OECD: Update on PE Discussion Draft

The OECD’s Working Party 1 held a meeting with commentators on 7 September 2012 on the discussion draft relating to the interpretation and application of the commentary to article 5 (permanent establishment or PE) of the OECD model tax treaty. In response to comments made to the draft, Working Party 1 has made some preliminary changes; further amendments are possible.

The concept of a permanent establishment is defined in article 5 of the OECD model treaty and is used to allocate taxing rights when an enterprise in one treaty partner country derives profits from the other treaty partner country. The OECD has been working to clarify the interpretation and application of article 5, and the discussion draft addresses a multitude of problems relating to the concept of a PE.

Some of the main points of interest are as follows:

- A preliminary clarification will be made in relation to contract manufacturing, so that intermittent and incidental visits by personnel of the principal to a contract/toll manufacturer (e.g. for quality control purposes) will not easily lead to the conclusion that premises are “at the disposal of” the principal. It became clear that on a literal reading of proposed paragraph (4.2) on contract manufacturing that the presence of inventory owned by the principal could lead to the conclusion that premises are “at the disposal of” the principal (with only article 5(4) of the model treaty mitigating the possibility that a PE will be created – although matters may be more complex if there is more than mere storage of inventory (article 5(4)(f)).
- In the proposed paragraph on activities of a recurrent nature (6.1), the example of a commercial fair taking place for 15 consecutive years (which was subject to considerable criticism) is replaced with an example concerning drilling operations that, due to seasonal circumstances, take place for four months in each of the five consecutive years.
- Working Party 1 is divided on the issue of the subcontracting of building projects. Specifically, it is Germany’s position that no PE will be created for the general contractor if all of the work is subcontracted and none of the general contractor’s own personnel are present on site. Conversely, most of the other OECD member countries believe that the presence of the general contractor’s own personnel is not required to give rise to a PE of the general contractor in these circumstances.
- No changes were made to the draft as it relates to an agency PE, so the OECD leaves open the possibility that an agent can bind its principal by other than purely legal means (i.e. economically or commercially). It should be noted that this seems to run counter to a number of domestic Supreme Court decisions in Europe, in which the courts have explained “binding” to mean legally binding.

The next Working Party 1 meeting will take place in February 2013 and a revised discussion draft is expected then. The final changes will be included in the next update of the model convention, currently scheduled for 2014.

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