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Discussion of substantive issues related to international cooperation in tax matters

Revision of the United Nations Manual for the Negotiation of

Bilateral Tax Treaties between Developed and Developing Countries

**Revision of the United Nations Manual for the Negotiation of
Bilateral Tax Treaties between Developed and Developing Countries***

Note by the coordinator of the working group

Addendum

Article 5 – PERMANENT ESTABLISHMENT

* The present paper was prepared by Professor Jon Bischel, a member the working group on Revision of the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (Coordinator: Professor Brunetti). The views and opinions expressed are those of the authors and do not necessarily represent those of the United Nations.

Generally, each country will attempt to tax a non-resident enterprise that is engaged in the active pursuit of business in its territory when engaged with a certain degree of intensity or regularity. The differences in the rules concerning source of income, problems of allocating income to one or the other country and the undesirability or futility of taxing certain business activities of a non-recurring, preparatory or ancillary nature led to development of the permanent establishment concept. The concept provides that an enterprise of one treaty country shall be taxable in the other treaty country only if it maintains a permanent establishment. However, the lack of definitions for “business” and “enterprise” sometimes results in disagreement between taxpayers and tax administrations about whether an enterprise constitutes a permanent establishment.

SIGNIFICANCE: The definition of the term permanent establishment is central to source country taxation of business profits since under Article 7 no tax is imposed upon source country business profits unless a permanent establishment exists. (See UN Model, Article 7(1) taxing business profits attributable to a permanent establishment). Further, gain from the sale of merchandise is generally exempt from source country taxation unless such property forms part of a permanent establishment.

Paragraph 1 of Article 5 of both the models and treaties actually in force set forth the basic principle that a permanent establishment means a “fixed place of business through which the business of an enterprise is wholly or partly carried on.” In paragraph 2 of the model treaties, this principle is illustrated with the following non-exhaustive specific examples: a place of management, a branch, an office, workshop, and a mine, an oil or gas well, a quarry or other place of extraction of natural resources. Additional examples added by some recently negotiated treaties between developed and developing countries include an agricultural, pastoral or forestry property; a store or other sales outlet. Note, the list of examples does not necessarily signify a permanent establishment, as the conditions of Article 5(1) must also be met for them to constitute a permanent establishment.

Under Article 5(3) of OECD based treaties construction jobs, assembly projects and building sites are considered permanent establishments, if they last more than 12 months in duration. By contrast, the UN Model uses durations of more than six months. Most treaties between developed and developing countries use the more than six months criteria. Some treaties also employ the more than six month criteria in regard to the exploration for or exploitation of natural resources located in a source country, as well as use of substantial equipment in taxing state by, for or under contract with the enterprise. Other treaties provide the use of substantial equipment in the taxing state at any time shall constitute a permanent establishment even in the absence of a fixed place of business.

The UN Model and some treaties (e.g. New Zealand-South Africa, Article 5(5)(a)) negotiated by developing countries use a time criteria of more than six months within any twelve-month period with regard to permanent establishments arising from the furnishing of services, including consulting services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose. Under the provision, the furnishing of any service may lead to taxation as a deemed service permanent establishment even if an enterprise has no fixed place of business in the taxing state as required under Article 5(1). Some developed country negotiators view the provision as at odds with treaty provisions addressing independent personal services, as well as being difficult to administer, and in certain cases having a potential adverse effect on the transfer of technology.

Under Article 5(4) of the model treaties, certain preparatory and auxiliary business activities or functions will not cause a fixed place of business to be deemed a permanent establishment. They include:

- (a) The use of facilities solely for the storage, display or delivery of goods or merchandise belonging to the enterprise. Generally, this limitation would include facilities used for packaging and dispatch, but not for sale. The UN Model deletes the word “delivery” on the basis that a continuous connection and hence the existence of such a supply of goods should be a permanent establishment, despite the small amount of income which would normally be attributed to such activity.
- (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery. As previously noted, the UN Model deletes the word “delivery” although the UN commentary on Article 5 states that almost 75 percent of tax treaties entered into by developing countries have included delivery of goods in their treaties.
- (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.
- (d) The maintenance of a fixed place of business solely for purchasing goods or merchandise or for collecting (not evaluating or editing) information for the enterprise.
- (e) The maintenance of a fixed place of business solely for any other activity of a preparatory or ancillary nature of the enterprise. Under this subparagraph, all preparatory and ancillary activities are exempted from permanent establishment taxation. Hence, the list of exceptions under subparagraphs (a) to (d) are specific examples and not intended to be exclusive. By contrast, an activity cannot be considered as preparatory or auxiliary, if it is similar to the essential and significant part of the activity of the enterprise as a whole. A permanent establishment would also exist if any of the exempt functions were performed for other enterprises or with core activities.

Under Article 5(5) of the model treaties, regardless of the existence of an office or other fixed place of business, a permanent establishment will exist if business activities are carried on through a dependent agent who habitually exercises an authority to conclude contracts on behalf of an enterprise. Note, the provision does not require any special business activity as long as the activity is essential and significant to the principal’s business. An exception is made for a dependent agent’s activities limited to those permissible if carried on through a fixed place of business mentioned in the Article 5(4) exclusion provision. Moreover, the OECD Model, Article 5(6) and UN Model Article 5(7) negate permanent establishment status for independent agents, providing they are acting in the ordinary course of their business. Independent agents acting outside the ordinary course of their business when acting for a principal are treated as dependent agents.

The UN Model expands the scope of its Articles 5(5) and 5(7) in two respects. An addition is made to 5(5) which results in permanent establishment status where a dependent agent maintains a regular stock of goods from which the dependent agent makes regular deliveries and additional sales related activities are conducted in the source state on behalf of the foreign enterprise which have contributed to the sale of such goods. A further addition is made to 5(7) (Article 5(6) of the OECD Model) which has the effect of restricting the category independent agent. Under the provision, an agent will not be considered independent if its activities are devoted wholly or almost wholly on behalf of an enterprise. However, it is as yet unclear what standard would be employed to determine whether the agent's activities are devoted wholly or almost wholly on behalf of an enterprise.

Article 5(6) of the UN Model does not have a counterpart in the OECD Model. It provides that the collection of premiums or insurance of risks, except re-insurance transactions, in the other State by an insurance company of a Contracting State will be deemed to the agency permanent establishment unless the activities are performed through an independent agent.

OECD Model Article 5(7) and UN Model Article 6(8) both provide that the existence of a subsidiary company in a treaty country does not of itself constitute that subsidiary a permanent establishment of its parent company. However, it should be noted that a subsidiary company may constitute a permanent establishment of its parent if the subsidiary satisfies the dependent agent requirements under Article 5(5).
