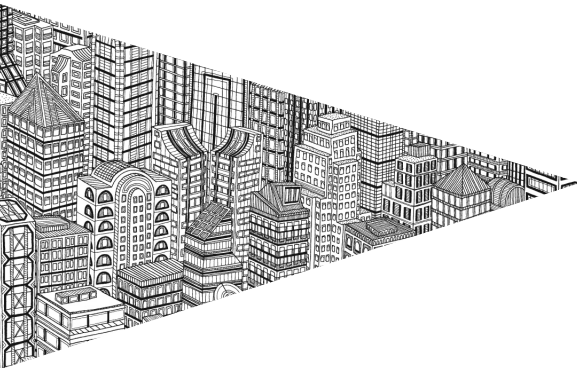


International Tax Alert



OECD proposes changes to commentary to model tax convention regarding permanent establishments

Executive summary

On 12 October 2011, the OECD's Centre for Tax Policy and Administration released a public discussion draft on proposed changes to the Commentary on Article 5 (Permanent Establishment) of the OECD Model Tax Convention (OECD Model), referred to in this Tax Alert as the Discussion Draft.

The highlights of the Discussion Draft include:

- ▶ Confirmation that the PE analysis should be unaffected by any prior business restructurings;
- ▶ Clarification of exceptions to the PE definition which may be particularly relevant in the context of limited risk distribution and contract manufacturing models; and
- ▶ Clarifications concerning the application of the PE concept in the context of joint ventures and partnerships.

The proposed additions and changes to the Commentary on Article 5 of the OECD Model will be considered for inclusion in the next update to the OECD Model and Commentary, which is currently planned for 2014. The OECD invites comments on the Discussion Draft before 10 February 2012.

Detailed discussion

The notion of PE contained in Article 5 of the OECD Model is a key concept of international taxation, and is used for the allocation of taxing rights when an enterprise of one state derives business profits from another state. The

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existence of a PE of an enterprise in another state determines whether or not the business profits of that enterprise can be taxed in that state. In the Discussion Draft, the OECD Committee on Fiscal Affairs presents proposals aimed at clarifying the interpretation and application of the PE concept in the OECD Model. Some highlights of the Discussion Draft are discussed below.

“Fixed place” PEs - Article 5(1) of the OECD Model

“At the disposal of”

The current Commentary to Article 5 indicates that place of business may constitute a permanent establishment if that place is “at the disposal” of the enterprise. The Discussion Draft would clarify the meaning of the phrase “at the disposal of.” The Discussion Draft indicates that whether or not a place of business can be considered to be at the disposal of the enterprise depends on the extent of that enterprise’s presence at the location and the activities it performs. Thus, a certain location would be considered to be at the disposal of the enterprise where (1) that enterprise has an exclusive legal right to use that location, and that location is used for carrying on the enterprise’s own business activities; or (2) that enterprise carries on its business activities on a continuous and regular basis at a location that belongs to another enterprise or is used by several enterprises.

For example, the Discussion Draft explains that a location which is owned and used by a contract

manufacturer cannot be deemed to be at the disposal of the enterprise that owns the parts that are assembled by the contract manufacturer, solely because the products of that enterprise are used in the business of the contract manufacturer. In general, a location where an enterprise does not have a right to be present, and which it does not use itself, is not “at the disposal” of the enterprise.

With respect to situations involving post-business restructurings, the Discussion Draft notes that for purposes of a PE analysis, it is insignificant whether the relevant facts and arrangements resulted from a business restructuring. For example, whether the premises of a converted local entity that manages risks or performs activities on behalf of a foreign enterprise constitutes a PE of the foreign enterprise should be analyzed solely on the basis of Article 5, irrespective of whether or not a business restructuring had taken place. This is consistent with the approach adopted for transfer pricing aspects of business restructurings. For these reasons, no additions or changes to the Commentary were proposed in this respect.

This discussion goes beyond what is contained in the Technical Explanation (TE) to the US Model Income Tax Convention (US Model).¹ The TE to the US Model does not mention either the contract manufacturing or the business restructuring situation. Instead, it focuses on the use of a physical

location and the foreseeability of the “more than temporary” use of the physical location to determine the existence of a PE.

Foreign Enterprise’s Seconded Employees

Temporary intra-group secondments of employees to another state often give rise to PE discussions. The proposed additions to the Commentary on Article 5 would clarify that, for the purposes of the PE analysis, it is important to make a distinction between cases where (1) employees of a foreign enterprise, while being formally employed by that enterprise, actually perform the business activities of another (resident) enterprise; and (2) employees of a foreign enterprise carry on the business activities of that foreign enterprise. In particular, the Discussion Draft observes that, under the first scenario, the foreign enterprise cannot be considered to carry on its business activities at the location where the employees in question are based and, accordingly, no PE issues are likely to arise in that context.² The TE to the US Model does not discuss the issue of seconded employees.

Main Contractor who Subcontracts all Aspects of a Contract

The Discussion Draft suggests changes that would clarify whether a main contractor that subcontracts all aspects of a project, can have a PE in the state where the subcontracted activities take place. The Discussion Draft notes that an enterprise may be deemed to carry on business activities in another state, even

where such activities are carried on through subcontractors, acting alone or together with employees of the enterprise. In that case, a PE may be found to exist if the conditions under Article 5 are met (i.e., 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 business). This suggested change would apply to PEs generally as well as construction/installation PEs. The TE to the US Model does discuss subcontractors in the PE context. However, the discussion is limited to the issue of duration of time at a particular site for purposes of determining the existence of a PE and does not address the particular assignment or delegation of work.

Joint Ventures and Partnerships

The Discussion Draft would add to the Commentary statements clarifying that the term “enterprise of a contracting state” as used in Article 5 refers to any form of enterprise carried on by a resident of a contracting state, including a company, partnership, sole proprietorship or other legal form. Whether or not the collaboration of different enterprises on the same project will amount to a separate enterprise depends largely on the relevant domestic law. In many cases, a separate company will not be set up to carry on the enterprise, but the parties agree

to each carry on a separate part of the business, and although they will share the overall output from the project they will not necessarily jointly carry on business activities or share the profits from such activities. Thus, it would be difficult to treat such an arrangement as a separate enterprise in the context of Article 5 (even though it may be considered a “joint venture” under local law). The Discussion Draft also proposes adding language that where the enterprise is organized as a fiscally transparent partnership, the enterprise is carried out by each partner. Accordingly, where the partnership has a PE, each partner’s share of the profits attributable to that PE will be considered to be derived by an enterprise of the state in which each partner is resident. The TE to the US Model does not discuss the issue of “enterprise of a contracting state” in the context of partnerships and PE determinations. However, US case law has addressed the issue.³

Exceptions to the PE Definition - Article 5(4) of the OECD Model

Article 5(4) of the OECD Model contains a number of exceptions to the PE definition. By way of example, the use of facilities for storage, display or delivery of goods and merchandise, or the maintenance of a stock of goods or merchandise for the purpose of processing by another enterprise, does not normally result in the creation of a PE.⁴ In addition to specifically listed activities, Article 5(4) provides that the exception to the PE definition also applies to any

other unspecified activities, as well as to any combination of the activities listed in Article 5(4), provided that the (resulting) activities are of a preparatory or auxiliary character.⁵ The Discussion Draft suggests the Commentary be changed to clarify the following:

- ▶ The relevant exceptions apply where the goods and merchandise belong to the enterprise. For example, whether the storage or delivery takes place before or after a sale contract has been concluded with customers is irrelevant for the application of these exceptions, as long as the title to the goods and merchandise has not passed to the customers, and the goods are still at the location of the enterprise.⁶
- ▶ Immovable property under development and data cannot be classified as “goods and merchandise,” because this term refers to tangible property. Accordingly, the exceptions for storage, display and delivery would not cover these cases.⁷
- ▶ The exceptions in question can be relied on where the place of business is used for any combination of storage, display and delivery of goods and merchandise, or for maintenance of stock for these purposes⁸

Finally, the proposed clarifications in the Discussion Draft provide that the maintenance of an office whose employees are involved in the negotiation of the essential parts of contracts for the sale of goods to buyers in that state cannot qualify

as an activity of a preparatory and auxiliary nature, and cannot benefit from the exceptions. Whether or not such an office constitutes a PE should thus be assessed against the background of Article 5(1).

The TE to the US Model generally provides that the exceptions to determining that a PE exists are those instances where there is only activity of a preparatory or auxiliary character and does not go into the detail provided in the Discussion Draft.

Dependent Agent PEs - Article 5(5) of the OECD Model

According to the Discussion Draft, the Working Party has extensively discussed two recent court cases concerning *commissionaire* arrangements where a French and a Norwegian court have reached conflicting conclusions as to whether or not a *commissionaire* under civil law, who cannot legally bind its (undisclosed) principal, may, nevertheless, constitute a dependent agent PE for that principal.⁹ The Discussion Draft proposes to add a new example to the Commentary

on Article 5(5) which would indicate that, in some countries, an enterprise could be bound by an agent, even where the agent did not formally disclose that he was acting for the enterprise and the name of the enterprise was not stated in the contract. The TE to the US Model does not contain language similar to the proposed example in the Discussion Draft.

Implications

The OECD Model and its Commentary influence the interpretation of tax treaties in many countries, although in the United States the US Model Treaty is accorded greater weight in terms of interpretative authority.¹⁰ As a general matter, the Treasury Department negotiates its income tax treaties using the US Model Treaty as the starting point for the terms of the various provisions of the treaties. However, the Treasury Department will sometimes agree to include specific language from the OECD Model in its negotiated treaties and typically references distinctions from the US Model in the TE to a particular treaty. Though

the Commentary to the OECD Model is generally not considered binding on taxpayers and the judiciary of OECD member countries, it can be important in understanding tax treaties that follow the OECD model. US courts have also cited to the OECD model for interpretative guidance.¹¹

Though the proposed additions and changes to the Commentary on Article 5 will not be finalized until after the OECD receives comments on the Discussion Draft by 10 February 2012, the Discussion Draft is an indicator of potential future change within bilateral agreements and may also be useful in situations that are not addressed in the TE to a specific treaty or the US Model Treaty. In any event, once the proposed Commentary is finalized, it will not be included in the OECD Model Tax Convention and Commentary until the next update, which is currently scheduled for 2014. In the meantime, taxpayers may wish to consider whether it is appropriate to provide comments on the Discussion Draft.

Endnotes

1. United States Model Income Tax Convention (2006).
2. Paragraph 38 of the OECD Discussion Draft.
3. See, e.g., *Unger v. Commissioner*, T.C. Memo 1990-15, aff'd, 936 F.2d 1316 (D.C. Cir. 1991) (holding that a permanent establishment of a US partnership would be attributed to a Canadian resident who was a limited partner in the partnership).
4. Art. 5(4) a)-d) of the OECD Model Tax Convention.
5. Art. 5(4) e)-f) of the OECD Model Tax Convention.
6. Paragraphs 79-83 of the OECD Discussion Draft.
7. Paragraphs 84-92 of the OECD Discussion Draft.
8. Paragraphs 93-97 of the OECD Discussion Draft.
9. See CE 31 March 2010, Zimmer Ltd, No 304715 and 380525 conclusions Julie Burguburu, BDCF No 6/2010; Borgarting Lagmannsrett, dated 2 Mar. 2011, Dell Products vs Skatt Ost, ref 10-032855ASD-BORG/03.
10. Note that generally the United States will first look to the US Technical Explanation to a particular treaty and to its own US Model when dealing with a question of treaty interpretation.
11. For example, in *Nat'l Westminster Bank, P.L.C. v. United States*, 58 Fed. Cl. 491, 498 (2003), in interpreting the US-UK Income Tax Treaty, the Court of Federal Claims noted that the OECD Model Income Tax Treaty and Commentary "serve as a meaningful guide in interpreting treaties that are based on its provisions." Also, in *Taisei Fire & Marine Ins. Co. v. Commissioner*, 104 T.C. 535 (1995), the Tax Court determined that given the absence of any provision dealing with insurance or reinsurance in the US-Japan Income Tax Treaty, the OECD Model was illustrative in holding that a PE did not exist in that case.

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