Issues Arising under Article 5 (Permanent Establishment) of the Model Tax Convention

(adopted by the OECD Committee on Fiscal Affairs on 7 November 2002)

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1. INTRODUCTION

1. This note represents the conclusions of the Committee on Fiscal Affairs[1] with respect to a number of technical issues arising from the current definition of permanent establishment, as found in Article 5 of the Model Tax Convention.

2. The approach generally followed by the Committee has been to focus on practical cases. The particular cases that were examined by the Committee included cases that dealt with the definition of permanent establishment under Article 5 of the OECD Model Tax Convention as well as cases dealing with the attribution of income to permanent establishments under Article 7. Since the issue of attribution of profits to permanent establishments is currently under discussion, the Committee decided to limit its discussion to issues related to the definition of permanent establishment in Article 5 of the Model Tax Convention.

3. During the course of its discussions, the Committee recognised that a number of cases raised the question of whether the concept of permanent establishment was still adapted to modern ways of doing business. Of particular concern in that respect are the area of services and the actual and potential business use of new communication technologies (*e.g.* electronic commerce).

4. The Committee believes, however, that this important question, which addresses the fundamental principles underlying Articles 5 and 7 more than the application and interpretation of these Articles, should be studied separately. For this reason, this report is restricted to problems related to the application and interpretation of the current provisions of the Model Tax Convention that define the concept of permanent establishment. The broader question of whether these provisions should be substantially changed has already been the subject of discussions within the Committee as well as in the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, a consultative group that has been set up to examine the application of existing treaty rules in the context of electronic commerce. That question will be the subject of future work by the Committee.

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5. This note is divided as follows:

- Part 2 deals with problems in applying the "fixed place of business" standard under paragraphs 1 and 2 of Article 5;
- Part 3 deals with problems in the treatment of building sites and construction or installation projects under paragraph 3 of the Article;

1 See, however, the observations by the Czech Republic in Annex 2.

- Part 4 deals with problems in identifying preparatory and auxiliary activities under paragraph 4 of the Article;
- Part 5 deals with problems related to agency permanent establishments under paragraphs 5 and 6 of the Article;
- Annex 1 includes all the changes to the Commentary of the Model Tax Convention that result from this report.

6. Each issue identified in Parts 2 to 5 is presented with a description of the issue, a summary of the discussions and the conclusions of the Committee.

2. "FIXED PLACE OF BUSINESS" (PARAGRAPHS 1 AND 2)

a) Issue 2.1: "Fixed place of business": the geographical link requirement

Issue

7. The need for a geographical link and a certain duration have always been important features of the permanent establishment concept, but the application of these requirements has historically been flexible and sometimes inconsistent. As far as the geographical link requirement is concerned, the issue is that of the proper interpretation of the concept of "fixed place".

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8. The discussions on the meaning of the phrase "fixed place of business" revealed that this phrase should not be interpreted as a reference to a narrow geographical point and that virtually all countries adopt a broader interpretation. As noted in paragraph 20 of the Commentary on Article 5 in relation to construction sites, there can still be a permanent establishment if the nature of a business is such that activities in relation to a single project may have to be relocated continuously. It was agreed that the concept of "fixed place" ought to be applied on the basis of the nature of the relevant business. That would mean, for example, that a particular street or market could constitute a "fixed place of business" for someone who regularly set up a stand on that street or in that market, even though the stand was not permanently fixed to the ground and the exact location of the stand might vary from time to time.

9. The Committee found that the concept of a place that constitutes a coherent whole commercially and geographically in relation to a particular business (this wording is derived from that used in paragraph 18 of the Commentary on Article 5) would be relevant in applying the concept of "fixed

place of business". For example, a market would constitute such a coherent whole commercially and geographically in relation to market activities so that business activities regularly carried on in different parts of the market could constitute a permanent establishment. The same could not be said in the case of activities carried on in different markets as these would not constitute one such coherent whole. Any geographical area that commercially or economically constitutes a unit could thus constitute a fixed place of business for an enterprise even though the business activities of that enterprise would move within that area.

10. The Committee also noted, in that respect, that returning regularly to a number of different places, each of which would constitute such a unit, could result in a number of different permanent establishments. Thus, for example, if a book-seller regularly came back to two different markets on two different days of the week, he could be found to have two permanent establishments.

Conclusions

11. The Committee agreed that the concept of "fixed place" ought to be applied on the basis of the nature of the relevant business so that the term "place" should be interpreted to refer to any location that constitutes a coherent whole commercially and geographically in relation to a particular business. For example, whilst a farm or a market would constitute such a "coherent economic whole" so that business activities regularly carried on in different parts of the farm or the market could constitute a permanent establishment, the same could not be said in the case of activities carried on in different farms or markets. Any geographical area that commercially or economically constitutes a unit could thus constitute a fixed place of business for an enterprise even though the business activities of that enterprise would move within that area. It was agreed that the Commentary should be amended to clarify that point through a series of examples.

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12. It has therefore been decided to add the following new paragraphs 5.1 to 5.4 to the Commentary on Article 5:

> 5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single 'place of business' (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be

identified as constituting a coherent whole commercially and geographically with respect to that business.

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

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5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

b) Issue 2.2: "Fixed place of business": time requirement

Issue

13. The Committee discussed the time requirement incorporated in the concept of "fixed place". It was generally agreed that the current situation, where different interpretations were sometimes adopted, was unsatisfactory and that the OECD should attempt to provide greater guidance in that respect.

Discussion

14. The attention of the Committee first focused on paragraph 6 of the Commentary on Article 5. It was noted that the first sentence of the paragraph states that for a place of business to constitute a permanent establishment, it must have a "certain degree of permanency, *i.e.* if it is not of a purely temporary nature." The Committee contrasted that statement with that in the second sentence of the paragraph, which reads as follows:

> If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment even though it existed, in practice, for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (*e.g.* death of the taxpayer, investment failure), it was prematurely liquidated.

15. It was argued that the second sentence contradicted the first sentence to a certain extent and, also, seemed to include a contradiction in itself. Indeed, it may appear surprising to suggest that a place of business which exists only for a very short period of time because of the special nature of the activity of the enterprise (2nd sentence) is not of a purely temporary nature (1st sentence). The same could be said about the conclusion that a place of business which existed for a very short period of time because of the special nature of the activity of the enterprise could be said not to have been set up merely for a temporary purpose.

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16. It was therefore decided that paragraph 6, and in particular the first sentence thereof, should be clarified. In doing so, however, the second part of the second sentence, which deals with cases of unforeseen termination, was maintained as it was found to be clear and helpful.

17. The Committee then examined two different cases of temporary business activities: that of recurrent activities, where the business exists for short periods of time but on a recurrent basis over a number of years (*e.g.* a stand in a fair that is occupied for a few weeks each year over a long period of time) and that of temporary projects that are not repeated (*e.g.* a one-shot project, such as the broadcasting of a major sport event, that lasts a few weeks).

18. The Committee agreed that, in the case of recurrent activities, a permanent establishment could exist even if each period of time spent in the country was of a short duration. It was also agreed that the recurrent character of such activities could be determined on the basis of elements establishing the intention of the taxpayer or of evidence that the activities have actually been carried on at one place on a recurrent basis over a long period of time.

19. The Committee had more difficulty with respect to the second type of case. Whilst it was generally agreed that, as implied in paragraph 6 of the Commentary, a crucial factor was the nature of the business under consideration (so that it should be recognised that some businesses need a substantial place of business in order to earn their income whilst others can earn income quickly and without substantial equipment), this was found not to be a factor that would facilitate the practical application of the "fixed" concept. That led the Committee to discuss the suggestion that an administrative threshold of, for example, 6 months, could be adopted by countries to minimize administrative difficulties and provide greater certainty to taxpayers.

20. Various proposals were examined in that respect, including a suggestion that a 6 month rule could be applied as a one-sided deeming provision that would deem a place to be a permanent establishment if it existed for more than 6 months but that would not imply that the place would not be a permanent establishment if it lasted less than that period of time.

21. Another proposal was to adopt an administrative interpretation under which it would merely be considered that a permanent establishment did not exist in the case of activities lasting less than 3 months, without prejudging the issue with respect to longer activities (unless these were recurrent activities, in which case they could constitute a permanent establishment notwithstanding the three month threshold).

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22. During the discussions, it was noted that any rule based on an arbitrary period of time would face the traditional difficulties common to safe harbours.

23. After substantial discussion, it was agreed that the Commentary should take account of the practices that have been followed by member countries. Whilst these practices have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months. One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that

was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. Conversely, practice shows that there were many cases where a permanent establishment had been considered to exist where the place of business was maintained for a longer period. The Committee decided that, for ease of administration, countries should be invited to consider these practices when addressing disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

Conclusions

24. The Committee has decided that paragraph 6 of the Commentary on Article 5 should be replaced by the following paragraphs:

> 6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, *i.e.* if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even 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 that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

6.1 As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

6.2 Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12 month period provided for in paragraph 3 would equally apply to such cases.

6.3 Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus - retrospectively - a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (*e.g.* death of the taxpayer, investment failure), it was prematurely liquidated.

c) *Issue 2.3: Relationship between the enterprise and the fixed place of business*

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Issue

25. Paragraph 1 requires that a fixed place of business must be a place through which the business of the enterprise is wholly or partly carried on in order to constitute a permanent establishment. It has been suggested that this requires that the enterprise have a certain legal right to use the place as a basis for carrying on its business activities.

Discussion

26. The Committee noted that paragraph 4 of the Commentary already makes it clear that the mere fact that an enterprise "has a certain amount of space at its disposal" which is used for business activities is sufficient to constitute a place of business so that no formal legal right is required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

27. Whilst the Committee agreed that no formal legal right to use a particular place was required for that place to constitute a permanent establishment, it recognised that the mere presence of an enterprise at a particular location would not necessarily mean that that location was at the disposal of that enterprise. That led the Committee to discuss the circumstances in which the presence of representatives of one enterprise on the premises of another enterprise could constitute a permanent establishment. One example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

28. A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e. g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and because the office at the headquarters of the other company is at his disposal, it will constitute a permanent establishment of his employer provided that the other conditions of Article 5 are met.

29. A third example is that of a road transportation enterprise which uses a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock is so limited that that place cannot be considered as being at that enterprise's disposal so as to constitute a permanent establishment of that enterprise.

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30. A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office where he is performing the most important functions of his business (*i.e.* painting) would constitute a permanent establishment of that painter.

31. The Committee also discussed the meaning of the words "a place … through which" *["une installation … par l'intermédiaire de laquelle"]* in paragraph 1 of Article 5. It first noted that the 1963 Draft Convention used the words "a place … in which" *["une installation … où"]* and concluded that the drafting change had been made in an attempt to accommodate situations where business is not literally carried on "in" a place. For instance, it may look awkward to use the preposition "in" with respect to a construction site (*e.g.* a

road) or automated equipment. For that reason, the Committee considers that the word "through" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

Conclusions

32. The Committee has decided that the following paragraphs should be added to the Commentary:

> 4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.
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> 4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

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4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (*e.g.* a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (*i.e.* painting) constitute a permanent establishment of that painter.

4.6 The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

d) Issue 2.4: Place of management

Issue

33. Sub-paragraph 2 *a*) of Article 5 provides that "a place of management" is an example of the term "permanent establishment". The meaning of this phrase can pose difficulties. In some cases, member countries have agreed that an enterprise has a permanent establishment in the State where it carries on activities because the management of the enterprise is found to be situated there. These cases have mainly arisen where enterprises resident in one State have established business activities, but no fixed offices, in another State and carried on such activities continuously for several years, maintaining only a limited presence in the first State. However, the scope of application of this principle has so far been restricted, and has not been extended to cases where substantial activities are carried on in the State of residence or in a third country, or where actual management functions are attached to the part of the enterprise in the State of residence.

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Discussion

34. The Committee discussed whether a roving business can be deemed to have a "place of management" in the country in which it operates, even if it has no office or other fixed place at which the management activity is carried out. It concluded that the examples listed in paragraph 2 are intended to be illustrations of the principle stated in paragraph 1, and that a "place of

management" must meet the "fixed place of business" standard in order to qualify as a permanent establishment under that paragraph. In the circumstances described, therefore, the business in fact has no "place of management" within the meaning of Article 5, even if all the management activities take place within the country of its operations. Some delegates, however, questioned whether this was an appropriate result.

35. The Committee further observed that the issue may arise only in a limited number of cases. Businesses that do not have offices are likely to be small, including many operated as sole proprietorships. The residence rules of the country of activity will tend to classify many, if not most, such businesses (or their employees) as residents, and the rules of Article 4 will in most cases operate so as to allow the country of activity to tax the income arising from that activity as income of a resident. Exceptions to this general scenario will probably be infrequent.

36. The Committee also agreed that the reference to "place of management" in Article 5 must be distinguished from the reference to the "place of effective management" because an enterprise can have only one place of effective management even though it can have many places of management.

37. An additional point was raised about the "place of management" example. An example was discussed involving a foreign parent corporation seconding an employee to its subsidiary for three months in order to manage it. On a literal reading of paragraph 2, it could be argued that the foreign parent has a permanent establishment in this situation because it is managing the subsidiary through its employee. The Committee agreed that although Article 5 and its Commentaries do not state explicitly that the "management" referred to is the management of the enterprise itself, not of some other entity, this concept is so widely understood that no clarification is necessary (in the context of that example, the Committee did not extensively discuss whether there were some other legal basis on which such a manager might give rise to a permanent establishment).

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38. The Committee also discussed the case of a craftsman who owns a house in one state, of which he is a resident, and who works at various sites in a neighbouring state, where he also has a house. The Committee agreed that in that case, the craftsman's house in the other state could be considered to be a place of management, and thus a permanent establishment, to the extent that the craftsman uses that house to manage his business, *i.e.* if it is where he receives calls, stores his tools, prepares his accounting records, etc.

Conclusions

39. The Committee decided that no change to the Commentary was required to deal with this issue.

e) Issue 2.5: Active v. passive activity

Issue

40. It is very easy for a taxpayer to ensure that a permanent establishment exists if that is the result desired. Some enterprises have set up permanent establishments in countries that do not tax foreign source interest income in order to lend money to other companies within a multinational group. The country where the debtors are located attributes the income to a permanent establishment in the other country and does not impose tax, but the passive foreign source interest income is also not taxed by the country where the permanent establishment is located. The question is whether it might be possible to clarify that the "business" carried on by the enterprise through the purported permanent establishment must be an active business that involves more than simply earning passive income.

Discussion

41. The Committee discussed whether it would be possible or advisable to change the Article or the Commentary in a way that would satisfactorily address this point. The difficulty presented is that of identifying the cases which are truly abusive; a rule that broadly required an active business would affect many holding companies set up for legitimate non-tax purposes.

42. It was noted that this may be a domestic law problem for some countries. Several delegates stated that in their countries, an actual business is required before a permanent establishment can be found to exist, and the mere passive receipt of income would not qualify. Some delegates were of the opinion that the problem does not arise where a real business (such as the management of loans) gives rise only to passive income; the problem is where there is in fact no "business" carried on at all by the enterprise, suggesting that a solution to this problem may already exist in the "carrying on business" language of Articles 5 and 7.

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43. The Committee agreed that the mere transfer of a loan to a particular location would not be enough to trigger the application of paragraph 4 of Article 11 since a business had to be carried on at that location for a permanent establishment to exist. It concluded that the issue should be addressed through a clarification of the "effectively connected" requirement in paragraph 4 of Article 11.

44. The Committee thus agreed that an amendment to the Commentary on Article 11 was advisable to deal with the issue. It also agreed that whilst the issue was more likely to arise in the context of Article 11 than in the context of Articles 10 and 12, similar changes should be made to the Commentary on the latter Articles for the sake of consistency.

Conclusions

45. It has been decided to add the following paragraphs to the Commentary:

Commentary on Article 10

32.1 It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a shareholding be 'effectively connected' to such a location requires that the shareholding be genuinely connected to that business.

Commentary on Article 11

25.1 It has been suggested that the paragraph could give rise to abuses through the transfer of loans to permanent establishments set up solely for that purpose in countries that offer preferential treatment to interest income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a debt-claim be 'effectively connected' to such a location requires that the debt-claim be genuinely connected to that business.

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Commentary on Article 12

21. It has been suggested that the paragraph could give rise to abuses through the transfer of rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to royalty income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a right or property be "effectively connected" to such a location requires that the right or property be genuinely connected to that business.

f) Issue 2.6: Cables and pipelines

Issue

46. Is a submarine cable that passes through the territorial waters of a country a permanent establishment in that country? Under what circumstances do other cables or pipelines constitute permanent establishments?

Discussion

47. The Committee first observed that such a cable or pipeline would constitute immovable property under the domestic laws of some countries. Where this is the case income derived from the use of the cable or pipeline will be taxable under Article 6 and the issue of whether it is a permanent establishment may have little practical significance.

48. The Committee then discussed whether a cable or pipeline would constitute a permanent establishment where the application of Article 6 is not relevant, either because the cable or pipeline does not constitute immovable property in the country where it is located or because no income falling under Article 6 is derived therefrom. It concluded that whilst it appears to be a fixed place of business, the real issue was whether paragraph 4 of Article 5 applied as it could be argued that the cable or pipeline was used solely for purposes of delivery and that the mere use of facilities for purposes of delivery does not constitute a permanent establishment under sub-paragraph 4 *a*) of Article 5.

49. The Committee agreed that the application of the Model in each case would need to take account of the distinction between enterprises that are in the business of transporting data, power, oil, gas etc. through cables or pipelines and enterprises for which such transport is merely incidental to their business, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country.

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50. In the first case, subparagraph 4 *a*) would not be applicable to the extent that the enterprise transports, through the territory of another country, data, power, oil or gas that belongs to other enterprises as the application of that paragraph is restricted to the delivery of goods or merchandise that belongs to the enterprise itself. Also, since such an enterprise would be in the business of transporting property for other enterprises through cables or pipelines, it could not reasonably argue that the operation of a cable or pipeline that crosses the territory of a country, qualifies as an activity of a preparatory or auxiliary character carried on for itself so as to be covered by subparagraph 4 *e*).

51. In the second case, the Committee agreed that subparagraph 4 *a*) would be applicable as the cable or pipeline that crosses the territory of a country would be owned and operated therein solely for purposes of delivery of goods belonging to the enterprise.

Conclusions

52. The Committee has decided that the following paragraph 26.1 should be added after paragraph 26 of the Commentary on Article 5:

26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a*), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e*) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a*) would be applicable.

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g) Issue 2.7: Permanent establishment in relation to an enterprise

Issue

53. In paragraphs 1 to 4 of Article 5, the expression "permanent establishment" is not defined in relation to the enterprise. Thus, for example, the argument could be made that any construction project lasting more than 12 months represents a permanent establishment for any enterprise involved in the project so that a sub-contractor engaged on the project for a few days or weeks would be deemed to have a permanent establishment. In this case, it could be further argued that, technically, the source country would have the right to tax the sub-contractor's income since there is no requirement in Article 7 that the permanent establishment be that of the enterprise itself – a

result contrary to the last sentence of paragraph 19 of the Commentary on Article 5 which states that the activities of the sub-contractor must last more than 12 months for him to be taxed.

54. It has therefore been suggested that the expression "of an enterprise" should be added after the expression "permanent establishment" whenever it occurs in paragraphs 1, 2 and 4 and that the wording of paragraph 3 should be amended along the following lines: "A construction site constitutes a permanent establishment of an enterprise only if its activities at that site continue beyond a period of twelve months".

Discussion

55. The Committee examined these suggestions and concluded that whilst a literal interpretation of the Article could produce the result noted above, such a result would clearly be unreasonable and absurd. The Committee noted that the relevant provisions of the Model Tax Convention where the term "permanent establishment" is used always refer to a permanent establishment in relation to the business of an enterprise, thereby making clear the relationship between the enterprise and the permanent establishment. In light of the context of the Convention and the purpose of Article 7, and having regard to the statement already included in paragraph 19 of the Commentary on Article 5, the Committee therefore concluded that a clarification of the Article was not necessary.

Conclusion

56. For these reasons, the Committee concluded that no change to the Commentary was required to deal with this issue.

R (19)

3. BUILDING SITES AND CONSTRUCTION OR INSTALLATION PROJECTS (PARAGRAPH 3)

a) Issue 3.1: Supervisory activities and the aggregation of construction contracts

Issue

57. An installation project began in January of 1998 and ended in April of 1999. Contractor C was given a contract to perform part of the installation, beginning in January of 1998 but lasting for less than twelve months. Beginning in March of 1998, C assigned more personnel to the same site, based on a separate contract for supervisory services made by the same client for the same overall project, but not in connection with C's installation activities.

Rather, C supervised the work of other contractors on other parts of the project, and for this purpose remained on site until the end of the project.

58. C established a single construction site organisation and was provided with fully furnished offices. An employee remained at the offices during the entire period of C's involvement with the project. The question is whether the two contracts may be considered to be a single unit, and whether profits from the supervisory activities may be attributed to the permanent establishment.

Discussion

59. This example presents two separate questions: (1) Do these facts present a "coherent whole commercially and geographically", allowing the contracts to be aggregated in computing the 12-month period? (2) When and under what circumstances are supervisory activities included within the scope of paragraph 3?

60. With respect to the first question, the Committee reached agreement that a coherent whole probably exists in this situation, although most delegates agreed that in an actual case they would seek a more complete explanation of the facts. In light of this agreement, the Committee concluded that an amendment of the Commentaries on this point is not needed.

61. The second question gave rise to a wider variety of views.

62. After discussion, the Committee agreed that because the text of paragraph 3 did not refer to activities but to the construction site itself, it was difficult to conclude that activities such as supervision which take place on the site and are related to it would not be covered by that paragraph. Whilst that approach was contrary to that put forward in paragraph 17 of the Commentary, the Committee considered that it was more in conformity with the text of the Article and that it reduced the chances that similar activities be treated differently and therefore simplified compliance. It also agreed that States wishing to address this point expressly in their bilateral conventions may do so.

R (19)

Conclusions

63. With respect to the first issue, the Committee concluded that an amendment of the Commentaries on this point was not needed.

64. With respect to the second issue, the Committee agreed that paragraph 3 applied where planning and supervisory activities took place on the construction site. It therefore agreed that the Commentary should be changed accordingly and to allow States wishing to clarify this point in their bilateral conventions to do so. It has therefore decided to replace the three last sentences of paragraph 17 of the Commentary on Article 5 by the following:

... On-site planning and supervision of the erection of a building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

b) Issue 3.2: Computation of the construction period

Issue

65. A construction project in State A undertaken by a foreign contractor lasted from the beginning of 2000 until the end of 2003. From 1 January 2003 until 1 September 2003 there was a complete cessation of work because of planning problems and shortages of raw materials.

66. There is no question that a permanent establishment existed in 2000-2002. The issue is whether a 9-month interruption is too long to be considered "temporary" under paragraph 19 of the Commentary on Article 5 (which provides that the "clock" for determining the 12-month period keeps running through "temporary" interruptions).

Discussion

67. Some taxpayers have requested that more certainty be offered in determining how to deal with interruptions in the construction period. It has been proposed that the Commentary should state that a six-month interruption will stop the clock (creating a rebuttable presumption if resumption of work is clearly foreseen at a definite date past six months) rather than use the vague concept of "temporary".

68. The Committee agreed that the rule of thumb contained in paragraph 19 is perhaps not always adapted to particular circumstances, but it is clear and easy to apply. A six-month rule might require a determination of when a work slowdown became a work stoppage. Whilst the Committee considered an addition to paragraph 19 of the Commentary to deal with cases where, for example, a strike could push a construction project which would normally have lasted less than 12 months beyond the 12 month threshold, it thought that such a result, which could appear somewhat arbitrary, would still be better than trying to design a safe harbour and trying to examine the nature of each interruption.

R (19)

Conclusions

69. The Committee, after having discussed a possible amendment as described above, decided against it because of the risk that it would generate abuses and because the determination of whether a new construction project

has truly begun should not be made solely on the basis of the period of time since work has stopped on a construction site.

c) Issue 3.3: Scope of the reference to "installation project"

Issue

70. It has sometimes been suggested that the reference in paragraph 3 to an "installation project" refers exclusively to a project for the fixed installation of heavy equipment in the context of a construction project.

Discussion

71. The Committee discussed this narrow point and concluded that the reference to an "installation project" in paragraph 3 of Article 5 refers to any installation project, regardless of whether the installation occurs in the course of, after, or independently from, the construction of a building or other structure. It was brought to the attention of the Committee that a different interpretation had apparently been adopted in some countries; for that reason, the Committee decided that the Commentary on paragraph 3 should be clarified in that respect.

Conclusions

72. The Committee has decided that the first two sentences of paragraph 17 of the Commentary on Article 5 should be replaced by the following (proposed additions are in ***bold italics***):

R (19)

17. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. ***Additionally, the term "installation project" is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors....***

d) Issue 3.4: Multiple installation projects

Issue

73. For purposes of computing the period of time referred to in paragraph 3 of Article 5 in relation to installation projects, the issue has arisen as to whether various contracts for the acquisition of similar equipment requiring installation could be aggregated.

Discussion

74. The Committee agreed that this issue was already dealt with in paragraph 18 of the Commentary on Article 5, which makes it clear that the twelve month test is to be applied to each individual installation project, unless such projects formed a whole commercially and geographically. Thus, successive installation projects resulting from completely unrelated purchases of similar equipment, where these different purchases result from the progressive expansion of a plant's capacity, should be treated separately for purposes of computing the 12 month period. The result would clearly be different, however, if the different sales were all part of an attempt to divide one project in smaller contracts.

Conclusions

75. Although there was unanimous agreement on the conclusion reached, the Committee considered that paragraph 18 of the Commentary on Article 5 was clear enough in that respect so that no clarification was required.

e) Issue 3.5: Renovations

Issue

76. The issue has arisen whether the reference in paragraph 3 to a "building site or construction ... project" covers renovation activities.

Discussion

77. The members of the Committee agreed that the renovation of a building or other structure was covered by the phrase a "building site or construction ... project" and that that interpretation reflected the practice previously followed.

R (19)

78. It was noted that renovations involve substantial structural work which, as opposed to mere maintenance or redecoration, requires construction workers as well as the establishment of a site that corresponds to a construction site.

Conclusions

79. The Committee has decided to amend the first sentence of paragraph 17 of the Commentary as follows:

> The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals***, the renovation (involving more than mere maintenance***

or redecoration) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging.

f) Issue 3.6: Coherent geographic whole

Issue

80. A non-resident company builds one half of an offshore platform on one site in State A and the other half on another site in that State and then tows the two halves to a third site in the same State for final assembly. Can these steps be regarded as part of a "coherent whole commercially and geographically" within the meaning of paragraph 18 of the Commentary on Article 5?

Discussion

81. This example suggests that there is a difference between a site and a project. This example should properly be regarded as a construction or installation project. Paragraph 20 of the Commentary already states that a construction or installation project that by its very nature moves from place to place can be a permanent establishment without being a geographic whole. Some delegates asked whether this is an issue limited to the oil industry. It was agreed that this was not necessarily the case.

Conclusions

82. The Committee has decided to replace paragraph 20 of the Commentary on Article 5 by the following (proposed additions are in ***bold italics***):

R (19)

20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. ***Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project***. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

g) Issue 3.7: Place of management of several construction sites

Issue

83. Employees of a company resident in State A come to State B and rent an office there. The company is engaged in the business of renovating old buildings and uses the office for storage, advertising activities, answering telephone calls, and maintaining books of account. The principal place of management of the company remained in State A.

Discussion

84. The Committee discussed this rather specialized example and concluded that the office should be a permanent establishment even if no renovation project lasts more than twelve months. In that case, whilst no particular construction site may itself constitute a permanent establishment, the office itself would. If the company's business had been appliance repair, it seems clear that a permanent establishment would exist and there is no reason to reach a different conclusion in the case of a business of managing building repairs. Article 5 requires that each workplace be examined separately, despite a general similarity between it and other workplaces of the same taxpayer and it was agreed that the part of the Commentary dealing with paragraph 3 should be clarified in that respect.

85. It was also agreed, however, that the fact that the office would constitute a permanent establishment would not change the situation as regards the various sites where the renovation activities are conducted, which would not themselves constitute permanent establishments to the extent that they last less than 12 months. For that reason, the only profits properly attributable to the permanent establishment constituted by the office would be those attributable to the functions performed and risks assumed through that office. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.

R (19)

Conclusions

86. The Committee has decided that paragraph 16 of the Commentary on Article 5 should be replaced by the following (proposed additions are in ***bold italics***):

16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within

the meaning of paragraph 2, associated with the construction activity. ***Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed and risks assumed through that office or workshop are attributed to the permanent establishment. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.***

4. PREPARATORY AND AUXILIARY ACTIVITIES (PARAGRAPH 4)

a) Issue 4.1: Use of "or" in paragraph 25

Issue

87. The first sentence of paragraph 25 of the Commentary to Article 5 reads as follows:

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, or to maintain or repair such machinery, as this goes beyond the pure delivery mentioned in sub-paragraph *a*) of paragraph 4.

R (19)

88. The words "or to maintain or repair" were substituted for the words "and to maintain and repair" in 1992 to conform the English version to the French version of the paragraph. It seems, however, that, as far as the first "and" is concerned, the change should have been made the other way around, *i.e.* the French version should have been modified to reflect the English version. Indeed, it does not seem right to suggest that a place used solely for storage and delivery of spare parts constitutes a permanent establishment.

Discussion

89. There was general agreement within the Committee that the first "or" in the English version should not have been added in 1992. It was decided that paragraph 25 should be amended: (i) to make clear that a permanent

establishment would exist only where activity in addition to mere delivery took place and (ii) to replace the reference to "supply", which might carry the connotation that parts were being sold from the fixed place of business, by "delivery", matching the text of the Article.

Conclusions

90. The Committee has decided that the first sentence of paragraph 25 of the Commentary on Article 5 should be modified in the following way:

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business ~~in order to supply~~***for the delivery of*** spare parts to customers for machinery supplied to those customers~~, or to maintain or repair~~***where, in addition, it maintains or repairs*** such machinery, as this goes beyond the pure delivery mentioned in sub-paragraph *a*) of paragraph 4.

b) Issue 4.2: Clarification of the "deeming" language

Issue

91. A producer of orange juice in State A sets up a number of "independent agents" in State B. One agent receives delivery and stores the juice, one distributes it to outlets, and one delivers it to customers and takes retail orders. Together, these separate elements constitute an extensive business presence in State B, but the taxpayer argues that no permanent establishment exists because each place of business must be examined separately under paragraph 4.

Discussion

R (19)

92. A majority of the Committee believes that the Commentary on Article 5 to some extent supports the taxpayer's position although on the facts given in the example there seems to be at least one permanent establishment (where retail orders are taken). Sub-paragraph *f*) applies to a collection of activities only if they are carried out at one fixed place of business. If the places of business are "separated from each other locally and organisationally", the activities cannot be aggregated to determine the overall character of the taxpayer's activities. A minority of the Committee, however, believes that the activities listed in paragraph 4 may give rise to a permanent establishment if they are not of a preparatory or auxiliary character.

Conclusions

93. The Committee proposes to break paragraph 27, which is already rather long, into two separate paragraphs. New paragraph 27 would consist of the

first five sentences and the last sentence of the paragraph as currently drafted. New paragraph 27.1 would read as follows:

27.1. Sub-paragraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of sub-paragraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. ***Places of business are not 'separated organisationally' where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.***

c) Issue 4.3: Storage facilities

Issue

94. A non-resident parent company owns a resident subsidiary that hitherto has been engaged in selling both automobiles and spare parts. The spare parts storage facility is now to be hived off and treated as a separate branch of the parent company. The activities of the storage facility will be limited to the storage, relocation, and distribution of the spare parts, which will be ordered "directly" from the parent by the customers. Specifically, this means that (a) the settlement of the transactions, with regard to both contracting and accounting, is to be effected exclusively by the parent in its name and for its account; (b) ancillary activities such as settling warranty claims, installing, performing customer service, and advertising are not performed by the storage facility; and (c) the necessary staff is provided under a lease contract, and the facility's own staff is engaged merely in instructing and supervising.

R (19)

Discussion

95. As in the previous example, the Commentary supports the view that the host country has lost its right to tax the income from the spare parts transactions. Its activities are limited to those listed in sub-paragraphs *a*) through *d*) of paragraph 4. These activities, unlike the "other" activities described in sub-paragraph *e*), are always exempt and are not subject to examination for whether or not they are truly preparatory or auxiliary. These conclusive presumptions were initially adopted to provide certainty to taxpayers that their income from these activities would be taxable, if at all, only in the country of residence.

96. Objection to the result achieved by the company in this example comes from the fact that tax planning has resulted in a reduction of the tax base through the reorganisation. To the extent that the reorganization is not exclusively tax-motivated, this would not be inherently offensive since the company might well have commenced the operation of its subsidiary with the same structure *i.e.* placing within the subsidiary only the automobile sales business and not the spare parts business. If that had been the case it is unlikely that the structure would have been regarded as offensive. As a practical matter it might be thought rather difficult for the company to sever the connection between the parts and automobile aspects of the business and an administration would undoubtedly wish to test such an arrangement to ensure that the subsidiary was not in fact acting as a permanent establishment for the parent in relation to the parts business and to ensure that there was some commercial purposes to the reorganization transactions. Many enterprises would wish to avoid the practical difficulties and the risk of potential tax administration interest involved in this separation so it may be that the situation described would not very often be seen in real cases.

Conclusions

97. The Committee did not adopt any change to the Model in relation to that issue.

5. AGENCY PERMANENT ESTABLISHMENTS (PARAGRAPHS 5 AND 6)

a) Issue 5.1: Level of presence of the agent in the source country

R (19)

Issue

98. No explicit requirement is expressed in paragraph 5 that the agent should be a resident of or have a fixed place of business in the Contracting State. *Prima facie* therefore an itinerant dependent agent such as a travelling salesman, not resident but visiting the Contracting State, might constitute a permanent establishment provided that he habitually concludes contracts in that State on behalf of his employer. Arguably, this creates the possibility of a permanent establishment in cases where the link with the Contracting State through the enterprise's participation in its economic life is more tenuous than that envisaged under the rules in paragraphs 1 - 4 of the Article.

Discussion

99. Technically, paragraph 5 seems to apply where a foreign enterprise operates in the source country through a non-resident dependent agent that has no fixed place of business in that country.

100. This view results from the wording of paragraph 5. Paragraph 5 constitutes an exception to paragraphs 1 and 2 because it does not explicitly require that the agent possesses a fixed place of business in the source country. It could be argued, however, that this interpretation introduces a paradox. The paragraph provides for a deemed permanent establishment only where contracts are concluded on behalf of the enterprise by an agent; it does not apply where contracts are concluded directly by the principal himself and not through an agent (see below). Thus, a permanent establishment exists where the enterprise acts indirectly in the State through an agent but not where it acts directly in that State.

101. The Committee, however, generally agreed that paragraph 5 is intended to extend the scope of Article 5 so as to give the source country the right to tax foreign enterprises whenever they participate in the economic life of the source country so as to come within the jurisdiction of that State's taxing rights (see paragraph 3 of the Commentary on Article 7). Thus, the foreign enterprise has the necessary degree of commercial presence in the source country if it either has a "fixed place of business" (paragraph 1) or otherwise carries on business activities in the source country on a regular basis (paragraph 5). The absence of a "fixed place of business" requirement explicitly justifies the treatment as a permanent establishment of a dependent agent with capacity to bind the enterprise, provided he works and contracts in a State with a sufficient degree of permanence that the "habitually" requirement is satisfied, and the apparent paradox identified above is properly resolved by treating the enterprise as possessing a permanent establishment where it contracts directly. It follows from this interpretation that a non-resident agent – whether the agent activities are carried out by a foreign dependent agent or by employees of the enterprise – must satisfy only the requirements in paragraph 5 to constitute a permanent establishment of the foreign enterprise.

R (19)

102. If the opposite conclusion were reached, it would be possible for a foreign enterprise to carry out extensive business activities in the source country through employees or non-resident dependent agents without becoming exposed to source country taxation. Whilst some countries felt that an employee of the enterprise could not in any event be considered an agent of the enterprise because the employee should simply be regarded as an emanation of the enterprise rather than an agent dealing with the enterprise, the general view was that an employee was properly to be regarded as an

agent for the enterprise and that this was explicitly the position adopted in the existing Commentary, *viz* paragraph 32.

103. The Committee concluded that the rationale behind the agency provisions is to prevent foreign enterprises from escaping source taxation by operating through agents rather than directly through a fixed place of business. Paragraph 5 requires that the agent habitually exercises his contractual authority. It implicitly follows that the agent activities must be relatively frequent in nature and also of a certain overall scale to satisfy the requirement. Whilst from a theoretical perspective there might be a paradox in the application of paragraph 5 from a practical point of view it may be considered to work reasonably well in identifying cases where substantial business is carried on and that is the proper criterion for giving source state taxing rights. The test of habitual exercise may mean that, in practice, the agent's links with the Contracting State will usually be sufficient for him to have a taxable presence in that State on his own account even though that is not an actual requirement of paragraph 5.

104. The Committee recognised that as a practical matter, agents that regularly visit a country but have neither residency status nor a fixed place of business there are hardly ever taxed as permanent establishments of their principals. For example, an individual who comes into a country one day each month to conclude sales contracts on behalf of a foreign principal is unlikely to be found and taxed by that country's revenue authorities. Furthermore, such situations are probably uncommon in modern commercial practice, although they may have been more usual in the past; and they may give rise to cases of double non-taxation if the visiting agent claims exemption in his own country because he literally satisfies the requirements of paragraph 5.

R (19)

105. The conclusion that there is no requirement that the agent himself should have a fixed place of business or be a resident of a Contracting State places considerable weight upon the requirement that the agent's authority must be exercised "habitually" and it is therefore important there should be a common understanding of that requirement. This point is addressed below.

Conclusions

106. On the basis of the foregoing conclusions, the Committee has decided that paragraph 32 of the Commentary on Article 5 should be amended as follows (proposed additions are in ***bold italics***):

32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents *i.e.* persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies ***and need not be residents of, nor have a place of business in, the State in which they act for***

the enterprise. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases. Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.

b) Issue 5.2: Agent with implied contractual authority

Issue

107. It has been proposed that the term "conclude" in paragraph 5 of Article 5 be replaced with "substantially negotiate or conclude". This would remove any doubt as to the existence of a permanent establishment where contracts that have been negotiated by an agent in one State are formally concluded in another State by signature there.

R (19)

Discussion

108. Paragraph 33 of the Commentary on Article 5 already provides that "A person who is authorized 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 enterprises is situated.". The concern expressed by those favouring the change described above is that some might interpret paragraph 5 of Article 5 as requiring a formalistic approach to the issue of contractual authority. Some delegates had even more serious concerns, namely, that the agency requirement can be circumvented by authorising the agent to negotiate all elements but one of a contract, a problem that, arguably, paragraph 33 of the Commentary only partly addresses.

109. There was general agreement that abusive arrangements under this paragraph need to be attacked, but also that it is difficult to formulate specific

rules by which to do so; clear standards are easy to administer, but also lend themselves to tax planning. The Committee also had difficulty in identifying exactly which cases are in fact abusive. It was argued, for example, that if the agent is paid a market-rate fee for concluding a sales contract, there is nothing left to tax in the hands of the principal even if a permanent establishment is found to exist. It could be argued, however, that in that case the existence of a permanent establishment would lead to taxation of trading profit which might well exceed the arm's length reward to the sales agent particularly if that agent were merely an employee of the enterprise.

110. It was suggested that the Commentary could elaborate further on "rubber stamp" and other similar practices. One suggestion was to clarify that the agent possesses contractual authority if the agent activities factually bind the enterprise. For example, in regard to most "rubber stamp" practices, the agent activities would presumably under most countries' commercial laws factually bind the principal to the concluded contracts. Similarly, the agent would be considered to possess actual authority to conclude contracts where the transactions were completed without the direct intervention of the foreign enterprise. An addition to the Commentary could be made to clarify this point.

Conclusions

111. The Committee has decided that paragraph 32 of the Commentary on Article 5 should be divided with the creation of a new paragraph 32.1, starting with the existing sentence which begins with "Also the phrase 'authority to conclude contracts ...' and that the following additional sentences should be added to the existing text at the end of new paragraph 32.1:"

> … Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

R (19)

c) *Issue 5.3: Habitually exercising an authority to conclude contracts*

Issue

112. As indicated above, the requirement that the authority to conclude contracts be habitually exercised is a fundamental feature of paragraph 5. Some potential for abuse might exist if a foreign enterprise attempted to circumvent the requirement that an agent "habitually exercises" an authority to conclude contracts by splitting up the coverage of the source country market among a large number of agents or by systematically sending in

different people to the source country to carry out the agent activities. It could then be argued that whilst each of these agents would have the authority to conclude contracts for the enterprise, none could be considered to habitually exercise this authority.

Discussion

113. The Committee agreed that it would be useful for the Commentary to provide some guidance as to what types of activity would be covered by the concept of habitually exercising an authority to conclude contracts. It concluded, however, that the type of abuse described above is probably best dealt with by the application of normal domestic anti-avoidance mechanisms.

Conclusions

114. The Committee has decided that the following clarification of when an agent "habitually" concludes contracts should be made in the Commentary on Article 5 through the addition of the following new paragraph 33.1:

33.1 The requirement that an agent must "habitually" conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

R (19)

d) Issue 5.4: Commercial representations

Issue

115. The issue of so-called "commercial representations" was raised by the tax authorities of many transition economies as being a source of difficulties. The typical problem involves a foreign enterprise setting up a commercial representation in a country and claiming that it does not constitute a permanent establishment because its activities fall under paragraph 4 of Article 5, even though some sales (officially concluded abroad) may result from these activities.

Discussion

116. Discussions led to the conclusion that "representation", standing alone, has no particular meaning in the treaty area, and may simply obscure the

discussion of the real issues. The existence of a permanent establishment is to be determined under the traditional rules of Article 5 applied to the particular facts at issue.

117. The Committee noted that the issue was most likely to arise in cases where a country gives a formal legal recognition to the concept of commercial representation or representative office and tries to prevent such entities from carrying substantial commercial activities. This will often be the case where the country does not want to allow foreign enterprises to carry branch operations on its territory but is ready to allow them to set up offices for preparatory or auxiliary activities. It may well be that such a legal situation creates an implicit presumption that the only activities carried on by the commercial representation or representative office are those that fall under paragraph 4 of Article 5.

118. In this situation, which is not common in member countries, tax authorities should make it clear that the legal restrictions on the activities of the commercial representation or representative office will not be relevant in determining whether, in fact, the real activities of these entities go beyond those referred to in paragraph 4 of Article 5.

119. Also, paragraph 5 of Article 5 is clearly relevant where contracts are substantially negotiated by employees working in commercial representations and representative offices, particularly in light of the following sentence of paragraph 33 of the Commentary on Article 5: "A person who is authorized 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 enterprises is situated." It is suggested above in this note that further clarification be provided in the Commentary with respect to that issue; such clarification could be useful in dealing with the problem of commercial representations or representative offices.

R (19)

Conclusions

120. The Committee concluded that whilst the issue of commercial representations or representative offices was primarily an administrative difficulty related to the commercial law of some countries, clarification of the circumstances in which an agent can be considered to have an authority to conclude contracts (see conclusions under section 5-2) would likely be useful for countries having to deal with that issue.

e) Issue 5.5: Meaning of independence

Issue

121. Paragraph 6 refers to "any other agent of an independent status". The practical application of that phrase has given rise to difficulties as the exact meaning of "independence" is unclear.

Discussion

122. Paragraph 37 of the Commentary clarifies that the agent has an independent status if he is legally and economically independent of the foreign enterprise. The Committee agreed that this means in general terms that the agent *vis-à-vis* the foreign enterprise must operate from a position of strength, knowledge or skill.

123. Paragraph 38 explains that the requirements of legal and economic independence are met where the agent has overall control over and bears the risk of his business. Thus an independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement. It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

R (19)

124. The Committee also discussed whether the existing discussion in paragraph 38 of the position of parents and subsidiaries should be extended.

Conclusions

125. The Committee has decided that the following changes should be made to paragraph 38 of the Commentary on Article 5. The sentence "A subsidiary is not to be considered dependent upon its parent company solely because of the parent company's ownership of the share capital" would be deleted and the existing sentence beginning "Another important criterion…" would become the final sentence of paragraph 38. The part of existing paragraph 38 that begins with the following sentence ("Persons cannot be said to act…") would then become new paragraph 38.7 and the following new paragraphs (which include the new paragraph 38.6 proposed in relation to issue 5-6 below) would be added before that paragraph:

> 38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.
>
> 38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.
>
> 38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.
>
> 38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.
>
> 38.5 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth

running of the agreement and continued good relations with the principal is not a sign of dependence.

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

38.7 [FROM OLD 38] Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

R (19)

f) Issue 5.6: Agent with only one principal

Issue

126. In deciding whether an agent is dependent or independent, it is important to take into consideration various facts and criteria. It has been suggested to mention explicitly in the Commentaries that an exclusive agency, taken alone, is not a decisive factor by inserting the following sentence after the fourth sentence of paragraph 38 of the Commentary on Article 5:

> An agent that sells goods on behalf of the enterprise under an exclusive agency contract is not to be considered dependent on that enterprise solely because of the exclusive contract.

Discussion

127. The Committee noted that some countries interpret paragraph 6 as if it read like the equivalent provision of UN Model, which provides that "when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph."

128. The fact that there is an exclusive agency (*e.g.* under which the agent is appointed the exclusive distributor of a product for a specified area), is not relevant to a consideration of the dependent or independent nature of the agent. By contrast, the fact that an agent acts exclusively for one principal is relevant in a determination of dependence or independence. The Committee therefore generally agreed that this kind of exclusivity – whether it takes the form of an exclusivity agreement or whether the facts reveal that the agent represents only one principal – is a factor to be considered, but never alone a decisive factor. A distinction might be drawn between the position of an agent whose principal has imposed a contractual condition of exclusivity and that of an agent with a single principal who has imposed no such condition. In the former case the contractual condition creates an element of dependence by the agent upon the enterprise since the agent has no opportunity to diversify his activities. Moreover the imposition of this important restriction on the activity of the agent might be simply one aspect of a more general restriction imposed on the activities of the agent which would be inconsistent with independence. Such a situation may exist de facto in the case of a parent and subsidiary agency relationship and may cause particular difficulty in the application of paragraph 6 where the parent's effective control over the affairs of the subsidiary makes it unnecessary for the reality of the subsidiary's dependent position to be recorded in writing. By contrast, where a single principal has imposed no condition of exclusivity no equivalent restriction is placed upon the scope of business of the agent who retains the opportunity to contract with other principals if this appears to be in the interests of his business.

R (19)

129. The essential enquiry which must be undertaken in applying the rule in paragraph 6 relates to the requirement, already reflected in paragraph 38 of the Commentary, that the agent's activities constitute an autonomous business conducted by an agent who bears risk and receives reward through the use of his entrepreneurial skills and knowledge. The existence of such an autonomous business is not necessarily inconsistent with a contractual condition imposing exclusivity upon the agent. From a practical perspective, too much emphasis on the exclusivity factor could lead to unreasonable results as an enterprise operating through an independent agent could end up having a permanent establishment without being able to influence its position

if the agent, for valid commercial reasons, decided to abandon all other principals.

Conclusions

130. The Committee has decided that the following new paragraph 38.6 should be added to the Commentary on Article 5 to deal with this issue:

> 38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

g) Issue 5.7: Agents acting in the ordinary course of their business

Issue

R (19)

131. It has been suggested that the practical application of the requirement that independent agents act in the ordinary course of their business is difficult. An important problem, it has been argued, is that it is difficult to envisage a situation where an ordinary business transaction entered into by an entity would not be carried out in the ordinary course of its business.

Discussion

132. Some delegates had difficulty justifying why two agents, performing the same activities for a particular foreign enterprise, should be treated differently, simply because the activities carried out were outside the line of the regular business of one agent but within the line of the regular business activities of the other. Other delegates felt that the distinction was justified and necessary, because an agent could not be considered to operate from a position of strength, knowledge and skill vis-à-vis the foreign enterprise where he was acting outside the scope of his regular business.

133. Paragraph 38 of the Commentary includes the following sentence: "Persons cannot be said to act in the ordinary course of their own business if,

in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations." On the assumption that paragraph 6 applies whether or not an agent binds its principal, that sentence provides limited guidance.

134. The Committee agreed that, in deciding whether or not particular activities fell within or outside the ordinary course of business, one must examine the business activities customarily carried out within the agent's trade or speciality rather than the other business activities carried out by that agent. Some delegates argued that the latter interpretation could have led to unreasonable results. For example, a business engaged solely in the production of goods would necessarily act outside its ordinary course of business when it entered into an agency agreement for the first time whereas later engagements of the same kind could be within the ordinary course of business. The Committee also agreed that whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively. For example, where the agent and principal are affiliated, the relevant comparison may rather be the business activities carried out within that corporate group. Furthermore, the total activities of the particular agent may be the most appropriate comparison in cases where all of the agent's activities deviate from those customarily carried out in his trade.

Conclusions

135. The Committee has decided that the following new paragraph 38.8 should be added to the Commentary on Article 5 to deal with this issue:

R (19)

> 38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

ANNEX 1

CHANGES TO THE COMMENTARY

The following are the changes to the Commentary of the Model Tax Convention that are put forward in the report (changes to the existing text are indicated by ~~strikethrough~~ in the case of deletions and ***bold italics*** in the case of additions):

1. Add the following paragraphs 4.1. to 4.6 to the Commentary on Article 5:

4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

R (19)

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a 'fixed place of business' (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

4.6 The words 'through which' must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business 'through' the location where this activity takes place.

2. Add the following new paragraphs 5.1 to 5.4 to the Commentary on Article 5:

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single 'place of business' (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

R (19)

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an 'office hotel' in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in

different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

R (19)

3. Replace paragraph 6 of the Commentary on Article 5 by the following paragraphs:

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, *i.e.* if it is not of a purely temporary nature. ***A place of business may, however, constitute a permanent establishment even 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 that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where***

the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

6.1 As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

6.2 Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12 month period provided for in paragraph 3 would equally apply to such cases.

R (19)

6.3 Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus – retrospectively – a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated.

4. Replace paragraph 16 of the Commentary on Article 5 by the following:

16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for

instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. ***Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed and risks assumed through that office or workshop are attributed to the permanent establishment. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.***

5. Replace paragraph 17 of the Commentary on Article 5 by the following:

17. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals***, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals,*** the laying of pipe-lines and excavating and dredging. ***Additionally, the term 'installation project' is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.*** ~~Planning and supervision of the erection of a building are covered by this term, if carried on by the building contractor, However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.~~

R (19)

6. Replace paragraph 20 of the Commentary on Article 5 by the following:

20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case

for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. ***Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project***. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

7. Replace paragraph 25 of the Commentary on Article 5 by the following:

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business ~~in order to supply~~***for the delivery of*** spare parts to customers for machinery supplied to those customers~~, or to maintain or repair~~***where, in addition, it maintains or repairs*** such machinery, as this goes beyond the pure delivery mentioned in sub-paragraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Sub-paragraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

8. Add the following paragraph 26.1 after paragraph 26 of the Commentary on Article 5:

R (19)

26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph a), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph e) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such

transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph a) would be applicable.

9. Replace paragraph 27 of the Commentary on Article 5 by the following:

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to sub-paragraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the sub-paragraphs *a*) to *e*) of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of sub-paragraph *e*) (see paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in sub-paragraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in sub-paragraph *f*).

27.1 Sub-paragraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of sub-paragraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. ***Places of business are not 'separated organisationally' where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.***

R (19)

10. Replace paragraph 32 of the Commentary on Article 5 by the following:

32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents *i.e.* persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies ***and need not be residents of, nor have a place of business in, the State in***

which they act for the enterprise. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term 'permanent establishment' in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. ***Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.***

11. Add the following paragraph 33.1 to the Commentary on Article 5:

R (19)

33.1 The requirement that an agent must 'habitually' conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is 'habitually exercising' contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

12. Replace paragraph 38 of the Commentary on Article 5 by the following:

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has *vis-à-vis* the enterprise. Where the person's commercial activities for the

enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. ~~A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital.~~

38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

R (19)

38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.5 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost

wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

38.7 [FROM OLD 38] Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

R (19)

Commentary on Article 10

13. Add the following paragraph 32.1 to the Commentary on Article 10:

32.1 It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a

shareholding be 'effectively connected' to such a location requires that the shareholding be genuinely connected to that business.

Commentary on Article 11

14. Add the following paragraph 25.1 to the Commentary on Article 11:

25.1 It has been suggested that the paragraph could give rise to abuses through the transfer of loans to permanent establishments set up solely for that purpose in countries that offer preferential treatment to interest income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a debt-claim be 'effectively connected' to such a location requires that the debt-claim be genuinely connected to that business.

Commentary on Article 12

15. Add the following new paragraph 21 to the Commentary on Article 12:

21. It has been suggested that the paragraph could give rise to abuses through the transfer of rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to royalty income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a right or property be 'effectively connected' to such a location requires that the right or property be genuinely connected to that business.

R (19)

ANNEX 2

OBSERVATIONS BY THE CZECH REPUBLIC

1. The Czech Republic agrees that the concept of "fixed place" ought to be applied on the basis of the nature of the relevant business.

2. In accordance with this statement, the Czech Republic believes that in the case of particular activities such as furnishing of various services which do not need an extensive equipment or space available, it is necessary to take into account their duration within the territory of a State concerned. A period of six months seems to be an appropriate period of time.

3. The Czech Republic is of the opinion that in the cases of services and activities performed on the territory of the Czech Republic on the basis of individual contracts (even repeatedly) with a customer (*e.g.* an extraordinary audit of economic results of business, an overhaul or a maintenance of an equipment, an introduction of a new software system), it means in the cases when the existence of a permanent establishment established on one's own initiative of a foreign resident with the aim to offer and to render the services (activities) to unlimited and unspecified circle of customers is not done (*e.g.* an audit or tax office), the computation of the above-mentioned period of six months is not affected by the fact that these services or activities are performed in connection with the unrelated contracts within the territory of the Czech Republic.

4. Thus the Czech Republic does not agree with the interpretation in proposed paragraphs 5.3 (first part of the paragraph) and 5.4 (first part of the paragraph) of the Commentary on Article 5.

R (19)

5. The Czech Republic does not agree with the statement that a large office building does not constitute a permanent establishment in the case where a painter works successively under a series of unrelated contracts for a number of unrelated clients in it. It seems to be absurd and economically unfounded. It opens room for abuse and the Czech Republic feels some ambiguity and contradiction because, for example, a particular street could, according to the report, constitute a permanent establishment for someone who regularly (or successively) set up a stand on that street, even though the stand was not permanently fixed and the exact location of the stand might vary. It must be clear that the contracts, clients, etc. are, in this case, each day, each period of time, also unrelated.

6. At the same time, the Czech Republic does not agree with the statement that each branch should be considered separately for the purposes of a permanent establishment in the case where a consultant works at different branches in separate locations pursuant to a single project for training the

employees of a bank. The Czech Republic believes that in such cases the fact that the work is not done in one particular location is immaterial. The activities performed at each particular branch are part of a single project, and such project must be regarded as a permanent establishment if it lasts more than a substantial period of time.

7. The Czech Republic believes that the example mentioned in paragraphs 17 and 18 (that a stand in a fair that is occupied for a few weeks each year over a long period of time could give rise to a permanent establishment in a State where the fair is regularly organised) is difficult to accept for various reasons. The purpose of a fair is primarily to exhibit and to attract and contact customers. Selling is rather secondary and incidental.

8. If it is not this case (not secondary or incidental), then it would be possible to adhere to philosophy that each participation each year gives rise to a permanent establishment separately as the purpose of the business was in such a way achieved.

9. The most inappropriate solution, in the view of the Czech Republic, is that of having a permanent establishment after many years.

10. As regards the proposed changes to paragraph 17 of the Commentary on Article 5, the Czech Republic adopts a narrower interpretation of the term "installation project" and therefore, it restricts it to an installation and assembly related to a construction project.

11. Furthermore, the Czech Republic adheres to an interpretation that supervisory activities will be automatically covered by paragraph 3 of Article 5 only if they are carried on by the building contractor. Otherwise, they will be covered by it, but only if they are expressly mentioned in a special provision.

R (19)

12. In the case of an installation project not in relation with a construction project and in the case that supervisory activity is carried on by an enterprise other than the building contractor and it is not expressly mentioned in paragraph 3 of Article 5, then these activities are automatically subject to the rules concerning the taxation of income derived from the provision of other services.