Issues in International Taxation

2002 Reports Related to the OECD Model Tax Convention

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

This publication, the eighth in the series "Issues in International Taxation", includes three reports on tax treaty issues that the Committee on Fiscal Affairs adopted on 7 November 2002. These three reports are:

- "Restricting the Entitlement to Treaty Benefits"
- "Treaty Characterisation Issues Arising From E-Commerce: Report Adopted by the Committee on Fiscal Affairs"
- "Issues Arising Under Article 5 (Permanent Establishment) of the Model Tax Convention".

These three reports have resulted in changes to the Commentaries of the OECD Model Tax Convention on Income and Capital which have been included in the update to the Model that was adopted by the Council of the OECD on 28 January 2003.

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PART I

RESTRICTING THE ENTITLEMENT TO TREATY BENEFITS

RESTRICTING THE ENTITLEMENT TO TREATY BENEFITS

1. Introduction

1. In April 1998, the Council of the OECD adopted the Report entitled "Harmful Tax Competition: an Emerging Global Issue" (the "1998 Report on harmful tax competition"). One of the issues for follow-up work identified in the Report was a possible restriction of the entitlement to treaty benefits.

2. This note is the result of the work done by the Committee on Fiscal Affairs on this issue.

2. Nature of the work done by the Committee

3. Recommendation 9 of the 1998 Report on harmful tax competition read as follows:

> "that countries consider including in their tax conventions provisions aimed at restricting the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax practices and consider how the existing provisions of their tax conventions can be applied for the same purpose; that the Model Tax Convention be modified to include such provisions or clarifications as are needed in that respect."

4. Paragraphs 119 and 120 of the Report clarified what types of provisions were envisaged:

> "119. Various approaches have been used by countries to reduce that risk. In some cases, countries have been able to determine that the place of effective management of a subsidiary lies in the State of the parent company so as to make it a resident of that country either for domestic law or treaty purposes. In other cases, it has been possible to argue, on the basis of the facts and circumstances of the cases, that a subsidiary was managed by the parent company in such a way that the subsidiary had a permanent establishment in the country of residence of the parent company so as to be able to attribute profits of the subsidiary to that latter country. Another example involves denying companies with no real economic function treaty benefits because these companies are not considered as

beneficial owner of certain income formally attributed to them. The Committee intends to continue to examine these and other approaches to the application of the existing provisions of the Model Tax Convention, with a view to recommending appropriate clarification to the Model Tax Convention.

120. There are, however, a number of additional provisions, such as limitation of benefits rules, which have been included in some tax treaties to specifically restrict access to their benefits. The Committee has also been reviewing these provisions with a view to propose changes to the Model Tax Convention aimed at denying the tax treaty benefits to entities and income covered by practices constituting harmful tax competition. The Committee intends to continue its work in this area with a view to modify the Model Tax Convention or the Commentary so as to include such provisions that countries will be able to incorporate in their tax treaties."

5. Based on the preceding, the work that the Committee was asked to carry out in relation to a possible restriction of the entitlement to treaty benefits dealt with the following:

- using the concepts of place of effective management and permanent establishment to reduce benefits obtained under a tax convention;
- the possible inclusion in the Model of various types of provisions aimed at ensuring that income sheltered from taxation through regimes constituting harmful tax competition do not inappropriately get the benefits of tax conventions;
- possible ways of ensuring that, where a country that is a party to a tax convention introduces measures resulting in harmful tax competition after the conclusion of the tax convention, benefits of the convention are not inappropriately granted with respect to income covered by such measures;
- the clarification of the concept of "beneficial ownership".

6. During its work, the Committee also discussed the extent to which one possible approach to dealing with the issues described above might be through a narrowing of the concept of residence in Article 4 of the Model Tax Convention. It concluded that it would not be appropriate to make changes to Article 4 or the Commentary on that Article because:

- to do so could damage the position of persons who are legitimately entitled to treaty benefits; and
- other more effective approaches could be pursued to prevent treaty benefits claims by entities associated with regimes constituting harmful tax competition.

3. Use of the concepts of place of effective management and permanent establishment

a) Changes adopted by the Committee

7. The Committee decided that the following changes should be made to the Commentary on Article 1 of the Model Tax Convention:

Add the following new paragraphs 10.1 and 10.2 to the Commentary on Article 1:

"10.1 Also, in some cases, claims to treaty benefits by subsidiary companies, in particular companies established in tax havens or benefiting from harmful preferential regimes, may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes (this will be relevant where the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

10.2 Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits were properly attributable."

b) Background

8. In some cases, countries have been able to determine, on the basis of the facts and circumstances of the cases, that the place of effective management of a subsidiary lies in the State of the parent company so as to make it a resident of that country either for domestic law or treaty purposes. In other cases, it has been possible to argue, on the basis of the facts and circumstances of the cases, that a subsidiary was managed by the parent company in such a way that the subsidiary had a permanent establishment in the country of residence of the parent company so as to be able to attribute profits of the subsidiary to that latter country.

9. Both of these approaches result in a reduction of the benefits that a taxpayer might otherwise claim under a tax convention. The Committee has considered these approaches and it emerged that some Member countries have used them in practice to resist inappropriate treaty claims, as shown by the examples below which are based on the experience of one country.

The place of effective management of a company and thus its residence is located with its parent company

10. Company A is constituted under the law of Country A, a low tax jurisdiction, and is a resident of that country under its domestic tax law. All of the shares in A are owned by trust B which is constituted under the law of Country B, another low tax jurisdiction, and which is a resident of that country. Company A owns all of the shares of company C, which is a resident of Country C. The sole director of company C is Mr D, who is a resident of Country C as well. Mr D is directly and fully entitled to the property of trust B. The income of company A consists of dividends from company C, interest on loans to company C and interest on bonds issued by a Country C bank. Investigations by the Country C tax administration showed that company A had no office or personnel of its own. All contacts with the bank concerning the bonds were conducted by Mr D. Later, a sale of all the shares and loans held by company A was negotiated and conducted by Mr D.

11. According to the Country C Supreme Court, in general it is to be assumed that the effective management of a company is exercised by its board of directors and that the place of residence of the company is congruent with the place where its board of directors exercises its duties. However, if judging from the circumstances it is to be assumed that the effective management of the company is exercised by some other person and not by the board of directors, then there may be ground to regard the place from which effective management is exercised by that other person as the place of residence of the company. In the case described above the Supreme Court concluded that company A was effectively managed in Country C by Mr D and thus the company was to be regarded as a resident of Country C, for the purposes of both Country C domestic tax law and the tax arrangement between Country C and Country A.

A place of management and thus a permanent establishment of a subsidiary is located with its parent company

12. Company X is constituted under the law of Country A and is a resident of that country according to its domestic tax law. Company X acts as a captive insurance company for a multinational group of enterprises. The top holding company of the group, company Y, is a resident of Country C. The main activities of the group are conducted from the offices of company Y. Investigations by the Country C tax administration showed the following facts. Company X employs one part-time director, who has little if any knowledge of the insurance business and two “local” staff members. It occupies space in an office building, the main user of which is another member of the group. The insurance contracts between company X and the members of the group follow standardised conditions set by company Y. These contracts are reinsured with independent insurance companies, through the intermediary of an insurance broker. The reinsurance contract is negotiated and concluded by personnel from company Y, following strategies set by company Y.

13. The Country C Court decided that, judging from the factual circumstances of the case, the place of effective management of company X was not located in Country C and company X was therefore not a resident of Country C. However, according to the Court, it was to be assumed that to a certain extent the daily management of company X was exercised at the office of company Y. The Court was of the opinion that this extent was such that it exceeded the normal amount of influence that a parent company has on its subsidiary on account of its position as shareholder. The Court therefore concluded that to the extent of that daily management a permanent establishment of company X was located with company Y in Country C.

4. New provisions aimed at restricting the benefits of tax conventions

a) Changes adopted by the Committee

14. The Committee discussed a proposal for amending the part of the Commentary on Article 1 that deals with the Improper Use of Tax Conventions. This led to the adoption of the following changes to that part of the Commentary:

> *Add the following paragraph 9.6 and replace paragraphs 10 to 21 of the Commentary on Article 1 by the following (changes to the existing text of the Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*
>
> "9.6 The potential application of general anti-abuse provisions does ***not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 9.2 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy.***
>
> 10. ***For instance, some forms of tax avoidance have already been expressly dealt with in the Convention,*** *e.g.* by the introduction of the concept of "beneficial owner" (in Articles 10, 11, and 12) and of special provisions ***such as paragraph 2 of Article 17 dealing with*** ~~for~~ so-called artiste-companies ~~(paragraph 2 of Article 17)~~. Such problems are also mentioned in the Commentaries on Article 10 (paragraphs 17 and 22), Article 11 (paragraph 12) and Article 12 (paragraph 7). ~~It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.~~

11. ***A further example is provided by two particularly prevalent forms of improper use of the Convention which*** ~~Improper uses of the Convention~~ are discussed in two reports from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Base Companies" and "Double Taxation Conventions and the Use of Conduit Companies".[1] As indicated in these reports, the concern expressed in paragraph 9 above has proved to be valid as there has been a growing tendency toward the use of conduit companies to obtain treaty benefits not intended by the Contracting States in their bilateral negotiations. This has led an increasing number of Member countries to implement treaty provisions (both general and specific) to counter abuse and to preserve anti-avoidance legislation in their domestic laws.

12. ***The treaty provisions that have been designed to cover these and other forms of abuse take different forms. The following are examples derived from provisions that have been incorporated in bilateral conventions concluded by Member countries.*** ~~Several solutions have been considered but, for the reasons set out in the above-mentioned reports, no definitive texts have been drafted, no strict recommendations as to the circumstances in which they should be applied made, and no exhaustive list of such possible counter-measures given. The texts quoted below are merely intended as suggested benchmarks.~~ ***These provide models*** that treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:

- the fact that these provisions are not mutually exclusive and that various provisions may be needed in order to address different concerns;
- the degree to which tax advantages may actually be obtained by a particular avoidance strategy ~~conduit companies~~;
- the legal context in both Contracting States and, in particular, the extent to which domestic law already provides an appropriate response to this avoidance strategy; and
- the extent to which bona fide economic activities might be unintentionally disqualified by such provisions.

Conduit company cases

13. ***Many countries have attempted to deal with the issue of conduit companies and various approaches have been designed for that purpose.*** One

1. These two reports are reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at pages R(5)-1 and R(6)-1.

solution ~~A solution to the problem of conduit companies~~ would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a "look-through" provision might have the following wording:

> "A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State."

Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.

14. The "look-through approach" ***underlying the above provision*** seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities.

~~15. Conduit situations can be created by the use of tax-exempt (or nearly tax-exempt) companies that may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies (the exclusion approach). The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident. As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause such as the following:~~

> ~~"No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."~~

~~The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).~~

~~16. Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.~~

15. ~~17.~~ General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. Whilst this seems adequate with respect to a normal international relationship, a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

> "Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State
>
> *a*) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
> *b)* exercise directly or indirectly, alone or together, the management or control of such company,
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law."

The concept of "substantial interest" may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.

16. ~~*18.*~~ The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (cf. paragraph 19 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies."

17. ~~19.~~ The approaches referred to above are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use of conventions. It has been suggested that the conduit problem be dealt with in a more straightforward way

by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

> "Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State
>
> *a)* have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
> *b)* exercise directly or indirectly, alone or together, the management or control of such company
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)."

18 ~~20~~. A provision of this kind appears to be the only effective way of combating "stepping-stone" devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underly the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.

19. ~~21~~. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

a) General bona fide provision

> "The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention."

b) Activity provision

> "The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the

other Contracting State is with respect to income that is connected with such operations."

c) Amount of tax provision

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

d) Stock exchange provision

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned—directly or through one or more companies each of which is a resident of the first-mentioned State—by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

e) Alternative relief provision

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.

20. Whilst the preceding paragraphs identify different approaches to deal with conduit situations, each of them deals with a particular aspect of the problem commonly referred to as "treaty shopping". States wishing to address the issue in a comprehensive way may want to consider the following example of detailed limitation-of-benefits provisions aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be

necessary and that many States prefer other approaches to deal with treaty shopping:

> ***"1. Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a "qualified person" as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits.***
>
> ***2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:***
>
> ***a) an individual;***
>
> ***b) a qualified governmental entity;***
>
> ***c) a company, if***
>
> ***i) the principal class of its shares is listed on a recognised stock exchange specified in subparagraph a) or b) of paragraph 6 and is regularly traded on one or more recognized stock exchanges, or***
>
> ***ii) at least 50 percent of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;***
>
> ***d) a charity or other tax-exempt entity, provided that, in the case of a pension trust or any other organization that is established exclusively to provide pension or other similar benefits, more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or***
>
> ***e) a person other than an individual, if:***
>
> ***i) on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision c) i) of this paragraph own, directly or indirectly, at least 50 percent of the aggregate vote and value of the shares or other beneficial interests in the person, and***
>
> ***ii) less than 50 percent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State***

in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States).

3. a) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income, derived from the other State, regardless of whether the resident is a qualified person, if the resident is actively carrying on business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), the income derived from the other Contracting State is derived in connection with, or is incidental to, that business and that resident satisfies the other conditions of this Convention for the obtaining of such benefits.

b) If the resident or any of its associated enterprises carries on a business activity in the other Contracting State which gives rise to an item of income, subparagraph a) shall apply to such item only if the business activity in the first-mentioned State is substantial in relation to business carried on in the other State. Whether a business activity is substantial for purposes of this paragraph will be determined based on all the facts and circumstances.

c) In determining whether a person is actively carrying on business in a Contracting State under subparagraph a), activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) or another person possesses, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be

considered to be connected to another if, based on all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

4. Notwithstanding the preceding provisions of this Article, if a company that is a resident of a Contracting State, or a company that controls such a company, has outstanding a class of shares

a) which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements ("the disproportionate part of the income"); and

b) 50 percent or more of the voting power and value of which is owned by persons who are not qualified persons

the benefits of this Convention shall not apply to the disproportionate part of the income.

5. A resident of a Contracting State that is neither a qualified person pursuant to the provisions of paragraph 2 or entitled to benefits under paragraph 3 or 4 shall, nevertheless, be granted benefits of the Convention if the competent authority of that other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. For the purposes of this Article the term "recognized stock exchange" means:

a) in State A ……..;

b) in State B ……..; and

c) any other stock exchange which the competent authorities agree to recognize for the purposes of this Article."

Provisions which are aimed at entities benefiting from preferential tax regimes

21. [OLD 15] ***Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices.*** ~~Conduit situations can be created by the use of~~ ***Where*** tax-exempt (or nearly tax-exempt) companies ~~that~~ may be distinguished by special legal characteristics***, the*** ~~.The~~ improper use of tax treaties may ~~then~~ be avoided by denying the tax treaty benefits to these companies (the exclusion approach). ~~The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident.~~ As such privileges are granted

mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause ~~such as the following~~ ***which would apply to the income received or paid by such companies and which could be drafted along the following lines:***

> "No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

21.1 [OLD 16] Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which enjoy, in that State, a preferential tax regime restricted to foreign-held entities (i.e. not available to entities that belong to residents of that State):

> ***"Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State."***

Provisions which are aimed at particular types of income

21.3 The following provision aims at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime:

> ***"1. The benefits of this Convention shall not apply to income which may, in accordance with the other provisions of the Convention, be taxed in a Contracting State and which is derived from activities the performance of which do not require substantial presence in that State, including :***
>
> ***a) such activities involving banking, shipping, financing, or insurance or electronic commerce activities; or***
> ***b) activities involving headquarter or coordination centre or similar arrangements providing company or group administration, financing or other support; or***
> ***c) activities which give rise to passive income, such as dividends, interest and royalties***
>
> ***where, under the laws or administrative practices of that State, such income is preferentially taxed and, in relation thereto, information is accorded confidential treatment that prevents the effective exchange of information.***
>
> ***2. For the purposes of paragraph 1, income is preferentially taxed in a Contracting State if, other than by reason of the preceding Articles of this Agreement, an item of income:***
>
> ***a) is exempt from tax; or***
> ***b) is taxable in the hands of a taxpayer but that is subject to a rate of tax that is lower than the rate applicable to an equivalent item that is taxable in the hands of similar taxpayers who are residents of that State; or***
> ***c) benefits from a credit, rebate or other concession or benefit that is provided directly or indirectly in relation to that item of income, other than a credit for foreign tax paid. "***

Anti-abuse rules dealing with source taxation of specific types of income

21.4 The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

> ***"The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "rights"] in respect of which the [Article 10: "dividend"; Article 11: "interest"; Articles 12 "royalties" and Article 21: "income"] is paid to take advantage of this Article by means of that creation or assignment."***

Provisions which are aimed at preferential regimes introduced after the signature of the convention

21.5 States may wish to prevent abuses of their conventions involving provisions introduced by a Contracting State after the signature of the Convention. The following provision aims to protect a Contracting State from having to give treaty benefits with respect to income benefiting from a special regime for certain offshore income introduced after the signature of the treaty:

> ***"The benefits of Articles 6 to 22 of this Convention shall not accrue to persons entitled to any special tax benefit under:***
>
> ***a) a law of either one of the States which has been identified in an exchange of notes between the States; or***
> ***b) any substantially similar law subsequently enacted."***

b) Background

15. The Committee has examined what new types of provisions for the Model Tax Convention could be appropriate to ensure that income sheltered from taxation through harmful tax regimes would not inappropriately get the benefits of tax conventions.

16. As part of that work, several possible provisions were put forward. Several delegates advocated the inclusion of a comprehensive limitation of benefits provision. Other delegates opposed the inclusion of such a provision favouring an Article by Article approach to those provisions most likely to be abused. It was decided that these two approaches need not be alternatives and that both could be included, complementing each other in a Convention. It was also agreed that the relevant part of the Commentary on Article 1 should be redrafted to include some of the provisions put forward during the work on this issue.

5. Restriction of the benefits of tax conventions after the introduction of a new regime

17. Another issue examined by the Committee was how to ensure that, where a country that is a party to a tax convention introduces measures resulting in harmful tax competition after the conclusion of the tax convention, benefits of the convention are not inappropriately granted with respect to income covered by such measures. Consideration of the provisions put forward by delegates in relation to the previous issue revealed that most would be effective in dealing both with regimes existing at the time of entry into effect of a convention and new regimes introduced later. However such provisions might not be included in a convention where no harmful preferential regime existed at the time of conclusion of the convention.

a) Changes adopted by the Committee

18. The Committee discussed the possibility of including in the Convention a so-called "switch-over clause" in order to deal with harmful preferential regimes introduced after the signature of a convention.

19. During that discussion, the Committee debated the merits of such a clause and examined a proposal for including such a provision in Article 23A. After discussion, it was agreed that the proposed provision should not be included in Article 23A but that the Commentary could include the suggestion to adopt such a clause and could provide an example.

20. The Committee therefore adopted the following change to be made to the Commentary on Articles 23A and 23B:

Add the following paragraph 31.1 to the Commentaries on Articles 23A and 23B:

"31.1 One example where paragraph 2 could be so amended is where a State that generally adopts the exemption method considers that that method should not apply to items of income that benefit from a preferential tax treatment in the other State by reason of a tax measure that has been introduced in that State after the date of signature of the Convention. In order to include these items of income, paragraph 2 could be amended as follows:

"2. Where a resident of a Contracting State derives an item of income which

a) in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, or

b) in accordance with the provisions of this Convention, may be taxed in the other Contracting State but which benefits from a

preferential tax treatment in that other State by reason of a tax measure

i) that has been introduced in the other Contracting State after the date of signature of the Convention, and

ii) in respect of which that State has notified the competent authorities of the other Contracting State, before the item of income is so derived and after consultation with that other State, that this paragraph shall apply,

the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such item of income derived from that other State."

6. Clarification of the concept of "beneficial ownership"

a) Changes adopted by the Committee

21. The Committee adopted the following changes aimed at clarifying the meaning of "beneficial ownership" in the Commentary on Articles 10, 11 and 12:

Replace paragraph 12 of the Commentary on Article 10 with the following new paragraphs (changes to the existing text of the Commentary appear in ***bold italics*** *for additions and* ~~*strikethrough*~~ *for deletions):*

"***12. The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words "paid...to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.***

12.1 Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would

be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" [1] ***concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.***

12.2 ~~Under paragraph 2,~~ ***Subject to other conditions imposed by the Article,*** the limitation of tax in the State of source ***remains*** ~~is not~~ available when an intermediary, such as an agent or nominee ***located in a Contracting State or in a third State,*** is interposed between the beneficiary and the payer ***but the beneficial owner is a resident of the other Contracting State.*** (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations."

Replace paragraph 8 of the Commentary on Article 11 with the following new paragraphs:

"***8. The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 to clarify the meaning of the words "paid to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.***

8.1 Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or

1. Reproduced at page R(6)-1 of Volume II of the loose-leaf version of the OECD Model Tax Convention.

nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[1] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

8.2 ~~Under paragraph 2,~~ ***Subject to other conditions imposed by the Article,*** the limitation of tax in the State of source ***remains*** ~~is not~~ available when an intermediary, such as an agent or nominee ***located in a Contracting State or in a third State,*** is interposed between the beneficiary and the payer ***but the beneficial owner is a resident of the other Contracting State.*** (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations."

Replace paragraph 4 of the Commentary on Article 12 with the following new paragraphs:

"***4. The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the State of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.***

1. Reproduced at page R(6)-1 of Volume II of the loose-leaf version of the OECD Model Tax Convention.

4.1 Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[1] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

4.2 ~~Under paragraph 1~~, ***Subject to other conditions imposed by the Article***, the ***limitation of*** ~~exemption from~~ tax in the State of source ***remains*** ~~is not~~ available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, ~~unless~~ ***in those cases where*** the beneficial owner is a resident of the other Contracting State. (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations."

b) Background

22. The Committee discussed various options concerning the clarification of the concept of "beneficial ownership". Some delegates noted that the beneficial ownership test very much depended on the facts and circumstances of the individual case and that it was therefore difficult to develop a generally applicable definition of the concept. Most delegates still took the view that it would be useful to further clarify the concept. It was

1. Reproduced at page R(6)-1 of Volume II of the loose-leaf version of the OECD Model Tax Convention.

noted that any addition to the Commentary had to be drafted in a neutral way so as to avoid inadvertent limitation of the concept.

Meaning of beneficial owner

23. The Model Convention does not provide a definition of "beneficial owner". The Commentary indicates that an intermediary, such as an agent or nominee, is not the beneficial owner, but otherwise does not elaborate on the meaning of the term. In the absence of more extensive clarification the concept of beneficial ownership presents several difficulties of interpretation and application. While it is obvious that the use of the concept excludes bare legal ownership as the criterion for determining availability of treaty benefits it is less apparent what is intended to be the salient connection with a stream of income in a case where different interests in the income are held by diverse hands who might each be considered, as a matter of general law, to possess some attributes of ownership.

Report on the use of conduit companies

24. Paragraph 14 *b)* of the 1987 report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[1] discussed the application of the requirement of beneficial ownership in abuse cases:

> "The OECD has incorporated in its revised 1977 Model provisions precluding in certain cases persons not entitled to a treaty from obtaining its benefits through a "conduit company".
>
> [...]
>
> *b*) Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its "beneficial owner". Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (paragraphs 12, 8 and 4 of the Commentary to Articles 10, 11 and 12 respectively). The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary

1. Reproduced at page R(6)-1 of Volume II of the loose-leaf version of the OECD Model Tax Convention.

or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company). In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as a mere intermediary, although this may indicate that further examination is necessary. This examination will in any case be highly burdensome for the country of source and not even the country of residence of the conduit company may have the necessary information regarding the shareholders of the conduit company, the company's relationships to the shareholders or other interested parties or the decision-making process of the conduit company. So even an exchange of information between the country of source and the country of the conduit company may not solve the problem. It is apparently in view of these difficulties that the Commentaries on the 1977 OECD Model mentioned the possibility of defining more specifically during bilateral negotiations the treatment that should be applicable to such companies (cf. paragraph 22 of the Commentary on Article 10)."

PART II

TREATY CHARACTERISATION ISSUES ARISING FROM E-COMMERCE:

(REPORT ADOPTED BY THE COMMITTEE ON FISCAL AFFAIRS)

TREATY CHARACTERISATION ISSUES ARISING FROM E-COMMERCE

(REPORT ADOPTED BY THE COMMITTEE ON FISCAL AFFAIRS)

1. Introduction

1. In January 1999, as a follow-up to the November 1998 Ottawa conference entitled "A Borderless World - Realising the Potential of Electronic Commerce", the Committee on Fiscal Affairs set up a Technical Advisory Group (TAG) on Treaty Characterisation Issues arising from E-Commerce with the general mandate "to examine the characterisation of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary." That Group was composed of business representatives and tax officials from OECD and non-OECD countries.

2. The final report of the TAG was released on 1 February 2001.[1] The report described the various treaty characterisation issues that were identified by the Group and presented the views of the Group concerning these issues; it also included an analysis of various categories of typical e-commerce transactions. The report included the recommendation that the OECD Working Party No. 1 on Tax Conventions and Related Questions "… issue a document clarifying, along the lines of section 3 of this report, how the various tax treaty characterisation issues arising from e-commerce should be solved…" and invited the Working Party "…to take account of the suggestions for changes to the Commentary of the OECD Model Tax Convention which are included in this report."

3. The Committee on Fiscal Affairs, through its Working Party No. 1, subsequently examined the TAG report in detail. It found the conclusions and suggestions of the TAG highly persuasive. It therefore decided to follow the TAG recommendation and adopted[2]

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1. The TAG report is available at http://www.oecd.org/pdf/M000015000/M00015536.pdf and in the publication entitled Taxation and Electronic Commerce — Implementing the Ottawa Taxation Framework Conditions, OECD, Paris 2001, page 85.

2. See, however, the observations by Greece and Spain included in Annex 3.

the present report, which largely reproduces the TAG report and generally adopts the TAG's suggestions for changes to the Commentary on Article 12.

4. The Committee expresses its thanks to the members of the TAG for their valuable work and their contribution to clarifying how existing tax treaties apply in the context of e-commerce.

2. Overview of the report

5. This report is divided as follows:

- sections 1 to 4 include a description of the various treaty characterisation issues that may arise in electronic commerce together with the conclusions of the Committee on how to address these issues;
- annex 1 reproduces all the changes to the Commentaries on the Model Tax Convention that are put forward in this report;
- annex 2 includes an illustrative list of typical e-commerce transactions with the conclusions of the Committee as to how payments arising from these transactions should be characterised for tax treaty purposes (this list is similar to the one included in annex 2 of the TAG report).

6. Throughout this report, it is generally assumed that the payments that are referred to are received in the course of carrying on a business, whether or not the payers are themselves carrying on business. It follows that all these payments are capable of falling within Article 7 of the OECD Model Tax Convention, which deals with business profits. Some payments, however, may be taken out of Article 7 by the rule of paragraph 7 of Article 7, which gives priority to any other Article that expressly deals with the specific type of income concerned. One such Article is Article 12, dealing with royalties. For these reasons, the payments referred to in this report should not be considered to fall within Article 21, which deals with other income.

3. Business profits and royalties

7. The definition of royalties currently found in paragraph 2 of Article 12 of the OECD Model Tax Convention reads as follows:

> "The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

8. In the OECD 1977 Double Taxation Convention, that definition also included "payments […] for the use, or the right to use, industrial, commercial or scientific equipment" and some bilateral conventions still include this previous definition of royalties.

9. This section analyses classification issues arising from the possible application of various elements of these two definitions to payments made in e-commerce transactions. It also examines classification issues arising from alternative treaty provisions which deal with the provision of services or technical fees.

a) Business profits and payments for the use of, or the right to use, a copyright

Analysis and conclusions

10. One of the most important characterisation issues arising from e-commerce is the distinction between business profits and the part of the treaty definition of "royalties" that deals with payments for the use of, or the right to use, a copyright. The conclusions below on how that issue should be addressed are fully consistent with the position already expressed in paragraphs 14 to 14.2 of the Commentary on Article 12 as regards software payments.

11. Since the definition of royalties applies to "payments for" any of the various items listed in that definition, the main question to be addressed in any given transaction is the identification of that for which the payment is made. Under the relevant legislation of some countries, transactions which permit the customer to electronically download computer programs or other digital content may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for treaty purposes. This would be the case, for instance, where a payment is made by a person for the downloading and the operation of a copy of a computer program. Whilst electronic downloading of the program may or may not constitute the use of a copyright by the user (as opposed to by the provider) depending on the relevant copyright law and contractual arrangements, that possible use of a copyright is not that for which the payment is essentially made.

12. In the case of transactions that permit the customer to electronically download digital products (such as software, images, sounds or text), the payment is made to

acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquiror.[1] This constitutes that for which the payment is essentially made. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

Changes to the Commentary

13. Based on that analysis, the Committee concluded that the following changes should be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Add the following paragraphs 17.1 to 17.4 immediately after paragraph 17 of the Commentary on Article 12:

"17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".

1. The same result would apply regardless of whether the payment was made as regards the downloading of one specific product or in the form of a subscription fee for the right to access a web site where that digital product may be downloaded.

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content."

b) Business profits and payments for know-how

Analysis and conclusions

14. Whilst e-commerce transactions resulting in know-how payments are relatively rare, in some transactions it is necessary to distinguish whether the payment is in consideration for the provision of services or the provision of know-how (i.e. information concerning industrial, commercial or scientific experience).

15. Paragraph 11 of the Commentary on Article 12 refers to the following key elements to identify transactions for the provision of know-how:

- according to the ANBPPI *[Association des Bureaux pour la Protection de la Propriété Industrielle]*, know-how is "undivulged technical information that is

necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique";

- "In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public";
- in the know-how contract "the grantor is not required to play any part himself in the application of the formula ... and ... does not guarantee the results thereof";
- the provision of know-how must be distinguished from the "provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party".

16. The paragraph also includes the following examples of payments which should not be considered to be received as consideration for the provision of know-how but rather, for the provision of services:

- payments obtained as consideration for after-sales service;
- payments for services rendered by a seller to the purchaser under a guarantee;
- payments for pure technical assistance; and
- payments for an opinion given by an engineer, an advocate or an accountant.

17. Applying these criteria and examples to e-commerce transactions, the Committee concluded that, for instance, online advice, communications with technicians and using the trouble-shooting database, would clearly involve actual services being performed on demand rather than the provision of know-how.

18. The distinction between payments for services rendered and payments for the supply of know-how may sometimes raise practical difficulties. Countries have used various criteria to solve these difficulties and the following are examples of criteria developed for that purpose:

- Typically, under a contract for the supply of know-how:
  (a) a "product" (i.e. knowledge, information, technique, formula, skills, process, plan, etc.) which has already been created or developed or is already in existence is transferred;
  (b) the product which is the subject of the contract is transferred for use by the buyer (i.e. it is supplied); and

(c) except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to others.

– By contrast, in a contract involving the performance of services, typically:

(d) the contractor undertakes to perform services which will result in the creation, development or the bringing into existence of a product (which may or may not be know-how);

(e) in the course of developing a product, the contractor would apply existing knowledge, skill and expertise - there is not a transfer (i.e. supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes; and

(f) the product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. However, in the course of rendering services the contractor would, in most cases, also produce as a by-product a work (e.g. plan, design, specification, report, etc., which could contain knowledge, etc. not otherwise known to the buyer and which may or may not be protected by patents, etc.) in which copyright would subsist. Unless specifically agreed otherwise, the contractor is the owner of such copyright and the buyer or any other person is, by law, precluded from using the property in which the copyright subsists for any purpose other than the purpose for which it was originally designed without first obtaining the approval of the contractor. This would not alter the nature of the contract which would remain one for the performance of services.

– Another factor is the incidence of cost, i.e. both the level and the nature of the expenditure incurred by the seller:

(g) in most cases involving the supply of know-how which is already in existence there would appear to be very little more which needs to be done by the supplier other than to copy existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure.

(h) a contract for the performance of services would, depending on the nature of the services to be rendered, involve the contractor in such items of expenditure as salaries and wages to employees engaged in researching, designing, testing, drawing and other associated activities, payments to sub-contractors for the performance of similar services, etc.

– These factors all point to the one main distinctive feature of know-how - that it is an asset and, as such, it is something which is already in existence and is not something brought into being in pursuance of the particular contract.

19. As regards the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, the Committee concluded that, as a general rule, the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

Changes to the Commentary

20. The Committee considered that it would be useful to provide greater guidance in the Commentary, on the basis of the above criteria and factors, on the distinction to be made between payments for the provision of know-how and payments for the provisions of services. It therefore concluded that the following changes should be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Replace paragraph 11 of the Commentary on Article 12 by the following paragraphs 11 to 11.5 (additions to the existing text of paragraph 11 appear in ***bold italics****):*

"11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the *"Association des Bureaux pour la Protection de la Propriété Industrielle"* (ANBPPI), states that 'know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique'.

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. ***Payments made under the latter contracts generally fall under Article 7.***

11.3 The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

— ***Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.***

— ***In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.***

— ***In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.***

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

— payments obtained as consideration for after-sales service,

— payments for services rendered by a seller to the purchaser under a guarantee,

— payments for pure technical assistance,

— payments for an opinion given by an engineer, an advocate or an accountant, and

— ***payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.***

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part." *[paragraph 45 below includes suggested changes to this last sentence]*

c) Business profits and payments for the use of, or the right to use, industrial, commercial or scientific equipment

Analysis and conclusions

21. As already mentioned, a number of bilateral conventions include a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" even though these words are no longer found in the definition of the current OECD Model Tax Convention.[1]

i) Digital products

22. A first question is whether the words "payments for the use of, or the right to use, industrial, commercial or scientific equipment" can apply to payments for time-limited use of a digital product (e.g. category 5 dealing with limited duration software and other digital information licenses).

23. The Committee concluded that payments for such use of digital products cannot be considered as payments "for the use of, or the right to use, industrial, commercial or scientific equipment".[2] Member countries reached that conclusion primarily because digital products are not considered to be "equipment" since the word "equipment" only applies to a tangible product (and the fact that the digital product is provided on a tangible medium would not change the fact that the object of the transaction is the acquisition of rights to use the digital content rather than rights to use the tangible medium). Additional reasons, which may, depending on the circumstances, apply to some or all payments for time-limited use of a digital product, are:

- because digital products cannot be considered as "equipment" since the word "equipment", in the context of the definition of royalties, applies to property that is intended to be an accessory in an industrial, commercial or scientific process and could not therefore apply to property, such as a music or video CD, that is used in and for itself;

1. Paragraph 9 of the Commentary on Article 12 indicates that these words were deleted from the definition of royalties in order " to exclude income from … leasing [of such equipment] from the definition of royalties and, consequently, to remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits…".

2. New Zealand reserves its position on whether payments for the use of digital products can be treated as payments "for the use of, or the right to use, industrial, commercial or scientific equipment." New Zealand is currently considering issues relating to the tax treatment of computer software generally.

- because such products cannot be viewed as "industrial, commercial or scientific", at least when provided to the private consumer. Based on the nature of these products or the purpose of their acquisition by the users, products such as games, music or videos cannot be considered as "industrial, commercial or scientific" (as these examples show, the two preceding reasons would be primarily relevant where the payment is made by a private consumer); or
- because the payments involved in that type of transaction generally cannot be considered to be "for the use, or the right to use" the product since these words do not apply to a payment made to definitively acquire a property designed to have a short useful life, which is the case for most of these products, e.g. where someone acquires a video game CD that is programmed to become unusable after a certain period of time.

ii) Computer equipment

24. In a few transactions the question arises as to whether tangible computer equipment (hardware) is being used by a customer so as to allow the relevant payment to be characterised as "payments for the use of, or the right to use, industrial, commercial or scientific equipment" (see categories 7, 8, 9, 11 and 13 in annex 2).

25. Such characterization is clearly appropriate where, for instance, the payment is for the rental of a computer and not for services. Factors that may indicate the rental of equipment as opposed to a service contract include:

- the customer is in physical possession of the property,
- the customer controls the property,
- the provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient.

26. This is a non-exclusive list of factors. All relevant facts bearing on the substance of the transaction should be taken into account when determining whether the agreement is a service contract or a lease.

27. In the case of application service provider transactions, the Committee concluded that these transactions should generally give rise to services income as opposed to rental payments. In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which the software is loaded, provides access to many customers to the same equipment, and has the right to update and replace the software at will. The customer may not have possession or control over the software or the equipment, will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.

28. Likewise, data warehousing transactions should be treated as services transactions. The vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

4. Provision of services

Analysis and conclusions

29. Whilst the OECD Model Tax Convention does not deal separately with payments for the provision of services, the distinction between these payments and payments made as consideration for the acquisition of property is relevant for certain bilateral conventions as well as for some domestic tax law purposes. The Committee therefore considered it useful to discuss the distinction between the provision of services and transactions resulting in the acquisition of property, noting that the preceding subsection already dealt with the particular question of the distinction between a rental of property and the provision of services.

30. The basic distinction between, on the one hand, a transaction resulting in the acquisition of property and, on the other hand, a transaction in services is whether the consideration for the payment is the acquisition of property from the provider. In this regard, a transaction resulting in the acquisition of property should be understood to include a transaction where a digital product (such as a copy of electronic data, a software program, digitised music or video images, and other forms of digital information and content), whether provided on a tangible medium or in the form of a digital signal, is acquired by a customer.

31. Generally speaking, if the customer owns the relevant property after the transaction, but the property was not acquired from the provider, then the transaction should be treated as a services transaction. For example, if one party engages another party to create an item of property that the first party will own from the moment of its creation, then no property will have been acquired by the first party from the other and the transaction should be characterised as the provision of services.

32. If, however, one party acquires property from another party, the transaction should nonetheless be characterised as a services transaction to the extent that the predominant nature of the transaction is the provision of services and the acquisition of property is merely ancillary. This would be the case, for example, where the relevant property itself has little intrinsic value and the provider creates value through the exercise of its particular talents and skills to create a unique result for the acquiror. Online consulting or other professional services is an example of an electronic commerce

transaction that typically results in services income. In these transactions, the customer usually does not acquire any form of property from the other party. If the customer does acquire property, such as a report, it most likely will have been created specifically for him and arguably was owned by the customer from the moment of its creation. If, however, the customer acquires a valuable report or other property that was not created specifically for that customer, then the transaction could give rise to income from the sale of property. For example, the sale of the same investment report or other high-value proprietary information to many customers should be treated as a sale of property rather than a service. Even if the customer obtained the report electronically by downloading it from a database of reports maintained on the vendor's server, the essential consideration would still be to acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquiror rather than to obtain a service.

5. Technical fees

Analysis and conclusions

33. The Committee examined how various e-commerce payments would be treated under alternative treaty provisions that allow source taxation of "technical fees".

34. Whilst these provisions may be drafted differently, they often include the following definition:

> "The term 'technical fees' as used in this Article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any service of a technical, managerial or consultancy nature."

35. Alternative formulations of provisions dealing with technical fees typically limit the application of these provisions to some categories of services that could fall within the scope of the definition above.[1] For these reasons, it was decided to restrict the analysis to that definition so as to try to clarify the limits of application of these provisions. In doing so, the three different types of services referred to in the definition were examined separately, i.e. technical services, managerial services and consultancy services.

i) Technical services

36. Services are of technical nature when special skills or knowledge related to a technical field are required for the provision of such services. Whilst techniques related

1. See, for example, the provision of the India-United States tax convention dealing with "included services".

to applied science or craftsmanship would generally correspond to such special skills or knowledge, the provision of knowledge acquired in fields such as arts or human sciences would generally not (the services of restoring an old art work is an example of an exception to this general rule). As an illustration, whilst the provisions of engineering services would be of a technical nature, the services of a psychologist would not.

37. The fact that technology is used in providing a service is not indicative of whether the service is of a technical nature. Similarly, the delivery of a service via technological means does not make the service technical. This is especially important in the e-commerce environment as the technology underlying the internet is often used to provide services that are not, themselves, technical (e.g. offering on-line gambling services through the internet).

38. In that respect, it is crucial to determine at what point the special skill or knowledge is used. Special skill or knowledge may be used in developing or creating inputs to a service business. The fee for the provision of a service will not be a technical fee, however, unless that special skill or knowledge is required when the service is provided to the customer. For example, special skill or knowledge will be required to develop software and data used in a computer game that would subsequently be used in carrying on the business of allowing consumers to play this game on the internet for a fee. Similarly, special skill or knowledge is used to create a troubleshooting database that customers will pay to access over the Internet. In these examples, however, the relevant special skill or knowledge is not used when providing the service for which the fee is paid, i.e. allowing the consumer to play the computer game or consult the troubleshooting database.

39. Many categories of e-commerce transactions similarly involve the provision of the use of, or access to, data and software (see, for example, categories 7, 8, 9, 11, 13, 15, 16, 20 and 21 in annex 2). The service of making such data and software, or functionality of that data or software, available for a fee is not, however, a service of a technical nature. The fact that the development of the necessary data and software might itself require substantial technical skills is irrelevant as the service provided to the client is not the development of that data and software (which may well be done by someone other than the supplier) but rather the service of making the data and software available to that client. For example, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. A payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

ii) Managerial services

40. Services of a managerial nature are services rendered in performing management functions. The Committee did not attempt to give a definition of management for that

purpose but noted that this term should receive its normal business meaning. Thus, it would involve functions related to how a business is run as opposed to functions involved in carrying on that business. As an illustration, whilst the functions of hiring commercial agents would relate to management, the functions performed by these agents (i.e. selling) would not.

41. The comments in paragraphs 37 to 39 above are also relevant for the purposes of distinguishing managerial services from the service of making data and software (even if related to management), or functionality of that data or software, available for a fee. The fact that this data and software could be used by the customer in performing management functions or that the development of the necessary data and software, and the management of the business of providing it to customers, might itself require substantial management expertise is irrelevant as the service provided to the client is neither managing the client's business, managing the supplier's business nor developing that data and software (which may well be done by someone other than the supplier) but rather making the software and data available to that client. The mere provision of access to such data and software does not require more than having available such a database and the necessary software. A payment relating to the provision of such access would not, therefore, relate to a service of a managerial nature.

iii) Consultancy services

42. "Consultancy services" refer to services constituting in the provision of advice by someone, such as a professional, who has special qualifications allowing him to do so. It was recognised that this type of services overlapped the categories of technical and managerial services to the extent that the latter types of services could well be provided by a consultant.

6. Mixed payments

Analysis and conclusions

43. There are a number of e-commerce transactions where the consideration of the payment could be considered to cover various elements (e.g. the software maintenance transactions described in category 12). These should be dealt with on the basis of the principles for dealing with mixed contracts which are set out in paragraph 11 of the Commentary on Article 12.

44. It was noted, however, that the last sentence of the paragraph provides that "it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part" where "the other parts [...] are only of an ancillary and largely unimportant character". The Committee considered that it would be more

practical, as well as more consistent with the conclusions put forward in the recently approved changes to the Commentary on Article 12, to provide that, in such circumstances, the treatment applicable to the principal part should generally be applied to the whole consideration.

Changes to the Commentary

45. The Committee therefore concluded that the following changes should be made to the Commentary on Article 12 of the OECD Model Tax Convention:

> *Replace the last sentence of paragraph 11 of the Commentary on Article 12 by the following (changes to the existing text appear in ~~strikethrough~~ **and bold italics**):*
>
> > "If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, ***then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration***. ~~then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.~~"

ANNEX 1

CHANGES TO THE COMMENTARY ON ARTICLE 12 OF THE OECD MODEL TAX CONVENTION

[Changes to the existing text of the Commentary appear in bold italics *for additions and ~~strikethrough~~ for deletions]*

1. Replace paragraph 11 of the Commentary on Article 12 by the following paragraphs 11 to 11.5:

Replace the last sentence of paragraph 11 of the Commentary on Article 12 by the following:

"11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the *"Association des Bureaux pour la Protection de la Propriété Industrielle"* (ANBPPI), states that 'know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. ***Payments made under the latter contracts generally fall under Article 7.***

11.3 The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- ***Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.***
- ***In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.***
- ***In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.***

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a guarantee,
- payments for pure technical assistance,
- payments for an opinion given by an engineer, an advocate or an accountant, and
- ***payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information***

in response to frequently asked questions or common problems that arise frequently.

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, ***then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.*** ~~then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.~~

2. Add the following paragraphs 17.1 to 17.4 immediately after paragraph 17 of the Commentary on Article 12:

"17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may

give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content."

ANNEX 2

ANALYSIS OF VARIOUS CATEGORIES OF TYPICAL E-COMMERCE TRANSACTIONS

1. This annex illustrates how the conclusions presented in sections 1 to 4 apply in the case of some typical electronic commerce transactions.

Category 1: Electronic order processing of tangible products

Definition

> *The customer selects an item from an online catalogue of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The product is physically delivered to the customer by a common carrier.*

Analysis and conclusions

2. Since it does not raise any difficulty as regards treaty characterisation, this category of transaction provides a useful starting point to understand other examples. In this type of transaction, the payment made by the customer constitutes consideration that clearly falls within Article 7 (Business Profits) rather than Article 12 (Royalties), because it does not involve a use of copyright.

Category 2: Electronic ordering and downloading of digital products

Definition

> *The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded onto the customer's hard disk or other non-temporary media.*

Analysis and conclusions

3. This category of transaction raises the fundamental characterisation issue discussed in paragraphs 10 to 12 of section 1 above, i.e. the distinction between business profits and the part of the treaty definition of "royalties" dealing with payments for the use of, or the right to use, a copyright. In the case of transactions that permit the customer to electronically download digitised products (such as software, images, sounds or text) for the customer's own use or enjoyment, the payment is made to acquire data transmitted in the form of a digital signal. Since this constitutes the essential consideration for the payment, that payment cannot be considered as royalties as a payment made for the use or the right to use a copyright. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the use of a copyright under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

Category 3: Electronic ordering and downloading of digital products for purposes of commercial exploitation of the copyright

Definition

> *The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded into the customer's hard disk or other non-temporary media. The customer acquires the right to commercially exploit the copyright in the digital product (e.g. a book publisher acquires a copyrighted picture to be included on the cover of a book that it is producing).*

Analysis and conclusions

4. This category of transaction illustrates a case where the payment qualifies as a royalty. Indeed, in that case, the payment is made as consideration for the right to use the copyright in the digital product. In the example given, that use takes the form of the reproduction and sale, for commercial purpose, of the copyrighted picture.

Category 4: Updates and add-ons

Definition

> *The provider of software or other digital product agrees to provide the customer with updates and add-ons to the digital product. There is no agreement to produce updates or add-ons specifically for a given customer. The customer does not acquire the right to commercially exploit the copyright in the digital product or in the update or add-on.*

Analysis and conclusions

5. This category of transaction should be treated

- like the transactions described in category 1 above if the updates and adds-on are delivered on a tangible medium;
- like the transactions described in category 2 above if the updates and adds-on are delivered electronically.

6. Since both categories 1 and 2 would give rise to payments falling under Article 7, payments made by the customer in this category of transaction should therefore be treated similarly.

Category 5: Limited duration software and other digital information licenses

Definition

> *The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are deleted or become unusable upon termination of the license.*

Analysis and conclusions

7. Under the OECD Model, that transaction should be treated exactly as transactions falling under categories 1 or 2 so that the payment to the commercial provider of the limited duration digital product would fall under Article 7 (Business Profits).

8. Also, if a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment", such payments cannot be considered as payments "for the use of, or the

right to use, industrial, commercial or scientific equipment" for the reasons set out in paragraphs 22 and 23 of section 1 above.

Category 6: Single-use software or other digital product

Definition

> *The customer receives the right to use software or other digital products one time. The product may be either downloaded or used remotely (e.g. use of software stored on a remote server). The customer does not receive the right to make copies of the digital product other than as required to use the digital product for its intended use.*

Analysis and conclusions

9. Whilst some Member countries view this type of transaction as contracts for services and others view them as being similar to the transactions referred to in categories 2 and 5, under both views the payments made in these transactions fall under Article 7 as business profits.

Category 7: Application hosting - separate license

Definition

> *A customer has a perpetual license to use a software product. The customer enters into a contract with a provider whereby the provider loads the software copy on servers owned and operated by the provider. The provider supplies technical support to protect against failures of the system. The customer can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the provider's server. This type of arrangement could apply, for example, for financial management, inventory control, human resource management or other enterprise resource management software applications.*

Analysis and conclusions

10. Under the OECD Model, this type of transaction gives rise to business profits falling under Article 7.

11. Where, however, a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment", the issue arises whether these words can be applied to all or part of the payments arising from these transactions.

12. As discussed in paragraphs 24 to 28 of section 1 above, these transactions should generally give rise to services income as opposed to rental payments. In a typical transaction, the vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

13. Another issue is whether payments arising in this type of transaction could be treated as payments for services of a "technical nature" under alternative treaty provisions that allow source taxation of "technical fees". To the extent that main service being provided is merely that of storing the data and software of customers, this service is akin to mere warehousing and the performance of that function does not require the direct exercise of any special technical skill or knowledge.

Category 8: Application hosting - bundled contract

Definition

> *For a single, bundled fee, the customer enters into a contract whereby the provider, who is also the copyright owner, allows access to one or more software applications, hosts the software applications on a server owned and operated by the provider, and provides technical support for the hardware and software. The customer can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the provider's server. The contract is renewable annually for an additional fee.*

Analysis and conclusions

14. Under the OECD Model, there would be no need to separate the payment described in this example as all of it would constitute business profits falling under Article 7.

15. Pursuant to the existing paragraph 11 of the Commentary on Article 12, however, the need to separate the payment into various components could arise when applying bilateral conventions that include the alternative provisions referred to in the previous

category (see paragraphs 43 to 45 of section 4 above). This would be the case to the extent that part of the payment relates to the provision of technical support for the software that would constitute services of a technical nature. In that case, that part would be treated differently from the parts relating to allowing access to one or more software applications and hosting such software applications as such functions do not require the application of special skills or knowledge (they essentially require owning the relevant equipment and software rights that are made available).

Category 9: Application service provider ("ASP")

Definition

> *The provider obtains a license to use a software application in the provider's business of being an application service provider. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. For example, the software might automate sourcing, ordering, payment, and delivery of goods or services used in the customer's business, such as office supplies or travel arrangements. The provider does not provide the goods or services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider's server, and does not have possession or control of a software copy.*

Analysis and conclusions

16. As regards the payment made by the customer, the issues are similar to those discussed under the preceding category.

Category 10: ASP license fees

Definition

> *In the example above, the ASP pays the provider of the software application a fee which is a percentage of the revenue collected from customers. The contract is for a one year term.*

Analysis and conclusions

17. This type of transaction, being essentially for the provision of a software product to be used in the business of the transferee, falls within Article 7. It is acknowledged that the fact that the ASP's customer will have access to the software copy hosted on servers owned and operated by the provider may technically involve the ASP displaying to the customers some copyrighted information (e.g. forms for data input). If, however, providing such access constituted the use of a copyright right by the ASP (for example a display or other right), such use of copyright would be such a minimal part of the consideration for the payment made by the ASP to the software provider that it should not be relevant for the treaty characterisation of that payment.

Category 11: Web site hosting

Definition

> *The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content on the site. The provider is compensated by a fee based on the passage of time.*

Analysis and conclusions

18. Under the OECD Model, this type of transaction gives rise to business profits falling under Article 7. Where a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of "technical fees", this type of transaction would not give rise to these two types of income under the circumstances and for the reasons presented under category 7, which deals with application hosting.

Category 12: Software maintenance

Definition

> *Software maintenance contracts typically bundle software updates together with technical support. A single annual fee is charged for both updates and technical support. In most cases, the principal object of the contract is the software updates.*

Analysis and conclusions

19. The remarks expressed in paragraphs 43 to 45 of section 4 above as regards mixed contracts, which refer to the principles set out in paragraph 11 of the Commentary on Article 12, apply to such transactions. Where, under those principles, part of the payment is regarded to be for the provision of technical support, the issues described in category 14 below as regards alternative treaty provisions that allow source taxation of "technical fees" will arise.

Category 13: Data warehousing

Definition

> *The customer stores its computer data on computer servers owned and operated by the provider. The customer can access, upload, retrieve and manipulate data remotely. No software is licensed to the customer under this transaction. An example would be a retailer who stores its inventory records on the provider's hardware and persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock.*

Analysis and conclusions

20. Under the OECD Model, this type of transaction gives rise to business profits falling under Article 7. Where a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of "technical fees", this type of transaction would not give rise to these two types of income under the circumstances and for the reasons presented under category 7, which deals with application hosting.

Category 14: Customer support over a computer network

Definition

> *The provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support can take the form of online technical documentation, a trouble-shooting database, and communications (e.g. by e-mail) with human technicians.*

Analysis and conclusions

21. Based on this description and under the wording of the OECD Model Convention, the payment arising in this type of transaction would fall within Article 7.

22. Based on paragraphs 14 to 19 of section 1 above and, in particular, the factors listed in paragraphs 15 and 16, the payment for online advice, communications with technicians and using the trouble-shooting database should not be considered as a payment for "information concerning industrial, commercial or scientific experience" (know-how) so as to constitute royalties since that payment is clearly for actual services being performed on demand rather than for the provision of know-how.

23. Whilst the provision of technical documentation could, depending on the circumstances, constitute the provision of know-how, this would require that the information be "undivulged technical information" as described in paragraph 11 of the Commentary on Article 12. Also, as mentioned in the same paragraph, know-how "is necessary for the industrial reproduction of a product or process". To the extent that know-how must be technical information relating to industrial reproduction of a product or process, information that merely relates to the operation or use of products as opposed to their development or production would not fall under the definition of know-how.

24. The remarks in paragraphs 43 to 45 of section 4 above, which deal with mixed contracts, would be relevant if the contract were considered to cover the provision of both services and know-how.

25. A last issue is how the payment arising in this type of transaction would be treated under alternative treaty provisions that allow source taxation of "technical fees".

26. Whilst the provision of online advice through communications with technicians may require the application of special skill and knowledge and might therefore constitute services of a technical nature, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. The part of the payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

Category 15: Data retrieval

Definition

> *The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.*

Analysis and conclusions

27. The payment arising from this type of transaction would fall under Article 7. Some Member countries reach that conclusion because, given that the principal value of such a database would be the ability to search and extract the documents, these countries view the contract as a contract for services. Others consider that, in this transaction, the customer pays in order to ultimately obtain the data that he will search for. They therefore view the transaction as being similar to those described in category 2 and will accordingly treat the payment as business profits.

28. Another issue is whether such payment could be considered as a payment for services "of a technical nature" under the alternative provisions on technical fees previously referred to. Providing a client with the use of search and retrieval software and with access to a database does not involve the exercise of special skill or knowledge when the software and database is delivered to the client. The fact that the development of the necessary software and database would itself require substantial technical skills was found to be irrelevant as the service provided to the client was not the development of the software and database (which may well be done by someone other than the supplier) but rather making the completed software and database available to that client.

Category 16: Delivery of exclusive or other high-value data

Definition

> *As in the previous example, the provider makes a repository of information available to customers. In this case, however, the data is of greater value to the customer than the means of finding and retrieving it. The provider adds significant value in terms of content (e.g. by adding analysis of raw data) but the resulting product is not prepared for a specific customer and no obligation to keep its contents confidential is imposed on customers. Examples of such products might include special industry or investment reports. Such reports are either sent electronically to subscribers or are made available for purchase and download from an online catalogue or index.*

Analysis and conclusions

29. These transactions involve the same characterisation issues as those described in the previous category. Thus, the payment arising from this type of transaction falls under Article 7 and is not a technical fee for the same reason.

Category 17: Advertising

Definition

> *Advertisers pay to have their advertisements disseminated to users of a given web site. So-called "banner ads" are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser. Advertising rates are most commonly specified in terms of a cost per thousand "impressions" (number of times the ad is displayed to a user), though rates might also be based on the number of "click-throughs" (number of times the ad is clicked by a user).*

Analysis and conclusions

30. The payments arising from these transactions would constitute business profits falling under Article 7 rather than royalties, even under alternative definitions of royalties that cover payments "for the use, or the right to use, industrial, commercial or scientific equipment".

Category 18: Electronic access to professional advice (e.g. consultancy)

Definition

> *A consultant, lawyer, doctor or other professional service provider advises customers through email, video conferencing, or other remote means of communication.*

Analysis and conclusions

31. Again, the payments arising from these transactions would constitute business profits falling under Article 7 rather than royalties. As already stated, the provision of on-demand advice is a service and not the supply of know-how.

32. As some of these transactions may involve the provision of technical, managerial or consultancy services, the issue also arises whether these could be considered as services "of a technical nature" under the alternative provisions on technical fees that have been previously referred to. To the extent that the services were rendered by someone acting as a consultant, they would constitute services of a consultancy nature so as to fall within the definition quoted in paragraph 34 of section 3.

Category 19: Technical information

Definition

The customer is provided with undivulged technical information concerning a product or process (e.g. narrative description and diagrams of a secret manufacturing process).

Analysis and conclusions

33. Payments arising from this category of transactions constitute royalties as they are made for the supply of know-how, i.e. "for information concerning industrial, commercial or scientific experience."

Category 20: Information delivery

Definition

The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. The principal value to customers is the convenience of receiving widely available information in a custom-packaged format tailored to their specific needs.

Analysis and conclusions

34. This type of transaction raises basically the same issues as the transaction described under category 15 above. The payments arising from these transactions therefore constitute business profits falling under Article 7 and are not technical fees for the same reason.

Category 21: Access to an interactive web site

Definition

The provider makes available to subscribers a web site featuring digital content, including information, music, video, games, and activities (whether or not developed or owned by the provider). Subscribers pay a fixed periodic fee for access to the site. This example differs from the previous one in that the principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or obtaining services from the site.

Analysis and conclusions

35. The subscription fee paid in this type of transactions would constitute a payment for services. As that payment is mainly for the interaction with the site for purposes of the personal enjoyment of the user and not for the provision of any service of a technical, managerial or consultancy nature, it would not, under the previously quoted definition of "technical fees", fall under the alternative provisions covering these types of payments. It should be noted, however, that any payment to the owner of the copyright in the digital content made by the provider for the right to display that content to its subscribers would constitute royalties.

Category 22: Online shopping portals

Definition

> *A web site operator hosts electronic catalogues of multiple merchants on its computer servers. Users of the web site can select products from these catalogues and place orders online. The web site operator has no contractual relationship with shoppers. It merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. The merchants pay the web site operator a commission equal to a percentage of the orders placed through the site.*

Analysis and conclusions

36. These payments are revenues from advertising or similar services that constitute business profits falling under Article 7.

Category 23: Online auctions

Definition

> *The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.*

Analysis and conclusions

37. These payments are revenues similar to those of an auction house and constitute business profits falling under Article 7.

Category 24: Sales referral programs

Definition

An online provider pays a sales commission to the operator of a web site that refers sales leads to the provider. The web site operator will list one or more of the provider's products on the operator's web site. If a user clicks on one of these products, the user will retrieve a web page from the provider's site from which the product can be purchased. When the link on the operator's web page is used, the provider can identify the source of the sales lead and will pay the operator a percentage commission if the user buys the product.

Analysis and conclusions

38. These payments constitute business profits falling under Article 7.

Category 25: Content acquisition transactions

Definition

A web site operator pays various content providers for news stories, information, and other online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new content specifically for the web site.

Analysis and conclusions

39. The two alternatives described above need to be distinguished. Where the site operator pays a content provider for the right to display copyrighted material, the payment would fall under the definition of royalties to the extent that the public display of the content constitutes a right covered by the copyright of the owner of the content. Where, however, the operator pays for the creation of new content and, as a result of the relevant contractual arrangements, becomes the owner of the copyright in the content so created, the payment cannot be for royalties and falls under Article 7.

Category 26: Streamed (real time) web based broadcasting

Definition

The user accesses a content database of copyrighted audio and/or visual material. The broadcaster receives subscription or advertising revenues.

Analysis and conclusions

40. The subscription or advertising fees that would be received in these transactions would constitute business profits falling under Article 7.

Category 27: Carriage fees

Definition

A content provider pays a particular web site or network operator in order to have its content displayed by the web site or network operator.

Analysis and conclusions

41. In that type of transactions, the web site or network operator is providing a commercial service for a fee and its income should be characterised as business profits under Article 7. In these transactions, unlike in those described in category 25, it is the owner of the copyrighted material who makes the payment, which makes it clear that Article 12 is not applicable.

Category 28: Subscription to a web site allowing the downloading of digital products

Definition

The provider makes available to subscribers a web site featuring copyrighted digital content (e.g. music). Subscribers pay a fixed periodic fee for access to the site. Unlike category 21, the principal value of the site to subscribers is the possibility to download these digital products.

Analysis and conclusions

42. The subscription fee paid in this type of transaction would fall under Article 7. As explained in paragraph 3 above, transactions that permit the customer to electronically download digitised products (i.e. music in this case) for the customer's own use or enjoyment do not give rise to royalties. This category of transaction is closer to category 2 than to category 21 since the essential consideration for the payment is not the temporary interaction with the site but, rather, the acquisition of the music data transmitted in the form of a digital signal.

ANNEX 3

OBSERVATIONS BY GREECE AND SPAIN

Greece

1. We do not adhere to the interpretation in the fifth dash of paragraph 11.4 [which the report proposes to add to the Commentary on Article 12 — see annex 1] and we take the view that all relevant payments are falling within the scope of Article 12.

2. We do not adhere to the interpretation in paragraphs 17.2 and 17.3 [which the report proposes to add to the Commentary on Article 12 — see annex 1] because the payments related to the downloading of computer software ought to be considered as royalties even if those products are acquired for the personal or business use of the purchaser.

Spain

3. The note includes new paragraphs after paragraph 17 of the Commentary on Article 12, in relation with electronic downloading of digital products and other similar categories appeared with the electronic commerce. In order to keep a coherent stance, Spain understands that the observation made to paragraphs 14 and 15 of the Commentary on Article 12 is also applicable to new paragraphs 17.1 to 17.4.

4. Nevertheless, Spain would like to take advantage of this opportunity to reconsider its position on the issue of the software and the royalties, on two different grounds:

- On our view, anyone who is using software for a business purpose should be deemed to be paying a royalty. Thus, it does not matter if that use implies to reproduce and sell, on his turn, the rights to new acquirers or if the software is used in the acquirer's business process as a tool for developing its activity. When there is not business but personal use we agree with the most extended view of not considering these payments as royalties.
- There is a difference to be made between standardised software and the software which is adapted to any extent to the acquirer's individual characteristics. In the

first case, when someone acquires standardised software for his personal or business use, even though he is acquiring the right to use that software, in fact, he is acquiring an object, something sold on a homogenous and massive basis to any purchaser, and that should be treated as a merchandise under Article 7. This does not happen in the second case, thus, it should be treated, in our opinion, under Article 12.

5. According with these considerations and with the need of coherence in relation with the new incorporations to the Model, Spain would like its current Observation on the Commentary on Article 12 to be substituted by the following:

> *"Spain* does not adhere to the interpretation in paragraphs 14, 15 and 17.1 to 17.4. Spain holds the view that payments relating to software fall within the scope of the Article where less than the full rights to software are transferred either if the payments are in consideration for the right to use a copyright on software for commercial exploitation or if they relate to software acquired for the business use of the purchaser, when, in this last case, the software is not absolutely standardised but somehow adapted to the purchaser."

PART III

ISSUES ARISING UNDER ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE MODEL TAX CONVENTION

ISSUES ARISING UNDER ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE MODEL TAX CONVENTION

1. Introduction

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

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

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

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

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

5. This note is divided as follows:

- Part 2 deals with problems in applying the "fixed place of business" standard under paragraphs 1 and 2 of Article 5;
- Part 3 deals with problems in the treatment of building sites and construction or installation projects under paragraph 3 of the Article;
- Part 4 deals with problems in identifying preparatory and auxiliary activities under paragraph 4 of the Article;
- Part 5 deals with problems related to agency permanent establishments under paragraphs 5 and 6 of the Article;
- Annex 1 includes all the changes to the Commentary of the Model Tax Convention that result from this report.

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

2. "Fixed place of business" (paragraphs 1 and 2)

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

Issue

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

Discussion

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

9. The Committee found that the concept of a place that constitutes a coherent whole commercially and geographically in relation to a particular business (this wording is derived from that used in paragraph 18 of the Commentary on Article 5) would be relevant in applying the concept of "fixed place of business". For example, a market would constitute such a coherent whole commercially and geographically in relation to market activities so that business activities regularly carried on in different parts of the market could constitute a permanent establishment. The same could not be said in the case of activities carried on in different markets as these would not constitute one such coherent whole. Any geographical area that commercially or economically constitutes a unit could thus constitute a fixed place of business for an enterprise even though the business activities of that enterprise would move within that area.

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

Conclusions

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

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

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

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

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

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

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

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

Issue

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

Discussion

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

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

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

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

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

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

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

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

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

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

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

stronger. Conversely, practice shows that there were many cases where a permanent establishment had been considered to exist where the place of business was maintained for a longer period. The Committee decided that, for ease of administration, countries should be invited to consider these practices when addressing disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

Conclusions

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

> "6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.
>
> 6.1 As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

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

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

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

Issue

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

Discussion

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

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

of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

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

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

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

31. The Committee also discussed the meaning of the words "a place … through which" *["une installation … par l'intermédiaire de laquelle"*] in paragraph 1 of Article 5. It first noted that the 1963 Draft Convention used the words "a place … in which" *["une installation … où"*] and concluded that the drafting change had been made in an attempt to accommodate situations where business is not literally carried on "in" a place. For instance, it may look awkward to use the preposition "in" with respect to a construction site (e.g. a road) or automated equipment. For that reason, the Committee considers that the word "through" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

Conclusions

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

> "4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.
>
> 4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).
>
> 4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e. g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.
>
> 4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

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

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

d) Issue 2.4: Place of management

Issue

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

Discussion

34. The Committee discussed whether a roving business can be deemed to have a "place of management" in the country in which it operates, even if it has no office or other fixed place at which the management activity is carried out. It concluded that the examples listed in paragraph 2 are intended to be illustrations of the principle stated in paragraph 1, and that a "place of management" must meet the "fixed place of business" standard in order to qualify as a permanent establishment under that paragraph. In the circumstances described, therefore, the business in fact has no "place of management" within the meaning of Article 5, even if all the management activities take place within the country of its operations. Some delegates, however, questioned whether this was an appropriate result.

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

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

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

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

Conclusions

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

e) Issue 2.5: Active v. passive activity

Issue

40. It is very easy for a taxpayer to ensure that a permanent establishment exists if that is the result desired. Some enterprises have set up permanent establishments in countries that do not tax foreign source interest income in order to lend money to other

companies within a multinational group. The country where the debtors are located attributes the income to a permanent establishment in the other country and does not impose tax, but the passive foreign source interest income is also not taxed by the country where the permanent establishment is located. The question is whether it might be possible to clarify that the "business" carried on by the enterprise through the purported permanent establishment must be an active business that involves more than simply earning passive income.

Discussion

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

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

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

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

Conclusions

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

Commentary on Article 10

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

Commentary on Article 11

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

Commentary on Article 12

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

f) Issue 2.6: Cables and pipelines

Issue

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

Discussion

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

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

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

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

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

Conclusions

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

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

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

Issue

53. In paragraphs 1 to 4 of Article 5, the expression "permanent establishment" is not defined in relation to the enterprise. Thus, for example, the argument could be made that any construction project lasting more than 12 months represents a permanent establishment for any enterprise involved in the project so that a sub-contractor engaged on the project for a few days or weeks would be deemed to have a permanent establishment. In this case, it could be further argued that, technically, the source country would have the right to tax the sub-contractor's income since there is no requirement in Article 7 that the permanent establishment be that of the enterprise itself - a result contrary to the last sentence of paragraph 19 of the Commentary on Article 5 which states that the activities of the sub-contractor must last more than 12 months for him to be taxed.

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

Discussion

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

Conclusion

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

3. Building sites and construction or installation projects (paragraph 3)

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

Issue

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

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

Discussion

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

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

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

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

Conclusions

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

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

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

b) Issue 3.2: Computation of the construction period

Issue

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

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

Discussion

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

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

Conclusions

69. The Committee, after having discussed a possible amendment as described above, decided against it because of the risk that it would generate abuses and because the determination of whether a new construction project has truly begun should not be made solely on the basis of the period of time since work has stopped on a construction site.

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

Issue

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

Discussion

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

Conclusions

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

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

d) Issue 3.4: Multiple installation projects

Issue

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

Discussion

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

Conclusions

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

e) Issue 3.5: Renovations

Issue

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

Discussion

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

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

Conclusions

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

> "The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals***, the***

renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging."

f) Issue 3.6: Coherent geographic whole

Issue

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

Discussion

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

Conclusions

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

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

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

Issue

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

Discussion

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

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

Conclusions

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

> "16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. ***Where, however, such an office or workshop is used for a number of construction projects and the***

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

4. Preparatory and auxiliary activities (paragraph 4)

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

Issue

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

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

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

Discussion

89 There was general agreement within the Committee that the first "or" in the English version should not have been added in 1992. It was decided that paragraph 25 should be amended: (i) to make clear that a permanent establishment would exist only where activity in addition to mere delivery took place and (ii) to replace the reference to

"supply", which might carry the connotation that parts were being sold from the fixed place of business, by "delivery", matching the text of the Article.

Conclusions

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

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

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

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

Discussion

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

Conclusions

93. The Committee proposes to break paragraph 27, which is already rather long, into two separate paragraphs. New paragraph 27 would consist of the first five sentences and the last sentence of the paragraph as currently drafted. New paragraph 27.1 would read as follows:

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

c) Issue 4.3: Storage facilities

Issue

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

Discussion

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

96. Objection to the result achieved by the company in this example comes from the fact that tax planning has resulted in a reduction of the tax base through the reorganisation. To the extent that the reorganization is not exclusively tax-motivated, this would not be inherently offensive since the company might well have commenced the

operation of its subsidiary with the same structure i.e. placing within the subsidiary only the automobile sales business and not the spare parts business. If that had been the case it is unlikely that the structure would have been regarded as offensive. As a practical matter it might be thought rather difficult for the company to sever the connection between the parts and automobile aspects of the business and an administration would undoubtedly wish to test such an arrangement to ensure that the subsidiary was not in fact acting as a permanent establishment for the parent in relation to the parts business and to ensure that there was some commercial purposes to the reorganization transactions. Many enterprises would wish to avoid the practical difficulties and the risk of potential tax administration interest involved in this separation so it may be that the situation described would not very often be seen in real cases.

Conclusions

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

5. Agency permanent establishments (paragraphs 5 and 6)

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

Issue

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

Discussion

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

100. This view results from the wording of paragraph 5. Paragraph 5 constitutes an exception to paragraphs 1 and 2 because it does not explicitly require that the agent possesses a fixed place of business in the source country. It could be argued, however, that this interpretation introduces a paradox. The paragraph provides for a deemed permanent establishment only where contracts are concluded on behalf of the enterprise

by an agent; it does not apply where contracts are concluded directly by the principal himself and not through an agent (see below). Thus, a permanent establishment exists where the enterprise acts indirectly in the State through an agent but not where it acts directly in that State.

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

102. If the opposite conclusion were reached, it would be possible for a foreign enterprise to carry out extensive business activities in the source country through employees or non-resident dependent agents without becoming exposed to source country taxation. Whilst some countries felt that an employee of the enterprise could not in any event be considered an agent of the enterprise because the employee should simply be regarded as an emanation of the enterprise rather than an agent dealing with the enterprise, the general view was that an employee was properly to be regarded as an agent for the enterprise and that this was explicitly the position adopted in the existing Commentary, viz paragraph 32.

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

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

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

Conclusions

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

> "32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies ***and need not be residents of, nor have a place of business in, the State in which they act for the enterprise***. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases. Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise."

b) Issue 5.2: Agent with implied contractual authority

Issue

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

Discussion

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

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

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

Conclusions

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

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

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

Issue

112. As indicated above, the requirement that the authority to conclude contracts be habitually exercised is a fundamental feature of paragraph 5. Some potential for abuse might exist if a foreign enterprise attempted to circumvent the requirement that an agent "habitually exercises" an authority to conclude contracts by splitting up the coverage of the source country market among a large number of agents or by systematically sending in different people to the source country to carry out the agent activities. It could then be argued that whilst each of these agents would have the authority to conclude contracts for the enterprise, none could be considered to habitually exercise this authority.

Discussion

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

Conclusions

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

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

d) Issue 5.4: Commercial representations

Issue

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

Discussion

116. Discussions led to the conclusion that "representation", standing alone, has no particular meaning in the treaty area, and may simply obscure the discussion of the real issues. The existence of a permanent establishment is to be determined under the traditional rules of Article 5 applied to the particular facts at issue.

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

commercial representation or representative office are those that fall under paragraph 4 of Article 5.

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

119. Also, paragraph 5 of Article 5 is clearly relevant where contracts are substantially negotiated by employees working in commercial representations and representative offices, particularly in light of the following sentence of paragraph 33 of the Commentary on Article 5: "A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprises is situated." It is suggested above in this note that further clarification be provided in the Commentary with respect to that issue; such clarification could be useful in dealing with the problem of commercial representations or representative offices.

Conclusions

120. The Committee concluded that whilst the issue of commercial representations or representative offices was primarily an administrative difficulty related to the commercial law of some countries, clarification of the circumstances in which an agent can be considered to have an authority to conclude contracts (see conclusions under section 5.2) would likely be useful for countries having to deal with that issue.

e) Issue 5.5: Meaning of independence

Issue

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

Discussion

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

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

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

Conclusions

125. The Committee has decided that the following changes should be made to paragraph 38 of the Commentary on Article 5. The sentence "A subsidiary is not to be considered dependent upon its parent company solely because of the parent company's ownership of the share capital" would be deleted and the existing sentence beginning "Another important criterion...." would become the final sentence of paragraph 38. The part of existing paragraph 38 that begins with the following sentence ("Persons cannot be said to act....") would then become new paragraph 38.7 and the following new paragraphs (which include the new paragraph 38.6 proposed in relation to issue 5.6 below) would be added before that paragraph:

> "38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary

indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

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

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

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

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

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

38.7 [FROM OLD 38] Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of

their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5."

f) Issue 5.6: Agent with only one principal

Issue

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

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

Discussion

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

128. The fact that there is an exclusive agency (e.g. under which the agent is appointed the exclusive distributor of a product for a specified area), is not relevant to a consideration of the dependent or independent nature of the agent. By contrast, the fact that an agent acts exclusively for one principal is relevant in a determination of dependence or independence. The Committee therefore generally agreed that this kind of exclusivity - whether it takes the form of an exclusivity agreement or whether the facts reveal that the agent represents only one principal - is a factor to be considered, but never alone a decisive factor. A distinction might be drawn between the position of an agent whose principal has imposed a contractual condition of exclusivity and that of an agent with a single principal who has imposed no such condition. In the former case the contractual condition creates an element of dependence by the agent upon the enterprise since the agent has no opportunity to diversify his activities. Moreover the imposition of this important restriction on the activity of the agent might be simply one aspect of a more general restriction imposed on the activities of the agent which would be

inconsistent with independence. Such a situation may exist de facto in the case of a parent and subsidiary agency relationship and may cause particular difficulty in the application of paragraph 6 where the parent's effective control over the affairs of the subsidiary makes it unnecessary for the reality of the subsidiary's dependent position to be recorded in writing. By contrast, where a single principal has imposed no condition of exclusivity no equivalent restriction is placed upon the scope of business of the agent who retains the opportunity to contract with other principals if this appears to be in the interests of his business.

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

Conclusions

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

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

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

Issue

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

Discussion

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

133. Paragraph 38 of the Commentary includes the following sentence: "Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations." On the assumption that paragraph 6 applies whether or not an agent binds its principal, that sentence provides limited guidance.

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

Conclusions

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

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

ANNEX 1

CHANGES TO THE COMMENTARY

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

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

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

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

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e. g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the

headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

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

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

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

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

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

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in

that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

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

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

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

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

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

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

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

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

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

"16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of

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

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

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

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

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

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

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

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

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

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

of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph a) would be applicable."

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

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

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

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

"32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies ***and need not be residents of, nor have a place of business in, the State in which they act for the enterprise***. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in

view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

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

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

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

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

"38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person

represents. ~~A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital.~~

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

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

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

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

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

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's

activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

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

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

Commentary on Article 10

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

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

Commentary on Article 11

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

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

Commentary on Article 12

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

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

ANNEX 2

OBSERVATIONS BY THE CZECH REPUBLIC

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

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

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

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

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

6. At the same time, the Czech Republic does not agree with the statement that each branch should be considered separately for the purposes of a permanent establishment in the case where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank. The Czech Republic believes that in such cases the fact that the work is not done in one particular location is immaterial. The activities performed at each particular branch are part of a single project, and such project must be regarded as a permanent establishment if it lasts more than a substantial period of time.

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

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

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

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

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

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

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