



Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l'OCDE

## **Comments of the Business and Industry Advisory Committee (BIAC) to the OECD on the OECD Public Discussion Draft:**

*“Proposed Clarifications of the Permanent Establishments Definition”*

**June 30, 2004**

BIAC has carefully studied the public Discussion Draft "Proposed Clarifications of the Permanent Establishment Definition," (Discussion Draft) dated 12 April 2004 together with the letter of the Committee on Fiscal Affairs Working Party No. 1 (WP1), also dated 12 April 2004, addressing BIAC's concerns about the 2002 Update of the OECD Model Tax Convention (MTC). BIAC is especially concerned about certain specific developments pertaining to the taxation of PEs (PE definition and allocation of profits).

The members of BIAC are of the opinion that this is the appropriate time to discuss with the OECD the question of whether or not the OECD developments go in the right direction, particularly when viewed in the context of the adverse consequences these developments presage for large enterprises active in many countries with business operations that are structured in cost-effective ways.

### **I. Introduction**

In the 2002 Update to the MTC, the OECD substantially altered the Commentary to Art. 5 of the Model. BIAC has informed the OECD of its concerns in a letter dated 15 September 2003. OECD WP1 as noted above, responded in a letter dated 12 April, 2004. At the same time, WP1 issued a Public Discussion Draft which proposed certain changes to the Commentary on Article 5, with a June 30, 2004 target date for comments from interested parties.

As stated, the business community is generally alarmed by certain developments which are considered a dubious and unwarranted restructuring of the PE concept. BIAC has serious questions on whether or not this restructure is in the best interest of developed economies, because they create further obstacles for international trade that could lead to a sharing of taxing right to business profits which is not commercially justified. Our members also fear that the essential conditions to protect international business operations, namely, legal security, practicality and administrative feasibility, are not sufficiently addressed in the new approaches being discussed at present in the OECD.

We, therefore, believe that, as a matter of some urgency, OECD and BIAC should enter into discussions of substance relating to the PE concept. With the 2002 Update of the MTC, the 2003 Report of the OECD Business Profits TAG, the ongoing work on the attribution of profits to the PE in WP 6 and, last but not least, the discussions on the taxation of services, both the tax authorities and the business community have become more aware of the problems facing them in a world featuring increasing international exchanges of goods and services, in the context of new business models being adopted by enterprises in order to be competitive internationally.

## **II. BIAC comments on the Discussion Draft of 12 April 2004**

Notwithstanding the thrust of the general comments above, BIAC gratefully acknowledges that the Discussion Draft addresses several important issues previously raised by the international business community. BIAC agrees with the Draft that in applying the PE definition, it should 1) only be applicable to one specific enterprise and not a group of companies as a whole, and 2) that the mere participation of a person in business negotiations should not necessarily create a PE. BIAC also welcomes the proposed clarification to the effect that the performance of management services by an enterprise for another member of multinational group, within its own premises, does not create a PE of the affiliate for which the services are rendered. After many recent changes, which extended the definition of a PE, the proposed clarifications in the Discussion Draft are striving to put limits to the scope of a PE and thus prevent an unwarranted dilution of its ability to protect foreign taxpayers.

Irrespective of this agreement in principle (and noting our fundamental concerns discussed in the paper), we have taken the liberty of redrafting the proposed new passages of the Commentary in some respects, to reflect our understanding of how these restrictions apply. From our point of view, certain ambiguities in the language used in the Discussion Draft could be misinterpreted to broaden the PE concept (in terms of broadening the tax base) instead of limiting it. In particular, the approach that a subsidiary may create a PE for its parent is, as will be outlined in more detail, not supported by BIAC. Our proposals are contained in the Attachment to this paper. We would welcome the opportunity to discuss them as soon as possible.

### **Fundamental requirements regarding the PE concept**

BIAC is still very concerned about the other changes to the Commentary, which are defended by WP1 in its letter to BIAC of 12 April 2004, as well as about some other proposed changes, which are currently under discussion in WP1.

#### **1. Fundamental requirements of the business community**

Before commenting on the specifics of the letter of WP1, as well as certain specific issues, in detail, we would first like to state the fundamental requirements of the business community regarding the PE concept (both its definition and the attribution of profits).

From the perspective of the international business community, there are three indispensable criteria that must be fulfilled by the PE concept:

- A. Clarity, in advance, as to whether or not, and when a PE is created.
- B. Clarity about the appropriate approach(es) to calculating the profit of a PE.
- C. Establishment of a regime with the lowest possible administrative burden for registering and administering a PE.

BIAC raises concerns about the ongoing revision of the definition of the PE because we see these fundamental requirements (i.e., legal security, practicality, administrative feasibility) as not being respected. Clarity in the definition of a PE, certainty in the profit allocation to a PE and a limitation of the administrative burden should be in the best interest of all OECD member states.

## **2. Clarity in advance, as to whether or not, and when, a PE is created**

The avoidance of international double taxation, which is a principal focus of the OECD (BIAC also), requires that the criteria to be applied in determining the existence of a PE be laid out in advance. The creation of a PE has such far-reaching consequences for taxpayers who, inter alia, have to file tax returns to avoid penalties as well as for tax authorities who have to determine whether to exempt or credit taxes, that a reliable definition of a PE is crucial for all interested parties.

We would like to illustrate this by two examples where the OECD and BIAC have divergent views, namely (a) the meaning of the expression "at the disposal" and (b) the assumption that a PE can be created if it exists for only a short period of time. Other examples can be found, in particular, regarding the application of the concept of the "deemed" PE under Art. 5, par. 5, MTC. We will come back to this particular situation in our discussion below.

### **A. Meaning of the expression "at the disposal"**

WP1 stated in its letter to BIAC of 12 April 2004 that, since the words "at the disposal of an enterprise" are not found in the language of Art. 5, MTC but are only included in the Commentary (since 1977), it "sees no benefit in defining that term". WP1 further stated that "the issue of when a particular location constitutes 'a place of business through which the business of an enterprise is wholly or partly carried on', is inherently related to the nature of the business under consideration. An abstract definition... would therefore not be possible."

This facts and circumstances approach will inevitably lead to situations where neither tax authorities nor taxpayers will be in a position to determine in advance whether or not a PE exists. This lack of precision is not helpful in interpreting Art. 5 correctly. At the very minimum, a non-exclusive list of criteria should be provided as to what constitutes "at the disposal". Similarly, safe harbour exceptions could be included.

While BIAC understands the principle which justifies the finding of no PE in the OECD example of a salesman visiting a customer at its premises on a regular basis, we do not understand the rationale for finding of a possible PE in the examples of a

painter working at the premises of a customer or a farmer repeatedly attending a market for a short period of time.

The main purpose of the PE concept of Art. 5, MTC is to grant taxation rights to the source state with respect to a foreign enterprise which is performing substantive activities and functions requiring a permanent physical presence. Art. 5, par. 1, MTC has always properly been interpreted to require some degree of physical presence, some type of fixed place of business at its disposal. For example, a general contractor subcontracting all of its work never has this kind of physical presence at its disposal. To reiterate, the main purpose of the permanent establishment concept is to give taxation rights to the source state if an enterprise is performing activities and functions which require a permanent physical presence. If a mere civil law responsibility would be sufficient to create a permanent establishment, the concept would become so diluted as to be virtually useless. The case of a company buying goods under a toll manufacturing agreement or contracting services, for example, could become problematical because the definition of "at disposal of" seems to have been broadened to include "at the direction of". Here to fore, nobody would have assumed a permanent establishment of the enterprise in question at the place of the producer's or service provider's residence. If this were the rule, the existence of a permanent establishment would, in most business arrangements, become the rule instead of the exception. We suggest that "at the disposal of" requires that an enterprise can make use of a place to the extent and for the duration it chooses to pursue its own business plan and activities.

We urge the OECD to reconsider the proposals made by BIAC on page 4 in the paper dated September 15, 2003 relating to the issue of "at the disposal of."

## **B. Duration of a PE**

We also remain concerned over the uncertainties arising out of the lack of any rules relating to the duration of an activity to be judged a PE.

In its letter to us of 12 April, 2004, the OECD wrote "We read the second sentence of Paragraph 6 of the Commentary to refer to a business which exists for a short period of time by reason of its very nature and to indicate that

a place set up for such business would not be set up merely for a temporary purpose even if it exists for a very short period of time because of the nature of that activity.” With all due respect, your response rearranges the words that we found unintelligible in the revised Commentary without providing any clarification. We still do not understand how the nature of the activity can transform a place that is intended to exist for a short period into a place of business that is not set up for a temporary purpose.

We understood the former requirement that “the place of business [must be] not set up merely for a temporary purpose” to involve a required and demonstrable intention of the taxpayer. The recent revisions have removed this condition. The elimination of this condition creates uncertainty that did not previously exist and introduces greater pressure for clarification. Specifically, what aspect of the nature of the business that will be carried on for only a short period of time distinguishes between a place of business that exists for a very short period of time that constitutes a PE and a place of business that exists for a very short period of time that does not constitute a PE?

The revised Commentary essentially acknowledges that it fails to answer this question. It merely points out, “It is sometimes difficult to determine whether this [a place of business constitutes a PE event 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 a very short period of time] is the case.”

The meaning of the Commentary must be clear and the language used must be understandable to the reader. The existing Commentary is not serving its purpose if the States that must enforce the treaties and the multinational enterprises that are trying to remain in compliance with the requirements of the treaties cannot determine what the treaties mean. The goal of voluntary compliance would best be served by a presumption that a fixed place of business can exist only if business is conducted at such place for a minimum period of time.

We, therefore, suggest that the OECD seriously considers using a minimum time period for which an activity has to be performed in a continuous manner before a PE

is created. The 183 day rule of Art. 15, MTC uses the concept of a time frame with great success and, notably, with a minimum amount of controversy associated in defining the scope of this definition. Art. 5, par. 3, MTC could be used as a precedent to establish a twelve month period as the minimum duration for a foreign enterprise's activities to rise to the level of PE. This can be derived from the fact that the construction and installation projects often require a substantial physical presence so that other businesses with less physical presence should, at the very least, also enjoy a twelve-month dominus rule.

A prescribed time frame allows businesses and tax authorities to assess, in advance, whether or not a PE will emerge. Except for extraordinary circumstances, for example, when a PE which is initially created to accomplish a long term agenda is closed down after a short period due to unforeseen events, there is little, if any, justification for defining a short term activity as being permanent even if it were of recurrent nature. Such an approach would only result in uncertainty whether or not a PE exists, which is unwarranted because these activities create no substantial permanent presence. In this context, the term "nature of the business" used by the OECD is generally not helpful for getting advance guidance.

The Commentary could suggest a minimum period of time as a general rule, even if paragraph 1 does not specify a minimum period of time. The Commentary could conclude that a place of business that does not exist for twelve months should "generally" or "except in the case of changed or unusual circumstances" be viewed as not fixed and, therefore, not constituting a PE. While such an objective standard is clearly preferred, clarification of the more subjective standard in the current Commentary is still necessary, especially if the Commentary is not revised to include this more objective standard.

### **3. Clarity about the appropriate approach(es) to calculate the profit of a PE**

BIAC suggests that whenever WP1 contemplates extending the PE concept to new or different activities, a practical example of the profit allocation should be discussed with WP6 as well as BIAC. The OECD should refrain from extending the PE concept

to situations where the allocation of a meaningful quantum of profit to the PE seems unlikely.

This particular reasoning was the basis for Art. 5, par. 4, MTC, which excludes some activities from the definition of PE, because the allocation of a substantial profit to these auxiliary activities is not justified. The same reasoning can be found in Art. 7, par. 5, MTC which states that no profits should be attributed to a PE by reason of the mere purchase of goods or merchandise.

To illustrate, examine the activities of a general contractor, who performs all activities in its country of residence. This is a case in point of the bankruptcy of a concept which would extend the PE concept to situations where, logically, no profits can be attributed to such a deemed PE.

In the case of our general contractor, if a contractual responsibility without physical presence were sufficient to create a PE, this would result in huge problems in allocating a profit to such a PE. Therefore, our general contractor, who subcontracted all of its activities to other entities, should not be regarded as having a PE in the first place. As such, a general contractor performs all its activities in its own country of residence. Therefore, a deemed PE would have no functions and an allocation of risk to such a phantom PE would be totally artificial. Following the discussions in WP6, the allocation of profits to a PE should follow the arm's length principle applicable to legal entities as far as possible. Hence, it should reflect the functions performed and the risks assumed by the PE (see Art. 5, par. 3, of the Commentary). The profit allocation to the PE would be nil, since all its functions were performed at home and all its risks assumed by the head office. The head office will, in practice, negotiate all terms and conditions of the business, establish guarantees, responsibilities, and render, as far as necessary, whatever services are involved at home. Accordingly, the extension of the PE definition to this set of facts makes no sense.

The difficulties encountered in attempting to reliably allocate a profit to a PE under the arm's length principle is also behind the business community's scepticism about the concept of the dependant agent that habitually concludes contracts and,

therefore, is deemed to create a PE under Art. 5, par. 5, MTC. Multinational enterprises are more and more using such structures (e.g. commissionaire arrangements, toll manufacturing, outsourcing), so as to organize global business operations in a cost effective way (centralization of functions and business activities, concentration on core functions). Thus, we urge OECD to desist from further extending this deemed PE approach.

If a lack of active involvement by a foreign enterprise in selling its goods and providing its services in a particular host country were to be indicative of a grant of authority to an affiliate residing there to conclude contracts in such country, an exposure of deemed PEs so created would be the result. Where there is an actual agent, BIAC believes that, provided that the agent has received clear guidance by the foreign enterprise on how to act, a PE should not be created. OECD has never answered the question as to how a profit allocation to a deemed PE be adequately justified, if the agent receives an arm's length remuneration for all functions performed or risks assumed. BIAC believes strongly that functions performed and risks assumed by the agent can only be remunerated once. There would be no profit left which could be allocated to the agency PE, particularly as the principal did not perform any activity and did not assume any risk in the country of the deemed PE. Many OECD countries subscribe to this opinion, which this probably explains why the agency PE under Art. 5, par. 5, MTC, despite its broad definition and the development of new business structures, was, up to now, comparatively infrequently raised on tax audits.

BIAC also urges OECD to discuss with the business community the issue of profit allocation under Art. 7, MTC first, prior to adopting a broader definition of a PE.

Additionally, BIAC would like to discuss whether Art. 5, par 5, MTC, dealing with dependent agents, should not be eliminated from the OECD Model. The fact that an authority to conclude contracts is exercised does not create sufficient economic involvement to assume a PE to exist. BIAC is open to discuss changes also for other parts of Art. 5, MTC if this would increase the certainty about the the basic soundness and application of the PE concept.

#### **4. Reduction of the administrative burden for a PE**

Compared to the taxation of subsidiaries, the taxation of PEs is quite uncertain, and their compliance with the various local laws, particularly as to profit allocation (but also, e.g., VAT) creates enormous work for the taxpayer. That is an important reason, why BIAC advocates a restrictive definition of the taxability of a PE, or, stated another way, an expanded definition of the tax relief afforded by the concept.

The administrative problems inherent in the taxation position of a PE could be substantially reduced if clarification was to be forthcoming that a PE could not be created merely by the acts of a subsidiary. A prerequisite of such a principle would be that the subsidiary receives an arm's length consideration for whatever activities it performs on behalf of the parent, although this would be fundamentally a question of adequate transfer pricing rather than creating a PE. It is notable that such a concept has already been incorporated in the Austrian/German Double Tax Treaty.

After a landmark case in Germany (Reichsfinanzhof 30.01.1930, ReichssteuerBlatt 1930 s. 148 ff), the relationship between subsidiary and parent company was clarified by insertion of a new rule in the then prevailing Model Treaty (and currently embodied in para.7 of article 5, MTC). For reasons of clarity and to avoid introduction of the same confusion as existed until the change in the Model Treaty of the League of Nations, we urge the OECD to refrain from implying a concept by which group internal arrangements could lead to a PE for the parent company in many countries.

The substantial burden of complying with the administrative requirements of a PE is subjected to another reason for supporting the position that an activity of a short duration should not be deemed to constitute a PE. The administrative costs relating to such short-term activities would be prohibitive. As is shown clearly by Art. 5, par. 4, MTC only activities of substantial nature can truly justify the complexities of PE treatment. This is why BIAC advocates the 12-month minimum time frame across the board.

### III. Conclusions

As previously discussed with the OECD Secretariat, BIAC would welcome an opportunity for a substantial discussion with WP1 and WP6 on all aspects of the PE concept. This extends naturally to a discussion of changes in the MTC itself, if necessary. BIAC takes exception to the perceived trend of narrowing the tax relief afforded by the PE concept. In this connection, we urge that the fundamental requirements of the PE concept, particularly, in this rapidly changing business environment, be thoroughly discussed with the international business community (essentially BIAC). In the interim, the necessity of supporting binding arbitration between OECD member states, as repeatedly requested by BIAC, is particularly urgent in view of the uncertainty surrounding existing PE approaches.

Such a discussion could cover among others the following questions:

- (1) What should be the fundamental requirements of the PE concept in the future?
- (2) Is it in the interest of the OECD countries to extend the PE definition (increasing host country taxation) and by this change the allocation of taxation rights?
- (3) Is it wise to extend the concept of the deemed PE (e.g. dependant agents)?
- (4) Is it acceptable to make subsidiaries deemed PEs?
- (5) How shall the service sector be dealt with (e.g. what does "disposal" and "duration" mean) ?
- (6) Is the profit allocation methodology practical if applied to certain businesses?
- (7) How could the concept be substantially improved in order to make it more practical (e.g. fixed place with time period as the only criteria, no deemed PEs, no extension of PE concept to subsidiaries, no allocation of certain assets, e.g. capital for banks)?

We would like to conclude this statement with the request that BIAC be involved in discussions about possible changes in the Commentary to the Model Treaty or even the Treaty itself, at an early stage. We, therefore, welcome the opportunity to discuss this subject with WP1 and WP6 as soon as possible. We think that, due to the importance of the subject, such discussions should take place earlier than spring 2005, e.g. in autumn 2004.