Int'l Tax Treaties
Prof. McIntyre, Fall, 2007

Notes on the Answers

1a.   The treaty provides in Art. 5(7) that merely having an affiliated company (SCo) will not cause NCo to have a PE. I see four risks of NCo having a PE.

(1) If SCo is given the authority to make contracts on behalf of NCo and regularly exercises that authority, then NCo would have a PE. Art. 5(5). Given that SCo is mostly a shell and the real deal is with NCo, it may be possible for the IRS to claim that SCo is acting for NCo. However, the actual contract is with SCo on the insistence of the U.S. Army Corps of Engineers, so there may be substance to SCo.

(2) A second risk is from the NCo employees working on the construction. Presumably, they will have an office or other place of business provided by SCo, and that place of business would be a PE of NCo.

(3) A third risk is that NCo will be viewed, as a result of its employees, as having a construction site for more than 12 months in the U.S. Art. 5(3).

(4) A fourth risk is that NCo will be viewed as exploiting its intangible property in the U.S. through the PE created by its employees. NCo is charging SCo $100 million for its know how, and that know how is being transmitted through the employees working in the U.S.

The risks above are minimized by making clear that SCo does not have the authority to conclude contracts and by putting the employees of NCo on SCo's payroll. However, the facts suggest that the latter step presents business problems. Taking that step would also mean that the employees will be taxable in the U.S. (see answer to Q1b). It would be especially useful for the employee remaining in the U.S. for 18 months to be put on SCo's payroll.

1b.   Some of the employees of NCo may be exempt from U.S. tax under Art. 15 of the treaty if they are residents of the Netherlands and not either residents or citizens of the U.S. (the facts stated in the question are silent on these points). They must not be present in the U.S. for more than 183 days in any twelve month period. All but one of the employees meet this test. In addition, they must be paid by NCo, and their salaries cannot be deducted by a U.S. PE of NCo. If NCo does have a PE in the U.S. (see answer to Q1a), then NCo probably will want to deduct the salaries. So, there may be a tradeoff of the deduction for NCo and the employees being subject to U.S. tax.

2.   The New Zealand Model Tax Convention would take into account the related activities of associated companies in deciding whether a company meets the 6-month test for having a PE. The

apparent point of the rule is to prevent taxpayers from avoiding having a construction site or other presence resulting in taxation by being in the source county for less than 6 months but then having an associated company continue the related activities. For example, assume RCo has a construction site in New Zealand for 4 months, and then an associated company continues that site for another 4 months. In that case, RCo would have a PE under the associated-enterprise rule.

Note that this rule only applies in determining whether time limits in the treaty are applicable. It would not cause RCo, in my example above, to have a PE merely because an affiliated company has a PE in the source country.

From a policy perspective, the rule makes a lot of sense. The point of the time limits is limit an exemption from tax in the source country to companies that have only a short-term project with the source state. If the project is continuing beyond the time limit but is being carried out by affiliated companies, there is no longer a reason for the exemption. The OECD Commentary indicates that such schemes should not work when, in substance, the enterprise has a PE for the required time period. That is, the OECD seems to be agreeing with the New Zealand policy. But the OECD solution of making general comments in the Commentary is not likely to be as effective as the New Zealand approach.

One technical problem with the New Zealand rule is that it seems to cause all associated companies engaged in the common project to have a PE. The drafters try to avoid that result by providing that a time period counted once will not be counted again. Some refinement of the language might be helpful.