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OECD releases Discussion Draft on interpretation of permanent establishment tests in Model Tax Convention

The OECD recently released a Discussion Draft, "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention," which proposes numerous changes affecting application of tax treaty rules regarding the circumstances in which a taxable presence or "permanent establishment" (PE) may be created.

Public comments are invited on the Discussion Draft's proposed changes and amendments. Interested parties are requested to submit their comments before February 10, 2012. PwC has been following closely the OCED's work on the PE issue, and will submit its own response on the various issues discussed.

Background

The threshold of activity that triggers the existence of a PE under the OECD Model Tax Convention (and reflected in most double tax treaties) normally is determined by two tests set forth in Article 5. First, under the fixed place of business test, there must be "a fixed place of business through which the business of an enterprise is wholly or partly carried on." If an enterprise has no fixed place of business under that test, the activities of a "dependent agent" still may create a PE for a foreign principal. This second test will be met when an agent is acting on behalf of an enterprise and that agent has and habitually exercises in the state concerned an authority to conclude contracts in the name of the enterprise and the agent is not an "independent agent" acting in the ordinary course of its business.

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The OECD Discussion Draft

The OECD Discussion Draft represents the fruits of the OECD's work over the last three years on PE tests in Article 5. This work is not intended to lead to any changes in the text of Article 5 itself, but rather to focus on specific areas of guidance in the Commentary to Article 5. The 59-page Discussion Draft addresses a large number (25) of issues of interpretation relating to the existing Commentary on Article 5.

The Draft arranges the issues on which amendments to the Commentary are proposed in the order in which the relevant paragraphs appear in the current Commentary to Article 5. Of the 25 issues discussed, some (such as the first point on whether a farm can be a PE) will not be of pressing concern to many. Others -- such as the discussion of the time requirement for the existence of a PE, the presence in a country of visiting employees from overseas, and what it means to conclude contracts in the name of the enterprise -- are much more fundamental.

For each of the issues discussed, the Discussion Draft includes a description of the issue that led to the recommendations now being proposed and the relevant recommendation itself, which in most cases includes proposed changes to the Commentary on Article 5. The Draft also includes an annex containing a consolidated version of the Commentary on Article 5 as the paragraphs would read if the proposals included in the Discussion Draft were adopted.

Specific Proposals

With 25 separate areas relating to the guidance on Article 5 being considered, the OECD document is inevitably somewhat detailed. However, some of the more important points in the Discussion Draft are as follows:

Meaning of the phrase “to conclude contracts in the name of the enterprise"

The discussion of this fundamental point has been focused largely on commissionaire arrangements, although the point has much wider ramifications given it is the key element of the dependent agent PE test in Article 5 (5). The Discussion Draft addresses the question whether the phrase “to conclude contracts in the name of the enterprise” from Article 5 (5) refers only to cases in which the principal is legally bound in relation to the third party, by reason of the relevant agency law as applied to the contract concluded by the agent. The alternative possibility is that it is sufficient for the test to operate if the foreign principal is “economically bound” by the contracts concluded by the person acting for it in order for a PE to exist (assuming the other conditions of Article 5 (5) are met).

There is no elaboration on what is involved in being “economically bound." It is noted that the OECD Working Group could not reach a common view on these issues. Instead, it was considered helpful to insert an example of a situation in which a foreign principal would be bound by a contract even though the contract would not literally be concluded in his or her name. Therefore, a new sentence is proposed for the Commentary stating that in some countries an enterprise could be bound by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract. ***Observation:*** This new sentence is intended to refer to the situation of a common-law agent entering into a contract on behalf of an undisclosed principal, although it potentially might be interpreted more broadly.

The Discussion Draft also refers to a "related issue" -- whether a dependent agent could be deemed to exist if it were established (it is not stated by whom) that the arrangements entered into in a particular case "did not make commercial sense" and were "primarily structured in such a way as to avoid the creation of a PE." The Discussion Draft provides no criteria for the test of "making commercial sense" or for identifying abusive arrangements of the sort referred to. The above issues are raised but not pursued.

Discussion of independent agent status

Notwithstanding that the existing guidance on the scope of the independent agent exemption is perhaps the least clear aspect of Article 5, there is surprisingly little further clarification of what it means to be an independent agent. The Discussion Draft itself notes that the Commentary includes conflicting statements concerning the scope of that exemption, but the OECD Working Group seems to have concluded that this issue could not be addressed "merely through changes to the Commentary." The Draft contains some discussion of entrepreneurial risk as a distinguishing feature of the independent agent, but the discussion leads to the conclusion that it was not necessary to clarify the concept of "entrepreneurial risk."

Time requirement for the existence of a PE

The discussion on this issue notes the concerns of business as to the uncertainty concerning the period required for a location to be considered a PE and refers to an earlier proposal for a specific minimum period of time (and that a suggested 12-month period be used for this purpose). Responding to this situation, the Discussion Draft retains its reference to a general practice of a six-month minimum period (while noting that country practice is not consistent), but then expands the discussion to include two cases in which the six-month period is not relevant (when there is regular short-term activity in a State each year but recurring over many years and also when the business concerned is conducted for a short duration only).

Presence of visiting employees/secondments

There are some helpful comments proposed for insertion in the Commentary that would clarify that cross-border secondment arrangements should not normally lead to a PE of the seconding vehicle. It is recognized that within a multinational group it is relatively frequent for employees of one company to be temporarily seconded to another company of the group to perform business activities that clearly belong to the business of that other company. It is noted that such employees will normally carry on the business of the company to which they are seconded rather than the business of the seconding vehicle so no PE of the latter should be created. The position is contrasted with cases in which employees of a foreign enterprise perform that enterprise's own business activities.

"Place of management" PEs

The Discussion Draft raises the question whether and in what circumstances a member of a corporate group may constitute a "place of management" of another company of the group so as to constitute a PE in accordance with the existing example in paragraph 2 of Article 5. There is no clarification offered regarding "place of management" as such, but some minor changes to the drafting of the Commentary do emphasize that each of the terms referred to in paragraph 2 of the Article 5 (e.g., "place of management," "a branch," and "an office") must be interpreted in such a way that such places of business constitute PEs only if they meet all the basic fixed

place of business PE requirements. This means that, for example, an office in the headquarters company providing accounting, legal, and HR services normally should not represent a PE of the vehicle to which the services are provided.

Preparatory or auxiliary activities

The Discussion Draft addresses whether the various activities mentioned in Article 5(4) (including the use of facilities for the storage of goods or the maintenance of a fixed place of business to collect information for the enterprise, etc.) are automatic exceptions from the PE rule or whether they also must meet a "preparatory or auxiliary" test. It is clarified that the various activities listed in subparagraphs (a) to (d) of Article 5(4) are deemed not to constitute a PE but that the other unspecified activities of sub-paragraph (e) must meet the preparatory or auxiliary test. However, in this case, the Discussion Draft helpfully confirms that activities within these exemptions may contribute to the productivity of the enterprise yet would not meet the PE test by virtue of being remote from the actual realization of profits by the enterprise. ***Observation:*** The intention behind this proposed change is to remove any suggestion that there is a link between the attribution of profits and the existence of a PE.

Observations

The proposed changes in general

We welcome the various points on which the OECD's proposals would meet its objective of clarifying the existing guidance on Article 5 -- for example, the discussion on activities that are preparatory or auxiliary to the business of the enterprise concerned and so do not lead to the creation of a PE. We also support other segments of the discussion addressing particular issues that have been the subject of increased PE focus, such as place of management PEs. However, we have concerns relating to the comments in the Discussion Draft on what it means to conclude contracts and the absence of any real guidance on the independent agent test.

Concluding contracts

The comments made in the Discussion Draft about the phrase "to conclude contracts in the name of the enterprise" clearly reflect a disagreement on the meaning of that phrase among the Member States that participated in the work of the OECD. This is obviously not a helpful position given that the main purpose of the OECD Model Tax Treaty is to apply common and standardized solutions to particular issues. However, while there realistically will be such areas of disagreement, our main concern is that the Discussion Draft will add uncertainty to this topic. That is because the Discussion Draft seems to recognize – and therefore legitimize – the concept of being "economically bound" without giving any indication of what that means or requires.

The OECD discussion also refers to the view that a PE might be deemed to exist when the commercial arrangements "did not make commercial sense" or are primarily structured to avoid the creation of a PE. Our concerns are that these comments are somewhat nebulous and out of step with the provisions of Article 5. While they are not pursued in framing the recommended changes to the Commentary (presumably on the basis they cannot be reconciled with the provisions of Article 5), it is a concern they may be picked up by tax authorities as OECD source material and given a wide variety of different interpretations, potentially putting taxpayers in a very uncertain position or opening the door to unjustified attacks.

Independent agent test

It is not clear why the OECD has not taken this opportunity to remedy the unsatisfactory state of the guidance on this exemption from the dependent agent PE test. Given the inherent uncertainties in the existing Commentary, coupled with the practical significance of the test, it would have been an ideal opportunity to clarify the scope of this exemption.

The Discussion Draft notes the existing and apparently conflicting guidance in the Commentary and concludes that the issue could not be addressed merely through changes to the Commentary. While it is understood that the French and English versions of the Article do seem to conflict, so that changes to the text of the Article itself would seem to be necessary (and we understand that changes to the Article are outside the scope of this work), there are other aspects of the Commentary guidance that could be remedied. In particular, as the Discussion Draft itself notes, there are "many factors" used to address independent agent status, which in practice makes application of the independent agent test difficult.

It is hard to see why changes to the Commentary would not be precisely what are required to remedy the current situation. We remain of the view that the guidance on what is to be an independent agent is in urgent need of overhaul.

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