EXAM NO. _____

Wayne State University
Law School

Fall 2001
Prof. Michael J. McIntyre

International Tax Treaties

Maximum Time: 2 hours
Maximum Points: 100
December 17, 2001
1:30 – 3:30 p.m., Room 1550

Instructions

1. **Write your examination number,** the name of this course (Int'l Tax Treaties), and the name of the instructor (McIntyre) in the appropriate spaces on your **bluebook** . Please do this now. Do **not** put your own name or any information on your personal status (i.e., graduating senior, graduate student) anywhere on the bluebook.

2. *Thank you for putting your exam number and other information in the appropriate spaces.* This is an **open book** examination. You are expected to have with you the course materials, including a copy of the OECD Model Treaty and the U.S. Model Treaty. You are permitted to have any books, notes, commercial outlines, or other materials you have used during the course. You may use a pocket calculator.

3. This examination has three (3) parts (A, B, and C) and three (3) questions (1, 2, and 3), all of which have subquestions (a, b, etc.). The answers to the questions and subquestions go in your bluebook.

4. After the exam questions are some legal materials (pages 8-20) that may be helpful to you in answering the questions.

Note To Proctor:

Students are permitted to take their copy of the Examination with them at the end of the examination period. Persons allowed to leave the examination room ***for any reason*** *must leave their copy of the examination and their bluebook with you to hold until they return.*

Start of Exam

Instructions. Answer the following three (3) questions in your bluebook. Write in ink on every other line (double space), do not write on the back side of any page, and **do not write in the margins**. Observe the maximum space limitations. *You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations.* (As a practical matter, a penalty is not imposed for exceeding the limits by two lines or less.) One page of a bluebook, double spaced, is 14 lines.

Note on Handwriting: A person with normal-sized handwriting typically gets about 10 to 12 words per line. Make an appropriate adjustment if your handwriting is unusually large or small. Please, do not count your words.

***Note to typists*: Put your exam number in the upper right hand corner of each page of your answer sheets. Number your answers clearly and observe the space limits. One handwritten line of normal size writing is equivalent to 1 line of a typed page (8½" × 11") with 1½ inch margins (pica) or 2 inch margins (elite). This notice is typed with a pica font (Courier 12 point) and has 1½ inch margins.**

A. (Previously Distributed Fact Pattern)
(Maximum Points: 50; Maximum Lines: 50)

Question 1. Mr. W is the owner-operator of Mex-Lex, a business consulting firm located in Detroit, Michigan. The firm is not incorporated. It provides business and tax advice to American companies engaged in business activities in Mexico. The firm has twenty employees, each receiving a salary. Senior employees also receive a bonus based on the profitability of Mex-Lex. Mex-Lex has a small office in Monterrey, Mexico. That office has a local support staff and one employee from the Detroit office. Mr. W and various employees of Mex-Lex use the Monterrey office when they have business in Mexico.

Mex-Lex specializes in helping U.S. firms make use of the Mexican maquiladora legislation. In general, a maquiladora is a Mexican corporation that processes or manufactures goods in Mexico for export, typically to the United States. Under the maquiladora legislation, special rules apply for the temporary importation of raw materials, machinery, and equipment for use in manufacturing goods for export. Complex rules apply in computing the Mexican

income tax and the Mexican assets tax (a property tax imposed on business assets used in Mexico that operates like a minimum income tax). The sales tax (VAT) is waived on goods imported by a maquiladora for export.

Under the typical arrangement, Mex-Lex assists a group of Mexican residents to establish a maquiladora under Mexican law. The Mexican residents are business people. They become the owners and operators of the maquiladora company. Mex-Lex also typically arranges for some unrelated U.S. firms to contract with the maquiladora for manufacturing and assembly of its products. Mex-Lex receives a flat fee from the U.S. firms for its work and also receives a commission from the maquiladora of one percent of its gross profits.

Mex-Lex assisted in the creation of MCo, a Mexican corporation qualifying for treatment as a maquiladora. MCo was established by five Mexican residents, each contributing capital of US $100,000. Mex-Lex then arranged for ACo, BCo, and CCo, all U.S. manufacturing firms, to make use of the services of MCo. The three firms loaned manufacturing equipment to MCo that allows MCo to produce specialized auto parts in accordance with the standards set by the three U.S. companies. The three companies send raw materials and parts to MCo for processing and assembly in Mexico. The companies then purchase the goods manufactured by MCo at an agreed price. The price is sufficient to allow MCo to earn a reasonable profit after paying the one percent commission to Mex-Lex.

MCo typically customizes the goods it makes according to the specifications of each of the U.S. companies. As a result, the products purchased by ACo typically would not be identical to products purchased by BCo and CCo. MCo is prohibited by its contracts with ACo, BCo and CCo from selling the goods it produces to anyone else. Employees of ACo, BCo and CCo visit the MCo plant quite frequently to see that the products are being manufactured properly. The employees typically stay for a couple of months and never for more than five months. They are paid by the U.S. companies.

The tax laws of Mexico provide that foreign residents and foreign corporations are not taxable in Mexico on business profits unless they have a permanent establishment (PE) in Mexico. Under the maquiladora legislation, a U.S. firm is treated as not having a PE in Mexico as a result of its relationship with a maquiladora. In accordance with this legislation, ACo, BCo and CCo have no PE in Mexico under Mexican domestic law and pay no income taxes to Mexico. Because of U.S. loss carryovers, the three firms also pay no income taxes to the United States.

In recent weeks, it has been reported that the Mexican government has become unhappy with the maquiladora legislation. According to the rumor mill, Mexico believes that the cost

of the program in lost tax revenues is no longer justified. It allegedly is considering legislation that would modify the tax exemption. In particular, it is said to be considering a repeal of the domestic law rule that provides that a maquiladora is not the PE of the foreign firms that it serves. In response to the rumors, ACo, BCo, and CCo have engaged Mex-Lex to lobby the Mexican government to retain the maquiladora legislation in its current form. They have advanced US $500,000 to Mex-Lex to cover its expected fees and the expected lobbying expenses. Mex-Lex has already begun the lobbying out of its Monterrey office and expects to open an additional office in Mexico City soon.

Answer each of the following three subquestions in your bluebook. You should assume that all of the articles of the U.S./Mexico treaty, other than Article 5 (Permanent Establishment), are based on the U.S. Model Treaty. You should assume that the treaty includes Article 5 of the actual U.S./Mexico treaty (attached).

(a) (10 points, 10 lines) Assume that Mex-Lex's lobbying efforts are unsuccessful and that Mexico repeals its domestic maquiladora legislation providing that a maquiladora is not a PE of the foreign firms for which it does manufacturing. In that event, would ACo, BCo, and CCo have protection against tax under Article 5 of the U.S./Mexico tax treaty? Explain.

(b) (10 points, 10 lines) Assume, for purposes of this subquestion only, that MCo causes ACo, BCo, and CCo to have a PE in Mexico and that the maquiladora legislation is repealed. Under those assumed facts, what income of ACo, BCo, and CCo is Mexico permitted to tax under the U.S./Mexico treaty on account of that PE? Explain.

(c) (10 points, 10 lines) Would the result in (a) above be different if the U.S./Mexico treaty contained the standard Article 5 found in the OECD Model Convention? Explain.

(d) (10 points, 10 lines) Does Mex-Lex have a PE in Mexico? More precisely, do the activities, etc., of Mex-Lex cause Mr. W to have a PE in Mexico? Explain.

(e) (10 points, 10 lines) Assume that Mex-Lex and Mr. W do have a PE in Mexico and that the Mexican tax code imposes tax on Mex-Lex and Mr. W to the extent allowable by treaty. Under these assumed facts, what income of Mex-Lex and Mr. W is taxable by Mexico under the U.S./Mexico treaty? In particular, discuss the taxation in Mexico of the one percent commission paid by MCo to Mex-Lex.

B.
(Maximum points: 30; maximum lines: 40)

Question 2. Miss S is a professional skiing instructor. She is 28 years old. She is a citizen of Country S and no other country. From December 1 to April 1, she lives in Country S, giving skiing instructions at a famous resort in that country. The resort provides her with free lodgings at the resort and a guaranteed salary of $10,000 for giving group lessons to guests at the hotel. The lodgings have a fair market value of $20,000. With tips and fees from private lessons, Miss S usually earns an additional $50,000 in Country S. In addition, Miss S owns shares in a Country S mutual fund. From the mutual fund, she receives annual dividends of $20,000, which she reinvests in the fund. Although she owns the mutual fund and is liable for taxes on its income, she holds it jointly with her mother, who lives in Country S. When she is living in Country S, Miss S visits here mother frequently, and the mother occasionally goes to visit her daughter at the ski lodge. The mother was a member of the Country S skiing team in the 1975 Olympics. Aside from her mother, Miss S has no close family. She has an active social life but no steady boy friend.

After the skiing season in Country S ends, Miss S goes to Country B, an island tourist destination, to relax on the beautiful beaches of that country. She stays there from April 1 to August 1. During that time, she lives in a small bungalow that she owns jointly with a girl friend who lives full-time in Country B. The bungalow is located just off one of Country B's nicest beaches. It is valued at $100,000. Miss S is an expert swimmer and does a lot of snorkeling around the coral reefs of the island. On several occasions, Miss S has been offered a job by one of the local resorts to give tourists a guided tour of the coral reefs, but she has always declined the offers. The job would pay $30,000 for the summer season.

At the beginning of August, Miss S travels to Country Z, located in the southern hemisphere. There she stays at a large resort and gives skiing instructions. The resort provides her with free lodgings and meals at the resort and pays her a guaranteed $6.000 to give skiing instructions to guests at the hotel. The meals and lodgings have a fair market value of $10,000. With tips and fees from private lessons, Miss S earns an additional $24,000 in Country Z. Miss S stays in Country Z from August 1 to November 1. She then returns to Country B for the month of November, before returning to Country S at the beginning of December.

Domestic tax rules. Miss S is treated as a resident under the domestic laws of County S, Country B, and Country Z. Country S and Country Z tax their residents on their worldwide income. They give relief from double taxation using the credit method and only through

their tax treaties. Both countries tax nonresident individuals only on income having a source in their country. Country B does not tax its residents with respect to their foreign earned income but does tax them on their foreign investment income. Under the tax rules of all three countries, earned income has its source where the services are provided, and dividends have their source in the country where the entity paying the dividends is located. Country Z includes in income the value of food and lodgings provided to employees. Country S and Country B do not tax such food and lodgings if they are provided on the business premises of the employer. All three countries tax income at a flat rate of 30 percent. They allow no deductions that are relevant to this question.

Tax treaty rules. Country S has a tax treaty with Country Z but does not have a tax treaty with Country B. Country Z has a tax treaty with both countries. All of the treaties are based on the OECD Model Convention.

(a) (8 points, 10 lines) In which country is Miss S a resident under the Country S/Country Z tax treaty? Explain. If you believe there is some doubt as to Miss S's country of residence, explain how that doubt would be resolved.

(b) (8 points, 10 lines) In which country is Miss S a resident under the Country B/Country Z tax treaty? Explain. If you believe there is some doubt as to Miss S's country of residence, explain how that doubt would be resolved.

(c) (12 points, 14 lines) For purposes of this subquestion only, assume that Miss S is a resident of Country S under the Country S/Country Z treaty and a resident of Country B under the Country B/Country Z treaty. How will Miss S be taxed by each of the three countries? In giving your answer, specify the relief from double taxation that she would be entitled to receive and discuss whether she will be subject to double taxation that is not relieved under the treaties.

(d) (12 points, 14 lines) For purposes of this subquestion only, assume that Miss S is a resident of Country Z under the Country S/Country Z treaty and a resident of Country Z under the Country B/Country Z treaty. How will Miss S be taxed by each of the three countries? In giving your answer, specify the relief from double taxation that she would be entitled to receive and discuss whether she will be subject to double taxation that is not relieved under the treaties.

C.
(Maximum points: 20; maximum lines: 20)

Question 3. Mr. P is a resident of Country P. Country P and Country Q have entered into a tax treaty based on the OECD Model Convention. Country B and Country R have no tax treaties. Under its domestic tax legislation, Country P taxes its residents on their worldwide income. Country Q taxes nonresidents on all income that it is permitted to tax under its tax treaties. Mr. P does not have a permanent establishment or fixed base in Country Q and has no real property (immoveable property) located in Country Q. He earns the following items of income:

(1) A directors fee of $10,000 for attending a directors meeting of QCo. QCo is a corporation that is a resident of Country Q for all relevant purposes. The directors meeting was held in Country B, an island resort.

(2) Gambling winnings of $20,000 won at the Casino Royale, located in Country Q.

(3) A consulting fee of $30,000 received for consulting work done in Country R and paid by RCo, a corporation resident in Country R. Mr. P does not have a fixed base or permanent establishment in Country R.

(4) Interest income of $5,000 paid by a bank located in Country Q.

(a) (12 points, 12 lines) How is Mr. P taxed by Country Q on each of the four items of income described above after application of the tax treaty between Country P and Country Q?

(b) (8 points, 8 lines) Assume for purposes of this subquestion that Article 21 (Other Income) of the tax treaty between Country P and Country Q is identical to Article 21 of the U.S./Australia protocol (attached) and that the treaty otherwise follows the OECD model. Would that change in the treaty affect the ability of Country Q to tax any of the items of income set forth above? Explain.

(c) (Bonus question, 1 point) Where in this course have we encountered a provision essentially the same as Article 21 of the U.S./Australia protocol?

End of Exam

Supplemental Materials

Article 5 (U.S./Mexio Treaty, 1994)
PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially
a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. The term "permanent establishment" shall also include a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, or supervisory activity in connection therewith, but only if such building site, construction or activity lasts more than six months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of advertising, supplying information, scientific research, or for the preparations

relating to the placement of loans, or for similar activities which have a preparatory or auxiliary character, for the enterprise;

f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e), provided that the total activity of the combination is of preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State in respect of any activities which that person undertakes for the enterprise, if such person:

a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

b) has no such authority but habitually processes in the first-mentioned State on behalf of the enterprise goods or merchandise maintained in that State by that enterprise, provided that such processing is carried on using assets furnished, directly or indirectly, by that enterprise or any associated enterprise.

6. Notwithstanding the foregoing provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to reinsurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a representative other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business and that in their commercial or financial relations with the enterprise conditions are not made or imposed that differ from those generally agreed to by independent agents.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment

or otherwise), shall not of itself constitute either company a permanent establishment of the other.

ARTICLE 21 (U.S. Australia Protocol, September 27, 2001)
Other Income

(1) Items of income of a resident of one of the Contracting States, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

(2) The provisions of paragraph (1) shall not apply to income, other than income from real property as defined in paragraph (2) of Article 6 (Income from Real Property), derived by a resident of one of the Contracting States where that income is effectively connected with a permanent establishment or fixed base situated in the other Contracting State. In that case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

(3) Notwithstanding the provisions of paragraphs (1) and (2), items of income of a resident of one of the Contracting States not dealt with in the foregoing Articles of this Convention from sources in the other Contracting State may also be taxed in the other Contracting State.
[*Note: This Protocol has not yet been ratified by Australia or the United States. In answering the questions on this exam, however, you should assume it is in effect*.]

OECD Commentary
Articles 4 & 5(1992 with 1994, 1995, and 1997 Updates)

Commentary on Article 4
Concerning the Definition of Resident

I. Preliminary remarks

1. The concept of "resident of a Contracting State" has various functions and is of importance in three cases:

a) in determining a convention's personal scope of application;
b) in solving cases where double taxation arises in consequence of double residence;
c) in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs.

2. The Article is intended to define the meaning of the term "resident of a Contracting State" and to solve cases of double residence. To clarify the scope of the Article some general comments are made below referring to the two typical cases of conflict, i.e. between two residences and between residence and source or situs. In both cases the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory.

3. Generally the domestic laws of the various States impose a comprehensive liability to tax-"full tax liability"-based on the taxpayers' personal attachment to the State concerned (the "State of residence"). This liability to tax is not imposed only on persons who are "domiciled" in a State in the sense in which "domicile" is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.

4. Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, conse-quently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on "residence" have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.

5. This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or situs. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference.

6. An example will elucidate the case. An individual has his permanent home in State A, where his wife and children live. He has had a stay of more than six months in State B and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being a resident of that State. Thus, both States claim that he is fully liable to tax. This conflict has to be solved by the Convention.

7. In this particular case the Article (under paragraph 2) gives preference to the claim of State A. This does not, however, imply that the Article lays down special rules on "residence" and that the domestic laws of State B are ignored because they are incompatible with such rules. The fact is quite simply that in the case of such a conflict a choice must necessarily be made between the two claims, and it is on this point that the Article proposes special rules.

II. Commentary on the provisions of the Article

Paragraph 1

8. Paragraph 1 provides a definition of the expression "resident of a Contracting tate" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws (cf. Preliminary remarks). As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service). In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory. According to its wording and spirit the provision would also exclude from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. This, however, has inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended. The exclusion of certain companies from the definition would not of course prevent Contracting States from exchanging information about their activities (cf. paragraph 2 of the Commentary on Article 26). Indeed States may feel it appropriate to develop spontaneous exchanges of information about companies which seek to obtain treaty benefits unintended by the Model Convention.
(Amended on 23 July 1992; see HISTORY)

8.1 It has been the general understanding of most Member states that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding.
(Added on 21 September 1995; see HISTORY)

Paragraph 2

9. This paragraph relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States.

10. To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will

satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State. The facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.
(Amended on 21 September 1995; see HISTORY)

11. The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.

12. Sub-paragraph a) means, therefore, that in the application of the Con-vention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.

13. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).

14. If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.

15. If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that

considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

16. Subparagraph b) establishes a secondary criterion for two quite distinct and different situations:

a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;

b) the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

17. In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

18. The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

19. In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, subparagraph b) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

20. Where, in the two situations referred to in subparagraph b) the individual has an habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them, subparagraph d) assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25.

Commentary on Article 5
Concerning the Definition of Permanent Establishment

1. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.
Paragraph 1

2. Paragraph 1 gives a general definition of the term "permanent establishment" which brings out its essential characteristics of a permanent establishment in the sense of the Convention, i.e. a distinct "situs", a "fixed place of business". The paragraph defines the term "permanent establishment" as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

- the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character-i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a "productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or

rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 20 below).
(Amended on 23 July 1992; see HISTORY)

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. 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, only 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. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus-retrospectively-a permanent establishment.

7. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other

State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances.
(Amended on 23 July 1992; see HISTORY)

9. Omitted

10. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business (cf. paragraph 35 below). But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.
(Renumbered and amended on 23 July 1992; see HISTORY)

11-24. Omitted

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. 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.
(Renumbered and amended on 23 July 1992; see HISTORY)

26. Moreover, sub-paragraph e) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of sub-paragraph e).
(Renumbered on 23 July 1992; see HISTORY)

27-30 Omitted.

31. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.
(Renumbered and amended on 23 July 1992; see HISTORY)

32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies. 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.
(Amended on 31 March 1994; see HISTORY)

33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.
(Renumbered on 23 July 1992; see HISTORY)

34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.
(Renumbered on 23 July 1992; see HISTORY)

35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.
(Renumbered on 23 July 1992; see HISTORY)

36-39 Omitted.

40. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company. (Renumbered on 23 July 1992; see HISTORY)

41. However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.
(Renumbered on 23 July 1992; see HISTORY)

42. The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company.
(Renumbered on 23 July 1992; see HISTORY)

End of Supplemental Materials