlined, is attached. The main change made in September seeks to address comments received to the effect that it would also be helpful to clarify that the mere fact that the activities of a local company further a foreign company's business in some manner or provide it with an economic benefit would clearly not result in a permanent establishment for the foreign company. The following was added for that purpose:

> "Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services."

Other work related to the permanent establishment definition

Working Party no. 1 is also carrying on other work related to the permanent establishment definition which could result in further changes in a subsequent update (no other changes on this topic will be included in the 2005 update).

In April 2004, the Business Profits TAG completed its report entitled "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?" The report was presented to the Committee on Fiscal Affairs in June 2004. Given the overall conclusion of the report that e-commerce in itself does not justify fundamental changes to the existing rules, it is not intended, at this time, to further examine the more fundamental alternatives discussed in the report. Some of the less drastic proposals examined in the report dealt with possible changes to the permanent establishment definition. There are no immediate plans to pursue most of these proposals.

As noted in the TAG report, however, the Working Party has already started work on one of these proposals in the context of its work on the application of tax treaties to services. That work is carried on by a Working Group. The Group met for the first time in July 2004 and will next meet in February 2005. It is expected that consultation with business as regards this particular issue will start in 2005.

The OECD work on corporate restructuring, which includes the examination of commissionaire arrangements, could also result in other changes to Article 5 or its Commentary. That work will also involve looking at other PE issues on which Working Party No. 1 has previously worked. One of these issues is that of the "subcontractor who subcontracts all aspects of a construction contract."

The Working Party has already had many discussions on a proposal concerning a change to the Commentary dealing with that issue. That change was previously approved by the Working Party in the following form:

> "***Issue III-8: Contractor who sub-contracts all aspects of a project***
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> *Issue*
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> It has been suggested that paragraph 19 of the Commentary on Article 5 should be amended to add the words "all or" after "performance of a comprehensive project subcontracts". It has been reported in that respect that taxpayers have made the argument that the language of the Commentary prevents a general contractor from having a permanent establishment if the entire project is subcontracted.
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> *Discussion*
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> The Working Party based its analysis on the fact that a general contractor would be in charge of and legally responsible for the construction site, even though not physically present therein. The site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor because 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. For this reason, the Working Party agreed with the proposed change.
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> *Conclusions and recommendations*
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> The Working Party recommends to replace the last two sentences of paragraph 19 of the Commentary on Article 5 by the following (proposed additions are in bold italics):

1. "… If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts ***all or*** parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. ***In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor because 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.*** The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months."

While that change was included in the first draft of the 2003 update that was released in October 2001, it was pulled out at the request of one country that wanted to have it reconsidered. The proposal has now been thoroughly reviewed by the Working Party at a number of meetings and the Working Party has confirmed its conclusion. It has agreed, however, to further examine the proposal in light of possible changes that could result from the work on corporate restructuring with a view to ensure consistent positions.

Another previous proposal will be similarly dealt with. That proposal, which was pulled out of the 2003 update following comments received from business representatives, was to add the following new paragraph 38.7 to the Commentary on Article 5:

> "38.7 As indicated in paragraph 38 above, another important criterion the assumption of entrepreneurial risk is a distinguishing feature of the independent agent. The character of the remuneration which an agent receives may provide a useful indication of whether (or to what extent) the agent bears the commercial risk of his activities. Factors suggesting that risk is not borne by the agent include contractual protection from losses or guaranteed remuneration. However the existence of a guaranteed stream of revenues will not be decisive where the agent is able to show that there remains a real possibility of loss as a consequence of risk borne by him in the conduct of the business. Where the overall scale of the agent's business is substantial this may be suggestive of the strength of the agent's position vis-à-vis his principals and hence his independence. And instances where an agent has demonstrated the strength of his position in reaching agreements with principals may provide firm evidence of independence."

Based on the business comments received, the Working Party concluded that whilst there was no doubt that bearing the entrepreneurial risk was an important criterion to identify an independent agent (as already stated in paragraph 38), the clarification proposed in paragraph 38.7 raised a number of questions that should be more fully examined in light of the OECD transfer pricing guidelines. In particular, it was suggested that the paragraph should be clarified because:

- the comments received indicated some confusion between a cost-plus remuneration and a guaranteed stream of income and between independence for purposes of Article 9 and for purposes of paragraph 6 of Article 5.
- the reference to a "distinguishing feature" in the first sentence may have been misleading.

It was therefore decided not to include paragraph 38.7 in the 2003 update and to review it as part of the work on corporate restructuring.

ANNEX

PROPOSED CLARIFICATION OF THE PERMANENT ESTABLISHMENT DEFINITION

Replace paragraph 33 of the Commentary on Article 5 by the following (the part added to the existing paragraph appears in bold 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. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated ***or if the ~~agent~~ first person has not formally been given a power of representation***. ***The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.*** Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either."

*Replace paragraphs 41 and 42 of the Commentary on Article 5 by the following (changes to the existing Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions)*

"41. ***A parent company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs 4, 5 and 6 above) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraph 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.*** ~~However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.~~

41.1 ~~42. The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company~~. ***The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 4, 5 and 6 above) and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article ~~latter company acts on its behalf~~ (see paragraphs 32, 33 and 34 above) ~~so that a permanent establishment is deemed to exist under paragraph 5 of the Article~~. The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State."***

Add the following new paragraph 42 immediately after paragraph 41.1 (see above change) of the Commentary on Article 5

"42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services."