UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 7, 2012

Mr. Pascal Saint-Amans
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OECD Centre for Tax Policy and Administration (CTPA)
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75016 Paris

Dear Pascal:

The United States Council for International Business ("USCIB") welcomes the opportunity to provide comments on the Public discussion draft related to the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (the "discussion draft"). We appreciate the hard work of the Working Group in preparing the discussion draft and the thoughtful guidance provided by the discussion draft. Nevertheless, there are areas in which additional guidance or clarification is needed. We look forward to working with the OECD to provide that guidance. We think it would be useful to schedule a formal consultation with business and USCIB would like to participate in such a consultation.

USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

Introduction

As is well known, the main use of the permanent establishment ("PE") concept is to determine the rights of a Contracting State to tax the business profits of an enterprise of the other Contracting State. The determination of whether an enterprise of the other Contracting State has a PE in the source State is fundamental to the taxation of business profits as a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a PE in the source State under Article 7 (Business Profits).

In this era of globalization, new business models, emerging economies and countries need for tax revenues, the practical application of the PE concept raises a number of issues. The discussion draft considers these issues and provides recommendations. We believe that the updating of the Commentary will be of great benefit to business and tax administrators as it will provide a framework for the adoption of consensus views as to how a number of these contentious issues should be resolved.

As a central theme to our comments, we respectfully submit that there is an urgent need to revisit the relationship between PE, Business Profits, Associated Enterprises (transfer pricing), and Mutual Agreement articles of the Model Convention. This reconsideration was undertaken to some extent during the revision of Article 7. With the issuance of the business restructuring provisions, a variety of ambiguities have been introduced in terms of the relationship among these articles, as well as the applicability of general anti-avoidance principles, as noted in our comments below.

The foregoing enumerated provisions need to be coordinated in order to minimize the risk of double or multiple taxation of MNEs and to coordinate the allocation of profits between the source country and the residence country.

When PE issues are raised by a tax administration with respect to a foreign enterprise ("FE"), there are three issues that may need to be addressed: (i) whether FE has a PE in the host country; (ii) if a PE exists, the allocation of business profits between FE and the PE; and (iii) the transfer pricing arrangement between the FE and affiliates in the host country. If there is a bilateral income treaty between FE's country of residence and the host country, double taxation may be avoided, although Competent Authority processes may be required.

The Model Convention (Article 5) defines the circumstances in which an enterprise can be deemed to have a PE in another country. In that case, the Business Profits article (Article 7) provides guidance as to how to attribute business profits to the PE.

Article 7(3) provides that where a country adjusts the profits attributable to a PE of an enterprise of another country and taxes these profits that have already been taxed in the other country, the other country will make an appropriate adjustment to the extent necessary to eliminate double taxation of the profits. In determining these matters, the mutual agreement article (involving a Competent Authority proceeding) will apply. The intention of Article 7(3) in this context is to ensure that there is no unrelieved double taxation of the profits that are properly attributable to the PE. This result may require that the two Contracting States resolve differences based on their potentially different interpretations of Article 7(2), applying transfer pricing principles, through the Competent Authority mutual agreement process.

The Commentary makes the observation that the enterprise should determine profits in both countries in a consistent manner, so that the task of the Competent Authorities will be straightforward, and there should be no need to make an adjustment. While the Commentary suggests that these controversies should be "fairly limited," recent experience indicates quite the contrary. These cases oftentime involve situations in which the source country is seeking to preserve its tax base by attributing profit to the PE. The Commentary also assumes that domestic remedies may be appropriate in many instances, although, again, practical experience suggests caution in this regard. Pursuit of domestic, administrative, or litigation remedies can be problematic in a subsequent Competent Authority proceeding if a complete victory is not achieved.

Reflecting a growing trend in the Commentary, many countries made observations on the Article 7 Commentary. In addition, there were even more reservations to new Article 7 itself. These observations can cause problems in Competent Authority contexts, as a country may take the position that it is not bound by the Commentary to the extent that it has entered an observation.

The process of addressing PE and Business Profit matters in recent years is reflective of a disagreement among OECD Member countries and source countries (particularly emerging countries) concerning the allocation of profits between the source state and the residence state.

Accordingly, we submit that there needs to be more precise coordination between Articles 5, 7, 9, and 25 and submit these comments in that context.

Issue 2 – Meaning of "at the disposal of" (paragraph 4.2 of the Commentary)

The issue of whether an enterprise has premises "at its disposal" underlies several of the topics addressed in the discussion draft. Therefore, we would like to make some general observations on this issue before addressing the specific recommendations made in the discussion draft.

First, we agree with the conclusion that it would be appropriate to provide further guidance on the phrase "at the disposal". While that expression is not found in the definition of "permanent establishment"

in the Model Tax Convention, it appears many times in the Commentary. We believe that the "at the disposal" concept is an appropriate elaboration of the essential requirements that a PE can exist under Article 5(1) only if the enterprise has established a "place of business" that is "fixed". Taxpayers have understood that language to mean that net basis taxation is appropriate only when the enterprise itself has established a place under its control where it undertakes its "core" business activities in the jurisdiction. The language of "at its disposal" is an accurate and useful expression of that concept.

Second, the discussion draft has made important progress in emphasizing the distinction between the business and establishment of an enterprise on the one hand and the business of and establishment of other persons who may be contractors to or suppliers to the enterprise on the other hand. We are aware of cases where tax administrations have asserted that an enterprise without actual physical presence in the jurisdiction could be subject to tax, based solely on the activities of contractors or service providers in the jurisdiction. Subject to the further clarifications noted below, we hope that the discussion draft will support and elaborate the principle also expressed in other recent additions to the Commentary (see, e.g., para 42) that a physical presence of the enterprise itself is required in order to constitute a PE under Article 5(1).

To that point, the distinction drawn in the discussion draft between the business of the enterprise and the business of the contractor is important. In an affiliated group, each entity performs a function. The functions of all entities are designed to advance the business of the group as a whole. That said, the analysis of whether a particular enterprise has a PE under Article 5(1) is determined on a strict entity-by-entity basis. The fact that an enterprise may have an associated enterprise operating in a jurisdiction that performs an activity which contributes to, or is even central to, the overall business purpose of the group is of no significance in the determination of whether the enterprise has a PE in the jurisdiction under Article 5(1). That determination can be based only on the location of the operations of the enterprise itself.

Third, we suggest that the Commentary reiterate that jurisdictions that prefer to include the alternative provision relating to services now expressed in paragraphs 42.11 – 42.48 of the Commentary must do so by including such a provision in their treaties. Expressly incorporating those provisions in the treaty is the principled approach to resolving this issue in contrast to endeavoring to create the same result through an unwarranted expansion of the concept of "at the disposal," as properly applied under Article 5(1). Working Party 1 has given long and serious thought to the alternative provision regarding services, which, if desired, countries are free to include in bilateral treaties. In the case of a treaty that does not contain such alternative provisions, paragraph 42.24 of the Commentary confirms that the standards of Article 5(1) will be applied in the normal way, so that no services-based PE can exist without an appropriate fixed physical presence.

This point is illustrated by the statements in paragraphs 13 – 14 of the discussion draft. The case study presented there parallels the facts in the case of Dudney v. Queen, 2000 DTC 6169 (FCA). In that case, the Canadian Federal Court of Appeal properly concluded that under a treaty provision comparable to Article 5(1), the individual did not have a fixed base in Canada.[1] Paragraph 14 of the discussion draft suggests that at least one member of the Working Group, although presumably a minority of Working Group members, considered those facts to constitute a PE under Article 5(1).

We believe that the facts of the example clearly do not constitute a PE under Article 5(1), on the basis that Peter (the taxpayer) does not have the premises of CLIENTCO at his disposal. In particular, the facts note that Peter does not have any particular office or room at his own disposal, as he is obliged to rotate among 10 different training rooms and meets employees in their own offices. We suggest that the Commentary include the example set forth at paragraph 13, but conclude that under such facts the client's premises are not at the taxpayer's disposal. The Commentary, however, could suggest that jurisdictions which would like to include the alternative provisions regarding services in their treaties in

[1] This case actually addressed Article 14 regarding independent personal services, but the Court's analysis would be equally applicable to an Article 5 permanent establishment issue.

order to subject the taxpayer to net basis taxation in these circumstances may do so, as contemplated by paragraph 42.23 of the Commentary.

The discussion draft proposes new Commentary text in paragraph 4.2 that sets out two new statements of interpretative guidance for determining whether an enterprise has premises at its disposal. First, "at the disposal of" is interpreted to include situations where "an enterprise has an exclusive legal right to use a particular location used only for carrying on that enterprise's own business activities." Second, "at the disposal of" also is interpreted to include situations where an enterprise "performs business activities on a continuous and regular basis during an extended period of time at a location that belongs to another enterprise or that is used by a number of enterprises." We believe that both expressions could benefit from some further elaboration.

We agree with the statement that an enterprise has a fixed place of business if it has an "exclusive legal right" to occupy a particular location, and the location is used only for carrying on the enterprise's own business activities. We believe, however, that the Commentary should further describe what is intended by that language; viz., in any case where an enterprise has an "exclusive" right to use a particular location, it must have the legal right to exclude others from using that place. Accordingly, this language appears to refer to legal rights such as a leasehold. As the discussion draft does not provide an example of a case that is described by this text, we suggest this rule be illustrated in the Commentary by reference to property ownership or a leasehold.

The second interpretation regarding performing business activities on a continuous basis is more problematic, as we believe that this proposed text is susceptible to erroneous interpretations, in at least two contexts. Both contexts raise issues due to the failure of this language to provide that the premises must be under the control of the enterprise itself.

The first problematic context arises when the enterprise conducts business through subcontractors. As properly reflected in the new proposed Commentary paragraph 10.1, the fact that an enterprise may carry on its business through subcontractors, in itself, does not give rise to a fixed place of business absent factors other than the contractor relationship. In light of the proposed new text in paragraph 10.1 stating that an enterprise may "carry on its business" through subcontractors, we are concerned that the proposed language in paragraph 4.2 referring to an enterprise that "performs business activities … at a location" could be regarded as implying that an enterprise has a PE at a location where it "carries on its business" through subcontractors, without further conditions.

This statement seems to be clearly contrary to the intended consequence resulting from the new paragraph 10.1 language, which indicates that the mere fact that a subcontractor may perform the work of an enterprise at a fixed place of business will not cause that fixed place of business to be "at the disposal" of the foreign enterprise. Accordingly, we suggest a conforming amendment to the paragraph 4.2 text be made to clarify that the mere fact that an enterprise or its subcontractors may be conducting business activity in some way in a state of itself is not sufficient to constitute a PE of the enterprise under Article 5(1), unless the enterprise itself has a physical, fixed, place of business in that state through which it is conducting part or all of its business.

The second problematic context arises where the enterprise may have personnel present at a location in cases similar to the example contained in paragraph 13 of the discussion draft concerning Peter and CLIENTCO. As discussed above, that fact pattern should not give rise to a "fixed place of business" on the basis that the enterprise does not have the client's premises "at its disposal". The proposed language in paragraph 4.2 seems to refer only to the length of time that the enterprise conducts business activities at a place to determine the existence of a PE. That interpretation conflicts with the purpose and proper meaning of "at the disposal", which should be that the enterprise must be able to exercise some degree of control over the premises (or equipment, if the "fixed place" is based on the control of equipment rather than premises). This proposed language does not include that element, and thus would be susceptible to erroneous interpretations in cases such as that of Peter and CLIENTCO. As noted above, the alternative provisions regarding services do create a PE based solely on the

performance of certain business activities over a defined time period. That type of PE rule, however, should not be imported into Commentary, which is interpreting the basic rules of Article 5(1).

We agree with the proposed Commentary text in paragraph 4.2 to the effect that the plant that is owned and used exclusively by a supplier or contract manufacturer is not at the disposal of the enterprise receiving the goods. That is a useful clarification, and we urge that the Working Group retain it in the Final Draft.

The Commentary should include the scenario of a toll-manufacturer or alternatively, delete the word "contract". Currently, it seems to reflect a relationship to the ownership of the materials, which in our view is not relevant and thus needs to be clarified (in line with the description of the issue included in the discussion draft).

It would also be useful to have more clarity with respect to the situations where, within MNE groups, employees have access to enter buildings throughout the world or, alternatively, seconded employees return to the home country offices on a regular basis to perform their activities. Query whether these situations result in the conclusion that the office in which they perform their (cross-frontier) activities is "at the disposal of the employer"? We think not.

Issue 3 – Can the premises of a (converted) local entity constitute a permanent establishment of a foreign enterprise under paragraph 1? (paragraph 4.2 of the Commentary)

This section of the discussion draft raises important issues on the points of both "at the disposal of" and "business of the foreign enterprise". The discussion, however, is potentially ambiguous as to the analysis of the second point, so we suggest that this latter point be clarified in the Commentary.

Paragraph 17 of the discussion draft states that the CARCO example raises the questions of whether the premises of the supplier are "at the disposal of" the principal, and whether it is the "business of the foreign enterprise" as opposed to the business of the contract manufacturer that is carried on at the location of the parts, inventory and manufacturing activity. The discussion draft properly concludes that the contract manufacturer does not give rise to an Article 5(1) PE of the principal. This is the correct conclusion, notwithstanding the contractor's activity is core to the overall business purpose of the foreign enterprise. The CARCO example effectively demonstrates this point, as the manufacture of automobiles is a core element of the business of the principal, which is engaged in the global manufacture and sale of automobiles. We recommend that the Working Group include the CARCO example in the Commentary as a useful illustration of this principle. The abbreviated version of this example in paragraph 4.2 does not sufficiently capture the Working Group's conclusion regarding the CARCO example, given the more detailed factual texture of the example itself.

The text of the discussion draft does not clearly answer the second question raised in paragraph 17 of the discussion draft, namely whether the business conducted at the location of the manufacturing activity is that of the foreign enterprise or that of the contract manufacturer. The discussion draft seems to have based the conclusion that no PE exists on the basis that the foreign enterprise did not have the premises of the contract manufacture "at its disposal", despite the fact that the foreign enterprise built the industrial plant, and owns the parts, work in process and finished goods at the location of the contract manufacturer. The language proposed to be included in paragraph 4.2 of the Commentary refers only to the "at the disposal of" point.

As a matter of treaty interpretation, it is correct that if the foreign enterprise does not maintain a "fixed place of business" in the State, then it is not necessary to determine whether the activity of the contractor constitutes the business of the foreign enterprise or the business of the contractor or supplier. Thus, strictly speaking it is not necessary to answer the second interpretative question posed by paragraph 17 of the discussion draft. In some cases, however, the latter question of whether the

business conducted by a contractor or supplier is that of the contractor or the supplier or the principal is relevant to the analysis, so it is an appropriate issue for the discussion draft to raise and answer.

In this case, it is clear that the business activity undertaken at the manufacturing location is the business of SUBCAR and not that of the foreign enterprise. It is generally the case that a contractor or service provider that provides goods or services to a foreign enterprise, conducts its own business, and not the business of the foreign enterprise, even when the business activities of the two entities may be integrally related, as is normally the case in an affiliated group where two entities contract as participants in a single production chain. We recommend that the Working Group confirm this point in the Commentary, consistent with paragraph 42 of the Commentary.

In discussing issue 3, the Working Group properly confirmed that the application and interpretation of Article 5 is not affected by any prior business restructuring (section 19, page 11 discussion draft), but did not recommend a change to the Commentary. The Working Group should include the comment that the PE analysis is unaffected by any prior business restructuring in the Commentary.

Issue 4 – Home office as a PE (proposed new paragraphs 4.8 and 4.9)

The Commentary in new paragraphs 4.8 and 4.9 is helpful in that it clarifies that the issue is whether the place of business is at the disposal of the employer (and not just at the disposal of the employee). However, it would be useful if the Working Group could include in the new Commentary the examples that are contained in the background discussion and also draw conclusions as to whether a PE exists in each of these cases. This is particularly important as these examples appear to deal with situations where the activities of the employees may not be considered preparatory or auxiliary.

Issue 6 – Time requirement for the existence of a permanent establishment (paragraph 6 of the Commentary)

We are disappointed that the Working Group has not accepted BIAC's repeated recommendation for the adoption of a more definite time limit for the establishment of a PE. It appears that the lack of a more definitive statement in this regard is due to an inability to achieve consensus among the delegates. We urge Working Party 1, when it reviews the discussion draft, to continue to work on this issue. We believe that the rule should be that if the establishment exists for less than 12 months, it is not permanent. If it is not possible to obtain consensus with respect to a 12 month time period, it would be helpful if the wording with respect to the 6 month time period could be made more definitive. We suggest that the last sentence of paragraph 6 of the Commentary be deleted and replaced by the following:

> "Generally, a place of business that does not exist for more than 6 months will not be considered fixed and therefore will not constitute a permanent establishment except in the case of the two limited exceptions described in paragraphs 6.1 and 6.2."

We reiterate our previous comments as to the problems experienced by the business community with respect to the PE concept when dealing with business activities of a short duration. As mentioned before, we object strongly to the assertion that a PE could be found based on either of the exceptions proposed in the discussion draft. However, given that our suggestions have been rejected, we are appreciative that the Working Group has attempted to clarify the application of the PE concept to short-term activities by way of the addition of more specific examples to the Commentary. The addition of these two specific exceptions is appreciated; however, the addition of these two specific exceptions raise new issues that are discussed below.

Recurrent activities

In the recurrent activities exception, it is unclear at what point the recurrent activity will constitute a PE. It seems logical that that point would be when the total amount of time spent by the individual at the commercial fair in State S exceeds the six month general limit (or whichever general time limit is in place in State S). Applying this test to the example in the discussion draft, the individual would have a PE in State S after approximately 5 years of attending the commercial fair. However, we would like to suggest that a minimum period test be applied to the amount of time that the individual must spend in State S in each year for the exception to apply. We suggest that this time limit should be two months. A yearly time minimum would be helpful in avoiding some of the issues discussed below with respect to retrospective constitution of PEs. Of course, the application of the recurrent activities exception assumes that the enterprise has the premises through which it is conducting its recurrent activities at its disposal.

In addition, the question arises as to whether a recurrent PE would exist on a retrospective basis. We suggest that this result, although arguably appropriate in the case of a continuous presence, is entirely inappropriate with respect to a PE that consists of recurrent, though not continuous, activity. The PE would first exist in the year in which the cumulative presence crossed the PE time threshold.

With respect to recurrent activities that do not constitute a PE until after the passage of several years, the opposite rule, the retrospective constitution of a PE is likely to cause immense compliance difficulties. Query, is the taxpayer expected to attempt to file returns for these years on the basis that a PE exists retrospectively? Would penalties apply with respect to returns that should have been filed but were not filed? It hardly seems in the interest of balanced tax administration to subject taxpayers to these difficulties where taxpayer may not have had any intention at the outset to attend the fair for prospective years.

In the absence of evidence of such an intention (i.e., a contract signed by the individual at the outset that reserved the space at the commercial fair for numerous future taxation years), a PE based on recurrent activities should be constituted on a prospective basis to avoid difficult compliance issues.

Another issue to be considered is whether and how the analysis would change if the taxpayer missed a year or two somewhere in the middle of the 15 year period. Query, would the taxpayer's intention with respect to attendance at future fairs be a determining factor? what if the individual were to attend fairs in different locations in the same state; in that case would an analysis with respect to the existence of a PE have to be done with respect to each location separately? We recommend that additional detailed guidance is required for the business community to be able to determine when a PE exists on the basis of recurrent activities.

We believe if an exception based on recurrent activities is to be retained in the Final Report it should contain the following limitations: (i) a PE should only be considered to exist if cumulatively the enterprise is present at the same location for at least six months; (ii) the PE would only exist on a prospective basis; (iii) in no event should presence less than two months be considered in determining whether a PE exists; (iv) if there is a break - the vendor misses a year at the fair – the requisite time thresholds reset to zero; and (v) the test applies separately to each separate location.

Finally, the example of the rental of a stand at a fair for a period of 5 weeks during 15 years relates to the recurrence element, but does not provide proper clarification on that element and its application to other, more common, situations (e.g. situations of not actually selling products). For instance, in the case of an MNE, how should this be applied to the situation whereby marketing personnel meet every year at a company headquarters solely for the purposes of performing "business activities"; query, whether this activity would trigger a PE? It is suggested that the time requirement remarks (specifically the element of recurrence) only refer to sales/services to end-consumer activities and not to "back-office/supporting" type of activities. In our view these more common examples, would not trigger a PE because the headquarters are not at the disposal of the marketing personnel and they are not conducting the business of the enterprise. These elements must always be met independently of the time element. So, the marketing personnel's presence at the headquarters would not create a PE regardless of its recurring nature.

One-shot projects

The second exception deals with situations where a unique and self-contained business is carried on for a short time exclusively in a particular state. The addition of a specific example to the Commentary is helpful, although we reiterate our previous comments as to the uncertainty caused by having any short-term business constitute a PE. If this exception is not limited to the unique and self-contained business, then it would dramatically undercut the general PE rule. We agree that non-resident caterers that operate their business in a state during a sporting event of limited duration (such as the Olympics) should not have PEs in that state, presumably assuming that they operate their business outside that state as well. Because of the importance of this distinction, it is important to maintain both the parts of the example illustrating both the unique and self-contained nature of the business and the business that is part of a larger multinational enterprise.

A basic time limit would still be helpful in applying this test, given that the business will be carried on in State S for four months. Although this is less than the six month general time limit described in paragraph 6 of the Commentary, it is nonetheless a more substantial period of time. It would be helpful to have a time limit standard under which these issues do not have to be considered in detail. For example, a note could be added to the Commentary that where activities constituted a business that was carried on exclusively in a country, the general six month time limit is reduced to a three or four month time limit because of the business's strong ties to that country. The absence of any kind of time limit is of concern to the business community.

Issue 7 - Presence of foreign enterprise's personnel in the host country (paragraph 10 of the Commentary)

The language in new paragraph 10 is important in that it clarifies that employees of a foreign enterprise who are seconded to a resident of the Other State do not in and of themselves constitute a PE of that foreign enterprise in the Other State. Furthermore, neither does their presence in the Other State mean that the foreign enterprise is carrying on business in the Other State. These are positive clarifications.

The proposed language however may suggest that employees who are not formally seconded will always constitute a fixed place of business and a PE of the foreign enterprise in the Other State. In order to alleviate this concern we suggest the fifth sentence of proposed paragraph 10 be amended to read as set out below.

> "It makes no difference whether or not the dependent agent is authorized to conclude contracts if he works at a fixed place of business of the enterprise within the meanings of paragraphs 1 and 2, subject to the provisions of Paragraph 4, (see paragraph 35 below)."

This is intended to clarify that the mere presence of the employee in the Other State does not in and of itself constitute a PE or fixed place of business. The standard rules have to be applied.

The proposed change to the Commentary is based on a "substance over form approach". The seconded employee is essentially economically employed by the entity to which the person is seconded and the economic employer is treated as the actual employer. It may be helpful to define secondment in the Commentary.

The principle of looking to the economic employer should not be extended to other cases in which the employee continues to work for the primary employer, but also has secondary obligations to other entities within the group. For example, if a MNE establishes cross-border reporting lines (e.g., marketing people operating within virtual teams), the employee of a first company may on occasion report to a supervisor in a second company; the mere reporting relationship should not create a secondment to the

second company. The employee should at all times be treated as an employee of the first company because the employee remains on the payroll of the first company, continues to carry on the business of the first company and merely reports to and is not under the control and direction of the second company.

Issue 8 – Main contractor who subcontracts all aspects of a contract paragraphs 10 and 19 of the Commentary)

This section of the discussion draft confuses the differences between the circumstances when an enterprise is regarded as carrying on its business through its own fixed place of business for purposes of the basic rule PE test of Article 5(1) and paragraph 10 of the Commentary, and the question of the period of time a construction site is regarded as existing under Article 5(3) and paragraph 19 of the Commentary. We recommend that these conceptually distinct issues be separated and discussed in their distinct contexts.

The discussion draft properly notes that the issue discussed in this section had its genesis in the context of Article 5(3) and paragraph 19 of the Commentary. The discussion draft improperly suggests that the same analytical approach should apply to Article 5(1) and paragraph 10 of the Commentary. This confusion is exacerbated by the use of the KCO example proposed at paragraph 47 of the discussion draft as a method to illustrate the issue in both contexts.

The KCO example is based on the Norwegian Supreme Court case of Offshore Accommodation Service AB v. Government of Norway, Case No. 327/2001 ("Safe Service"). In that case, a Swedish company entered into a contract to provide catering services on an accommodation platform situated in Norwegian waters. The Swedish company subcontracted the catering services to a Norwegian subcontractor. The Norwegian Supreme Court held that the Swedish company carried out activities under the contract through the subcontractor and thus had a PE under a special provision of the Nordic Double Tax Treaty.

It is important to note that the Safe Service case did not involve interpretation of the basic concept PE rule of Article 5(1). Rather, it interpreted Article 21(2)(a) of the Nordic Treaty, which *deems* a PE to exist if a resident of a Contracting State "carries on activities" in the other state in connection with surveying and exploration for or exploitation of hydrocarbon deposits. Article 21 of the Nordic Treaty does not have an analogue in the Model Tax Convention. Accordingly, great caution should be exercised in drawing any conclusions from the Safe Service case about the proper interpretation of Article 5(1). We believe that the discussion draft improperly suggests in Paragraphs 47, 48 and 50 that the Safe Service case is appropriate guidance for Article 5(1) and its interpretation in paragraph 10 of the Commentary.

The discussion draft proposes significant new Commentary in proposed paragraph 10.1. We believe that the context as set by the Safe Service case and the reference in paragraph 49 of the discussion draft that activities of a subcontractor can be "allocated" to a contractor, as extended to the Article 5(1) context by paragraph 50 of the discussion draft, are inappropriate expressions for Article 5(1) interpretation. For Article 5(1) purposes, the issues are whether the nonresident enterprise has the premises of the subcontractor at its disposal, and whether the subcontractor's activity is the business activity of the subcontractor or the foreign enterprise. As noted above in the discussion of "premises of a (converted) entity", in the normal case a contractor or a service provider conducts its own business activities, not the business activities of its principal.

The proposed paragraph 10.1 quite properly notes that the premises of a subcontractor do not *per se* constitute a fixed place of business of the principal. This is an important point and should be retained in the final version of the Commentary. We also suggest that another example be added to provide a parallel to the "small hotel" example (if this example is retained), where a contractor or service provider is regarded as carrying on its business, and not the business of its principal.

This could be done by reference to the KCO example. The discussion draft does not indicate whether members of the Working Group believe that such facts create a PE under Article 5(1). Under the facts as given, FCO is conducting its own business activities, not those of KCO. We recommend that the Commentary include this example, and conclude that even if KCO is regarded as having premises at its disposal in State S, FCO is not conducting the business of KCO for purposes of Article 5(1). We recommend that the Commentary provide more guidance as to the relevant factors to distinguish between the business of the foreign enterprise and that of the local entity.

If the "small hotel" example is retained in the Final Report, we suggest that the Final Report correct the reference in paragraph 51 to the owner "who would obtain the profits" as a factor in the analysis. Presumably, all enterprises are profit seeking. The "local independent enterprise" that obtained the contract to operate the hotel would be compensated through its fee (as negotiated with a third party) and would report its taxable income in that State. The fact that the nonresident enterprise may (or may not) be profitable is not relevant to the determination of whether a PE exists, so the Commentary should not imply that profitability is a factor in the determination of whether a PE exists.

If the proposed paragraph 10.1 of the Commentary is adopted, it would be appropriate to make clarifying and conforming revisions to existing paragraph 10. Paragraph 10 now provides as follows:

> The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents).

The reference to "persons receiving instructions from the enterprise" and "dependent agents" has created considerable uncertainty over the years. The category of persons who "receive instructions from the enterprise" as a literal matter could apply to many persons other than agents, as it could apply to any number of dependent (or independent) contractors or service providers.

In particular, we recommend that the reference to agents should describe only those persons who are, in fact, agents under applicable commercial law, and not other contractors or service providers that function in a principal to principal capacity in contrast to that of an agent. In order to clarify the question of when business activity of an enterprise can be carried out by persons other than employees (i.e. "personnel"), we propose that paragraph 10 be limited to the case of personnel, and new paragraph 10.1 be used to describe the circumstances under which a business of an enterprise might be regarded as being conducted by non-employees, such as subcontractors. To implement this clarification, the second sentence of current Paragraph 10 should be deleted, since the reference to "persons receiving instructions from the enterprise" is too broad and is inconsistent with other provisions of the Commentary. The reference to "dependent agent" in the fourth sentence similarly would be replaced with a reference to "personnel". The proposed paragraph 10.1 then would need to be refined to state when a contractor might be regarded as carrying out the business of the enterprise, and when it would be regarded as simply performing its own business.

With respect to the proposed paragraph 10.1 example of the "small hotel", we believe that this example should be deleted as it is not a useful elaboration of the principle that is intended to be illustrated. Since the facts state that the foreign enterprise owns the hotel, the enterprise would be subject to tax in any event under Article 6, so there is no need to find that the subcontractor's activities constitute the hotel owner's conduct of a trade or business. This case also is a good illustration of the need for further guidance (as mentioned above) on the relevant factors for distinguishing between the business of the foreign enterprise and the business of the subcontractor. If the on-site hotel operation were contracted out to an established hotel management company, for example, it would seem clear that the hotel management company was conducting its own business and not the business of the foreign enterprise.

Issue 10 – Meaning of "place of management" (paragraph 12 of the Commentary)

As the discussion draft notes, the example described in this section raises the questions of the proper relationship between the examples listed in Article 5(2) and the definition in Article 5(1), and the application of the "at the disposal" standard to the facts of the example. Both issues are important and deserve clarification.

To that point, we endorse the proposed changes to paragraph 12 of the Commentary. Even though the discussion draft does not propose new Commentary on the application of the "at the disposal" standard to the provision of management services, the explanatory material is useful and we encourage the Working Party to include the statement that the provision of management services (and not just the administrative services referred to in the example at paragraph 59 of the discussion draft) does not cause the management premises to be at the disposal of the enterprise receiving the benefit of the services.

Issue 11 – Additional work on a construction site (proposed new paragraph 19.1 of the Commentary)

The draft Commentary would clarify that the period during which the building or its facilities are being tested by the contractor should generally be included in the period during which the construction site exists. However, construction work completed pursuant to a guarantee that requires an enterprise to make repairs would not normally be included in the original construction period.

USCIB agrees with these conclusions and thinks these are useful clarifications that ought to be included in the Commentary.

Issue 12 - Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)

We commend the Working Group for clarifying that the activities described in subparagraphs (a) to (d) of Article 5(4) constitute "automatic exceptions" to a fixed place of business PE described in Article 5(1). We wholeheartedly agree that making all the exceptions subject to the "preparatory or auxiliary" condition would inject unnecessary uncertainty to the Commentary, resulting in more disputes with the tax authorities. Furthermore, the contrary view would be inconsistent with the historic background of this Article.

Issue 13 - Relationship between delivery and the sale of goods in subparagraph 4 a) (paragraphs 22 and 27.1 of the Commentary)

We agree with the Working Group's recommendation to clarify that subparagraphs a) and b) of Article 5(4) apply regardless of whether the storage or delivery of goods takes place before or after a contract for the sale of the goods or merchandise has been concluded, provided that the enterprise retains legal and beneficial ownership to the goods or merchandise while they are at the relevant location.

Issue 14 – Does a development property constitute a PE? (paragraph 22 of the Commentary)

The discussion draft clarifies that "goods" and "merchandise" does not include immovable property. This is a useful clarification and should be included in the Commentary.

Issue 15 – Do "goods or merchandise" cover digital products or data? (paragraph 22 of the Commentary)

The discussion draft clarifies that "goods or merchandise" does not include data, although tangible property that include data, such as CDs and DVDs are "goods or merchandise". This is a useful clarification and should be included in the Commentary. We request, however, that the Working Group clarify that an enterprise that delivers digital products will not be treated any less favorably than an enterprise that delivers tangible goods and enjoys the protections of Article 5(4).

Issue 16 – Carrying on various activities listed alternatively in subparagraphs 4 a) and b) (paragraph 22 of the Commentary)

The discussion draft clarifies that subparagraphs 4 a) and b) cover situations where a facility is used for any combination of storage, display, and delivery, without the application of the subjective test contained in Article 5(4)(f). This is a useful clarification and should be included in the Commentary.

Issue 18 – Fragmentation of activities (paragraph 27.1 of the Commentary)

We agree that paragraph 27.1 is not relevant where different, although related, enterprises are carrying out activities in the same state as that paragraph refers to activities carried on by one enterprise. Paragraph 41.1 of the Commentary states that "[t]he determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State."

Issue 19 - Meaning of "to conclude contracts in the name of the enterprise" (paragraph 32.1 of the Commentary)

We agree with the Working Group that the current Commentary on Article 5 does not provide sufficient guidance as to when a dependent agent is considered to possess "an authority to conclude contracts in the name of [an] enterprise." While the analysis of an agency relationship is strongly fact dependent, we believe it is important to have a framework to determine when a dependent agency PE arises. The current Commentary on Article 5 and the Working Group's proposed changes place heavy reliance on the ability of the agent to legally bind the enterprise, while at the same time providing that authority to conclude contracts in the name of the enterprise can be indicated by the conduct of the

parties. If MNEs are to have any confidence that their arrangements with agents will be respected, the Commentary should provide more detailed guidance. The Commentary should provide bright lines, so that MNEs can clearly determine whether their activities give rise to a PE. The fundamental question of whether an enterprise is subject to tax on its activities within a jurisdiction should not be a question of guesswork.

Undisclosed Agents

The Working Group sought to clarify the application of Article 5(5) to commissionnaire and undisclosed agent arrangements by recommending the insertion of a new example into the Commentary on Article 5 that provides: "For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to in the contract." The apparent intent of the new example is to clarify that an agent may be found to have an authority to conclude contracts in the name of an enterprise even if the enterprise is not legally bound, provided that the enterprise is "economically bound." However, this new example does not add clarity, but rather raises new uncertainties as to which countries or cases are implicated by the terms "some countries" and "certain cases."[2]

The uncertainties are compounded because the discussion draft does not explain what it means to be "economically bound," including how a person can be "economically bound" if it is not also legally bound.[3] If this example is referring to the manner in which undisclosed agents are treated in countries where the applicable agency law provides that an undisclosed agent is deemed to bind the principal, the example should make this explicit.

Moreover, if language is added to the Commentary that provides that doing business through an undisclosed agent or commissionnaire can give rise to a PE, the Commentary should also provide an example clearly distinguishing arrangements through undisclosed agents or commissionnaires from limited risk buy-sell arrangements, the latter of which should not give rise to a PE.

In limited risk buy-sell arrangements, an enterprise organized in one country generally ships goods to a buyer in the second country (sometimes on a consignment basis), the enterprise retains title to the goods until the goods are purchased by the buyer, and the buyer purchases the goods immediately prior to the time it sells the goods.

In typical limited risk buy-sell arrangements, the buyer bears the expense and risk of loss on the products sold to the ultimate customers; the buyer may from time to time and without notice to or consent of the enterprise move the products to different locations; the buyer is responsible to the enterprise for damage, destruction, theft, or loss of the goods prior to the purchase by the buyer; the buyer bears the cost of insurance of the consigned goods with the amount to cover any loss payable to the enterprise; upon request, the buyer must furnish the enterprise with an inventory of all products held on consignment, but it is not required to account for its sales proceeds; the buyer is under no obligation to purchase the

[2] Paragraph 112 of the discussion draft adds further confusion by explaining that "it was not possible [for the Working Group] to reach a common view on the situations dealt with in the *Zimmer* and *Dell DUF*] court decisions," both of which involved commissionnaire arrangements. But then the example proposed to be added to the Commentary does not appear to distinguish between commissionnaire arrangements. Further, the example proposed to be added to the Commentary does not appear to distinguish between commissionaire arrangements/indirect representation (a civil law jurisdiction concept) and undisclosed agent arrangements (a common law jurisdiction concept).

[3] If the Working Group intended to suggest that a foreign enterprise may be considered to be economically bound by using the cited example from the IFA 2009 Congress (i.e., by the foreign enterprise agreeing to fully reimburse a person for any amount that the latter may be required to pay customers under its contractual liability), then this should be made clear.

consigned products; and the enterprise has the right to recall any consigned products before they are purchased by the buyer. In these cases, the buyer should not be deemed to be an agent of the enterprise and cause the enterprise to have a PE in the buyer's country because the relationship between the enterprise and the buyer is that of a seller and purchaser.

Actual Authority to Conclude Contracts in the Absence of Legal Authority

Paragraph 113 of the discussion draft sets forth three additional scenarios that concern whether an agent concludes contracts in the name of a foreign enterprise. Generally, the three scenarios are: (1) multiple levels of contract approval within a multinational group, including by persons that are not employees of the foreign enterprise/principal; (2) standard form contracts for which no negotiations occur; and (3) sales governed by a "framework contract" applicable to all companies within a multinational group.

The three scenarios describe common arrangements used by MNEs

. The Working Group appears to conclude that the last two cases would cause an agency PE to exist if a dependent agent located in the source state were to enter into contracts in the name of the foreign enterprise, notwithstanding the use of a standard contract or framework contract. The Working Group unhelpfully explains that the first case "referred to the level of approval that was decisive for the contract to be legally concluded. . . ." Ultimately, the Working Group concluded that "these three cases raised questions of facts and that the Commentary already provided enough guidance to deal with them." However, we believe that the existing Commentary is inadequate and should directly address one or more of the situations described in the discussion draft.

The current Commentary indicates that in some cases an agent can be treated as having actual authority to conclude contracts on behalf of the enterprise even if it does not have the legal or contractual authority to sign or finalize the contract. Paragraph 32.1 of the Commentary provides that "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." Similarly, paragraph 33 of the Commentary explains: "A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise [an authority to conclude contracts in the name of the enterprise] 'in that State', even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation." This Commentary is generally understood as providing that where an enterprise gives "rubber stamp" approval over orders that the dependent agent solicits, the agent may be treated as having the authority to conclude contracts in the name of the enterprise.

Disregarding the terms of an agreement is an extreme measure and should not be permitted unless there are clear guidelines that will allow multinational taxpayers to predict the tax consequences of their arrangements. We agree that a rule that would allow an enterprise to avoid having a PE by withholding final authorization that is merely perfunctory could be subject to manipulation. However, where an enterprise provides more than merely perfunctory approval, the arrangement between the enterprise and the agent should be respected and the agent should not be treated as having the authority to conclude contracts in the name of the enterprise. For example, where an enterprise provides detailed instructions and guidance to an agent regarding the parameters within which the agent can negotiate, the fact that an enterprise routinely approves contracts that conform to its specifications does not indicate that its approval is perfunctory. The Commentary should clarify that routinely approving transactions does not indicate a lack of active involvement where the enterprise provides detailed instructions and guidance to prevent the agent from soliciting contracts that the enterprise would not approve.

Paragraph 32.1 of the current Commentary also explains that, "[l]ack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent," but does not explain whether "active involvement" by an enterprise requires the enterprise to advise the agent during the course of negotiations with customers, or whether it is sufficient that the enterprise provides instructions

or conditions that are acceptable to the enterprise before negotiations begin. We believe that a dependent agent should not be viewed as having an authority to conclude contracts on behalf of an enterprise where the agent acts pursuant to detailed instructions or guidelines from the enterprise, regardless of whether such instructions or guidelines are provided during negotiations with specific customers or before negotiations begin. We urge the Working Group to add language to the Commentary confirming that an agent that has the power to negotiate elements and details of a contract on behalf of the enterprise, but only within fixed parameters and under conditions established by the enterprise, does not give rise to a PE of such enterprise.

Finally, as explained in paragraph 42 of the current Commentary on Article 5(7), the fact that an enterprise is the recipient of services provided by a person in another state does not give rise to a PE in that other country. Accordingly, to the extent that a person is providing services to an enterprise, rather than acting as the enterprise's agent, no PE should arise even if the services provided relate to contracts between the enterprise and its customers. It would be helpful if the Commentary on Article 5(5) provided guidance confirming that the acts of a service provider under the circumstances described above does not amount to "concluding contracts in the name of the enterprise."

Grants of Authority on a Transaction-By-Transaction Basis

The current Commentary also does not provide any guidance on whether a dependent agent should be viewed as having an authority to conclude contracts on behalf of an enterprise where the enterprise gives the agent the authority to conclude contracts on a transaction-by-transaction basis. A general grant of authority to conclude contracts on behalf of an enterprise should be distinguished from a limited grant of authority that relates to only a specific transaction. If an agent's authority to conclude contracts must be separately secured for each transaction, the agent's activities should not give rise to a PE.

Issue 20 -- Is paragraph 5 restricted to situations where sales are concluded? (paragraph 33 of the Commentary)

This issue relates to the question whether the dependent agent PE is restricted to the conclusion of contracts for the sale of goods (e.g. commissionnaire or other sales agent type of relationships) or is also intending to cover the conclusion of leasing contracts or contracts for services (e.g. contract/toll manufacturer or contract R&D type of relationships). The proposed change to the Commentary notes that the word "contract" is not limited to the conclusions of contracts for the sale of goods and would include, e.g., leasing contracts or contracts for services. Under issue 19 it is stated that "the acceptance of the order was the conclusion of the contract" (section 113, page 37 DD).

The change to the Commentary raises the question what this implies for the situation where a toll manufacturer in a certain country concludes contracts (acceptance of purchase orders) for materials that are needed to manufacture the goods for the principal enterprise in another country. We believe there should be no difference in the PE analysis based on whether a manufacturer is a contract manufacturer and transforms materials owned by the person for whom the service of manufacturing is provided or toll manufacturer and engages in both purchasing activities and manufacturing activities. An enterprise that engaged in purchasing activities directly would not be considered to have a PE under Article 5 paragraph 4(d). Thus, purchasing activities of the toll manufacturer should not cause the enterprise to have a PE. The arm's length compensation due the toll manufacturer might be greater than the contractor manufacturer that transforms materials owned by the principal because it is performing an additional function, purchasing materials, but this distinction should not matter for purposes of determining whether a PE exists for the foreign enterprise.

Issue 22 -- Assumption of entrepreneurial risk as a factor indicating independence

The discussion draft contains limited discussions on "entrepreneurial risk" as a distinguishing feature and important criterion for determining whether an agent is of an independent status and concludes that it is not necessary to clarify this as it is only one of many factors included in the Commentary. Under issue 21 (also relating to independent agents), it is noted by the Working Group that the Commentary seems to include conflicting statements concerning the scope of Article 5, paragraph 6 on independent agents. At the same time, the conclusion is reached that this could not be addressed merely through changes to the Commentary itself.

We understand that changes to Article 5 itself are not in scope, but it is unclear why the Working Group does not take this opportunity to remedy the existing and apparently conflicting statements in the current Commentary. In addition, the discussion draft notes that there are "many factors" to distinguish independent and dependent agents making the application of the independent agent test difficult in practice. Why not remedy or clarify the Commentary now looking at the current opportunity to do that?

In conclusion, USCIB looks forward to working with the OECD on refining the Commentary on PEs.

Sincerely,

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