

# Recent Commentary Changes concerning the Definition of Permanent Establishment

Prof. Dr Jürgen Lüdicke\*

PricewaterhouseCoopers and University of Hamburg

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## 1. INTRODUCTION

Thank you for giving me the opportunity to share with you some thoughts on the recent Commentary changes concerning the definition of permanent establishment. What is a permanent establishment? There is an easy answer!

A permanent establishment situated in the source state is the decisive prerequisite for that state to tax the profits of an enterprise of another contracting state.

The recent Commentary changes discussed here pertain to the technical question whether an enterprise has a permanent establishment in the other contracting state. One should, of course, note that the wider agenda comprises the question under which prerequisites the source state may tax a foreign enterprise. This includes the question whether the traditional definition of permanent establishment still meets current economic requirements.

## 2. RECENT COMMENTARY CHANGES

The recent Commentary changes regarding the definition of permanent establishment allegedly adhere to the traditional wording of the OECD Model Tax Convention. The OECD Committee on Fiscal Affairs has explicitly stated that the fundamental principles underlying Arts. 5 and 7 should be studied separately. The Commentary changes, however, reflect modern economic and technical developments. And they also reflect the increasing importance of the trade and supply of services between industrial and

developing countries. This classifies the latter countries as predominantly source states. The discussion below takes a closer look at what has been changed.

### 2.1. Commentary changes concerning Art. 5(1)

#### 2.1.1. Relationship between the enterprise and the fixed place of business

The general description of the term “place of business” in Para. 4 of the Commentary on Art. 5 remains unchanged. The term covers any premises, facilities or installations used for carrying out the business. The term also covers situations where the enterprise “simply has a certain amount of space at its disposal”.

New Para. 4.1 states that no formal legal right to use the place of business is required. This position seems not too far removed from the recent trends in Germany. Currently, it looks as if the Federal Tax Court of Germany is carefully moving from the requirement of a “*Verfügungsmacht*” (a formal or other right to use) to a less formalistic approach under which it is sufficient that the enterprise’s de facto situation is such that it has a certain place of business at its disposal.

Therefore, we should concentrate on the question under which circumstances does it follow from the presence of an enterprise at a particular location that the latter is indeed at its disposal. New Para. 4.2 rightly states: “the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise.”

The Commentary gives four examples in Paras. 4.2 through 4.5. Two examples refer to a salesman who regularly visits a major customer at his office and a road transportation enterprise which uses a delivery dock at a customer’s warehouse every day for a number of years. In both cases, the “place of business” is not at the respective enterprise’s disposal. In contrast, in another example (in Para. 4.3), an employee is allowed to use an office in the headquarters of another company for a long period of time in order to ensure that the latter company complies with its obligations under bilateral contracts; here, a fixed “place of business” at the disposal of the employee’s company is accepted.

While there is probably not too much dispute about the denial or acceptance of a permanent establishment, the fourth example (in Para. 4.5) is worth discussing. A

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painter works three days a week for two years in the large office building of its main client. Para. 4.5 of the Commentary states: "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."

Nothing is said about, for example, a small room in which he could store his paint, paintbrush and other tools. Thus, it may be assumed that such a room should be irrelevant. But where is the painter's "place of business"? Is it just the space where he places his ladder? Is that small moving space really at his disposal? This author has doubts. The client's building is more the object of the painter's painting than a dedicated space or "place of business" at his disposal.

In addition, does the painter carry on his business "through" that building or "place of business"? This is a difficult question. New Para. 4.6 of the Commentary states: "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."

Such a broad interpretation is new. It is explained by an example (in Para. 4.6): "[A]n enterprise engaged in paving a road will be considered to be carrying on its business 'through' the location where the activity takes place". What does this mean?

In the author's view, this new interpretation indeed gives up the requirement of any "place of business" (or "*une installation (fixe) d'affaires*") in terms of a tangible object at the enterprise's disposal. Neither the road nor the paving bricks constitute a "place of business". It all comes down to the geographical area where the entrepreneur or his employees perform their work. The mere presence of the enterprise in a restricted area (such as a client's office building or a building site) constitutes a permanent establishment, provided the presence continues for a sufficiently long period of time.

There are two limitations, however. The first concerns the necessary period of time, and the second the necessary geographic coherence for a single place of business, which in turn can be regarded as being "fixed".

#### 2.1.2. Fixed place of business: time requirement

New Para. 6 of the Commentary deals with the requirement that the place of business have a "certain degree of permanency" in order to be "fixed". Timing is a soft issue. The Commentary, however, generally suggests a six-month period (unless the business has a shorter duration because of its nature).

One may agree to the six-month test (but certainly not to a shorter period of time) if the test is applied to a place of business that is comparable to those mentioned in Art. 5(2) of the OECD Model. But neither the painter nor the road workers in the above examples have such installations or establishments. They just work where they are engaged.

In the author's opinion, the six-month test is inconsistent with the underlying principle of Art. 5(3) of the OECD Model. A building site or a construction or installation

project constitutes a permanent establishment only if the duration is for more than 12 months. Amended Para. 17 of the Commentary explicitly includes the construction and renovation (involving more than mere maintenance or redecoration) of buildings, roads, etc. If the work of the painter or road workers qualified as a building site or construction project, these enterprises would have no permanent establishment if their presence was for a period of 12 months or less. If building operations or handicraft and similar physical services related to buildings which are carried out on the client's premises or just on his grounds in principle fall under the general definition of permanent establishment in Art. 5(1), the special rules for building sites and construction or installation projects would often be superfluous. Painting, road paving and similar physical services are of a temporary nature irrespective of whether they qualify as building sites or construction or installation projects.

It seems that these doubts are shared by the Commentary. Why does it mention that the painter is performing the most important function of his business in the client's office building? It is not disputed that, subject to Para. 4 (dealing with auxiliary activities), a "place of business" does not require the performance of important, or even the most important, business functions. Thus, would the result change if the painter were only one in ten or one in a hundred employees of an enterprise that is engaged in all types of facade cleaning and house painting? Also, would it matter if the enterprise has subsidiaries which it manages?

What the examples are really concerned with is a permanent establishment for the supply of services or, in other words, an "services permanent establishment" – be they tangible or intangible services.

Intangible services and alleged permanent establishments are of a temporary nature as well. For example, if the painter is replaced by a management consultant, does he maintain a "fixed place of business" in the client's office building if the client wishes to see him regularly for meetings and therefore makes a room or desk available to him for the time of the consulting project?

#### 2.1.3. Fixed place of business: the geographical link requirement

The Commentary deals with that type of services permanent establishment in new Para. 5.4 under the heading "necessary geographic coherence for a single place of business", which in turn can be regarded as being "fixed". The example given refers to a consultant who works pursuant to a single project for training bank employees. If he works at different branches at separate locations – towns or villages, it may be presumed – each branch should be considered separately. Para. 5.4. states: "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."

Is it appropriate for the number of branches and the geographical size of the client to be decisive for the existence

of a permanent establishment of the service provider? Also, is it possible to interpret this result from the existing language of Art. 5(1)?

In 1993, in the famous “Hotel Management” case, the Federal Tax Court of Germany decided that a foreign management firm maintained a place of business in the room that the domestic hotel company actually provided to the general manager for his managerial work over a period of 20 years. Whether there was a specific contractual agreement and whether the room was changed from time to time were both irrelevant. The Court, however, found that there was no permanent establishment with regard to the other employees of the management firm who worked in the same hotel performing various functions, but who had – in contrast to the general manager – no specific rooms at their disposal. The Court did not share the view of the lower tax court that the entire hotel should, so to speak, be regarded as a permanent establishment of the management firm.

#### 2.1.4. Comparison with the UN Model

It is interesting to compare Art. 5(1) of the OECD Model with Art. 5(3)(b) of the United Nations Model. The latter explicitly states that the term “permanent establishment” encompasses “the furnishing of services, including consultancy services”, if the “activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period”. Thus, a “services permanent establishment” under the UN Model is independent of any fixed “place of business”.

If the wording of the OECD Model covered the new approach of the Commentary, the only difference from the UN Model would relate to the geographical coherence for a single place of business.

#### 2.1.5. Conclusion regarding the Commentary changes concerning Art. 5(1)

In the author’s opinion, under the existing OECD Model, the object of the services (e.g. a building that is being painted), including the free space in or around it, does not in itself constitute a “place of business” for the performing party. Only the fact that the continuous use of rooms or equipment over a certain period of time occurs in the sole or prevailing interest of the performing party indicates that the rooms or equipment are indeed at the enterprise’s disposal and are de facto a “place of business” of that enterprise. For example, in the case of a management or technical consultant who works for a certain period of time in his client’s office building or factory, these premises should be regarded as the consultant’s permanent establishment only if he uses his room or desk predominantly in his or his firm’s own interest. That would not be the case if, for example, he spent the vast majority of his time in meetings with the client or in instructing the client’s staff on the spot in using the production machinery or in optimizing the production processes.

Regarding the example in Para. 4.3 of the Commentary (see 2.1.1.), in which an employee of one company uses an office of another company in order to control the fulfil-

ment of its bilateral obligations, one might conclude that the controlling work is carried out predominantly in the interest of the employee’s company and a permanent establishment of the latter is constituted.

#### 2.2. Building sites and construction or installation projects

These comments consider just one amendment to the Commentary with regard to building sites and construction or installation projects (Art. 5(3) of the OECD Model). It relates to supervisory activities.

Old Para. 17 (formerly Para. 16) of the Commentary stated: “However, planning and supervision is not included if carried out by another enterprise ....” Even an office on the building site which that enterprise uses exclusively for such activities did not constitute a permanent establishment because “its existence has not a certain degree of permanence”.

This has now been changed to the contrary. Para. 17 now states: “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.”

There are two issues. First, should Germany follow that recommendation? This author doubts it. For reasons of practicability, it should be the aim of treaty negotiations to reduce, not to increase, the number of foreign permanent establishments as much as possible.

Second, can Germany apply the new interpretation to its old treaties? This author does not think so. When they entered into force as part of German law, it was, under the old Commentary, indisputably clear that on-site planning and supervision did not constitute a permanent establishment.

#### 2.3. Level of presence of the agent in the source state

In an amendment to Para. 32, the Commentary addresses the question whether an agent within the meaning of Art. 5(5) of the OECD Model should be a resident of, or have a fixed place of business in, the contracting state. The answer is no.

In its 2002 Report (Para. 100), the Committee on Fiscal Affairs admits that this interpretation introduces a paradox. No permanent establishment and no taxable presence can be assumed where *ceteris paribus* the principal himself concludes the contracts.

Because the opposite solution would, however, allow a foreign enterprise to carry out extensive business activities in the source state through employees or non-resident dependent agents without becoming exposed to source-state taxation, the Commentary again seeks to extend the definition of permanent establishment and thereby the source state’s right to tax.

In the author's opinion, the new reading is not covered by Art. 5(5) of the OECD Model if one takes its correlation to Art. 5(1) into account.

Interestingly, the 2002 Report acknowledges the danger of the agent rule having too broad a scope! The Report (Para. 105) therefore stresses "the 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". The Report refers to Para. 33.1 of the Commentary, which contains some remarks on that requirement. There is, however, no concrete guidance on the necessary extent and frequency. They 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".

This clear statement is certainly not helpful in avoiding double non-taxation or double taxation and related mutual agreement procedures. Even if the contracting states unambiguously accept a permanent establishment, they will hardly agree on the attribution of profits.

It is interesting that Germany and the Netherlands reached a mutual agreement in 2002 regarding a major issue in international taxation. They agreed that the taxation of Dutch florists be equally split between the two countries in situations where their delivery staff occasionally sells flowers on German roads. Where is their place of business? Where is the certain degree of permanency? And which municipality in Germany should levy the municipal trade tax?

## 2.4. Agent with only one principal

There is another example of the tendency of the new Commentary to ease source-state taxation in the case of agents. New Para. 38.6 suggests that an agent is less likely to be independent if his activities "are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time".

In contrast, the new second sentence of Art. 5(7) of the revised (2001) UN Model suggests that such an agent is independent as long as his remuneration meets the arm's length test.

## 2.5. Consequences of a broader definition of permanent establishment

It is worth mentioning some practical consequences of the Commentary's extension of the definition of permanent establishment.

If an enterprise maintains a permanent establishment abroad, this leads inevitably to additional work, such as preparing accounts for tax purposes and tax returns, checking tax assessments, and quite often disputing them. Are taxpayers and tax authorities in a position to recognize and appropriately deal with these matters if an "intangible permanent establishment" disappears within months? Moreover, additional permanent establishments bear the danger of more cases of double taxation and may require mutual agreement procedures.

A particular issue that should be mentioned is the attribution of profits. Even if the contracting states agree on the existence of a permanent establishment, they may be far from agreeing on the level of profits to be attributed to it. The home state will hardly accept a significant creation of economic value in the other contracting state if no "real", i.e. tangible or material, place of business can be found.

International groups of companies generally rely on Art. 5(7) of the OECD Model and Paras. 40 through 42 of the Commentary, under which neither a controlling company nor a subsidiary normally constitutes a permanent establishment of the other company. Many services are, however, rendered in such groups where employees are sent to other group companies. It would severely hamper the globalization and cooperation within international groups if merely the regular physical presence of employees of another group company led to a permanent establishment in the office building or factory of the receiving company.

As a final point, the existence of a permanent establishment is important not only for the enterprise, but often also for its employees. Reference is made to Art. 15(2)(c) of the OECD Model. If an employee works abroad, he may be taxed in the host state, where he has no resident employer, only if his personal presence exceeds 183 days or if his remuneration is borne by a permanent establishment of his employer in that state. It is important to note that, in the latter case, source-state taxation would take place from the first day of the secondment. Taxation could even take place retroactively after the employee left the country just because the presence of his employer – now represented by other employees – in a "single place of business" turned out to last for more than the originally planned period of time. It would have been better to aim to restrict such taxation than to extend it to situations which are completely out of the control of the employees concerned.

## 3. CONCLUDING REMARKS

The basis of taxation in the source state is the fact that the enterprise derives profits in the source state which are connected to its economy or infrastructure in a way that requires or at least allows the profits to be taxed.

It is a long-standing tradition and common belief, however, that tax treaties should stipulate the threshold of a permanent establishment for such taxation. In the OECD, the permanent establishment threshold was regarded as:

- a fair compromise between the contracting states;
- giving sufficient protection against the erosion of their respective tax base; and
- last but not least, a practical approach to enterprises which normally have an utmost interest in restricting the number of countries in which they are taxable.

It is obvious that two contracting states are free to set the threshold differently because, for example, of a special situation in their bilateral economic relations.

Similarly, the OECD is free to decide that future tax treaties between the OECD Member countries should reflect modern economic and technical developments in a

different way. Consequently, the OECD Model may be changed after careful consideration of all the aspects. An important aspect is the practicability for globally acting enterprises as well as for the tax authorities involved. The increasing value of the supply of tangible and intangible services may be another aspect. But should not the OECD

*in principle* assume that its Member countries are by and large, to a comparable extent, a “home state” and a “source state”?

Whatever the result of such considerations, the OECD and its Commentary should respect the difference between changing the OECD Model and interpreting it.

## Agency Relationship: When Is There a Permanent Establishment?

Jacques Sasseville, Head\*  
Tax Treaty Unit, OECD

### 1. INTRODUCTION

Over the last few years, Working Party No. 1 of the OECD Committee on Fiscal Affairs has been discussing various issues and practical examples related to the definition of permanent establishment found in Art. 5 of the OECD Model Tax Convention. One such example is that of a general contractor who subcontracts all aspects of a construction contract. The work of the Working Party on this issue has led to the discussion of the following proposal for change to the Commentary on Art. 5:

Replace the last two sentences of paragraph 19 of the Commentary on Article 5 by the following (proposed additions are in italics):

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

This proposal has triggered much discussion raising fundamental principles related to the concepts of agency and permanent establishment. This note presents these issues as background for the discussion at the invitational seminar of the relationship between these two concepts.

Clearly, the finding of a permanent establishment in a situation involving an agency relationship leads naturally to the issue of the attribution of profits to such a permanent establishment. Conceptually, however, these issues are different, and the issue of the existence of a permanent establishment precedes that of attribution of profits. For that reason, the latter issue is not addressed in this note.

### 2. GENERAL PRINCIPLES

Art. 5 of the OECD Model considers two different types of permanent establishments. The first type, the “fixed place of business permanent establishment”, arises from the basic definition of permanent establishment in Art. 5(1), which refers to “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. In requiring the existence of a “fixed place of business”, the first part of the definition incorporates both a geographical requirement (i.e. that a fixed physical location be identified as a permanent establishment) and a time requirement (i.e. that the presence of the enterprise at that location be more than merely temporary, having regard to the type of business carried on). The second part of the definition simply requires that at least part of the business activities of the enterprise be carried on at the relevant location.

The basic definition of permanent establishment is supplemented by the rule of Art. 5(5) that deems a non-resident to have a permanent establishment in a country if another person acts in that country as an agent of the non-resident and habitually exercises an authority to conclude contracts in the name of the non-resident (the “agency permanent establishment”). That rule, however, does not apply to independent agents acting in the ordinary course of their business (a classic example of that exception is a broker concluding sales of securities on behalf of a number of foreign insurance companies or banks: although he concludes contracts in the name of his principals, he does so as an independent agent acting in the ordinary course of his business as such). The agency permanent establishment is a deeming provision that is only relevant when a permanent establishment cannot be found to exist under the basic definition in Art. 5(1).

In the context of the fixed place of business permanent establishment in Art. 5(1), the issue of agency is best discussed by reference to the factual situation of a non-resident who has a fixed place of business in a country but

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