Oecd model tax convention: fixed place of business: analysis

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Criteria of a " fixed place of business" under OECD Model Tax Convention on Income and on Capital 2005

Introduction

The OECD Model Tax Convention on Income and Capital (The Convention) regulates the right for one Contracting State to tax both the income and capital of the enterprise of another Contracting State. Chapter two of the Convention describes main terms used throughout the text of this Convention and this includes the concept of ' permanent establishment'. Under Article 7 of the Convention, a Contracting State may not tax the profits of an enterprise of another Contracting State unless the enterprise carries on its business from a permanent establishment situated within the taxing Contracting State. Clearly the requirement of clear guidance of the ascertainment of a permanent establishment is essential. This paper therefore explores and examines the criterion of a ' fixed place of business', which, under Article 5 of the Convention forms the definition of a permanent establishment. Part One of this paper will therefore examine the five tests used to determine the existence of a fixed place of business in order to determine liability to tax in the host Contracting State and provide a critical analysis of these criterion. Part two will question the existence of this harmonising principle in light of the political diversity o of tax policies across the globe.

Part One: Analysis of the Criteria for the ' Fixed Place of Business' under Article 5 of the OECD Model Tax Convention

A. Establishing the Fixed Place of Business Test – key considerations

1. Heritage and Moveable Property – Is there a distinction for tax purposes?

Article 5(1) of the Convention states that:

“ 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.”

Rohatgi notes that the ‘ place of business’ is one of five requirements to meet the definition of fixed place of business or permanent establishment. This essentially means that a place of business must exist in the jurisdiction of the Contracting, taxing State. As a starting point, the place of business constitutes:

“.. all the property and other tangible assets that are commercially used for business activities of the enterprise. [1] *”*

Reference to the place of business including tangible assets is also found in paragraph 2 of the commentary to Article 5 of the Convention which refers to machinery and equipment. The idea that a place of business can in some way include moveable assets does at first seem strange given that a fixed place of business would indicate the presence of heritage as the exclusive test. However, this raises two points in the analysis of Article 5 of the Convention. Firstly, this Convention is an international harmonisation document that endeavours to apply a uniform set of regulations to business enterprises belonging to Contracting states and the success of this regulation is dependent upon achieving a diverse application of ‘ place of business’ to cover all possible business entities. Secondly, not all business entities will include heritage as part of their operation and cannot be

rendered immune to tax liability on such a trifle. Market stall vendors and outdoor performers whose operations are owned by Contracting States other than the State in which they carry out their business are obvious examples and there are further illustrations under paragraph 4 of the OECD Commentary to Article 5:

" 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)."

1. Leased Equipment

(a) Is there a distinction between tangible and intangible property?

Paragraphs 8 of the OECD Commentary to Article 5 refers also to leased equipment constituting a permanent establishment so long as the activity is entrepreneurial:

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 Special Consideration of the Leasing of Containers

Paragraph 9 of the OECD Commentary states that:

" The leasing of containers is one particular case of the leasing of industrial or commercial equipment which does, however, have specific features."

Indeed, the Commentary goes on to state that the consideration of the leasing of containers is discussed in the report entitled , “ The Taxation of Income Derived from the Leasing of Containers. [2] ”

3. Dependent Agents

In addition to heritage, moveable property and leased equipment Article 5(5) of the convention and states that non-independent agents concluding contracts in one Contracting State, for and on behalf of the enterprise of another Contracting State, will themselves satisfy the criterion of a fixed place of business for the enterprise:

“…In respect of any activities which that person undertakes for the enterprise. [3] *”*

Analysis of this issue reveals three intriguing points on the matter of determination of the dependent agent. The first is the argument of Civil agency law versus the Common law counterpart. The second relates to the general success of harmonisation and the third is a critical analysis of the appropriateness of harmonising ‘ fixed place of business’ for the purpose of establishing a uniform rule for taxation, the most political topic in existence! Each of these points is assessed in detail in relation to the appropriateness of a uniform criteria for a ‘ fixed place of business’.

For now, the remainder of this chapter of part one, discusses the Model Tax Convention rules on the ascertainment of an independent or dependent agent.

As regards independent agents, the first thought is that these individuals are enterprises in their own right and are consequently irrelevant to the tax considerations of their clients. This point is altogether obvious and seems to be superfluously emphasised under Article 5(6). Paragraph 36 of the OECD Model Tax Convention Commentary on Article 5 states that while this factor does ‘ stand to reason’ it was nevertheless added into the Convention in order to supply clarity:

It is however also worth noting that the consideration of whether an agent is dependent or not is, for tax purposes, not exclusive to the paragraph 37 considerations of whether the agent is employed or self-employed.
Paragraph 37 states:

“ A person will come within the scope of paragraph 6, i. e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

a) he is independent of the enterprise both legally and economically, and

b) he acts in the ordinary course of his business when acting on behalf of the enterprise.”

Indeed, further subjective considerations, which are set out in paragraph 38 to the OECD Convention Commentary to Article 5, are used to supply the case-by-case criteria needed to ascertain whether the agent is capable of constituting a fixed place of business. As stated by Vogel:

“ The characterization of a person acting on behalf of a company is typically based on the actual facts and circumstances of the relationship between the company and the person. [4] *”*

The criteria that are set out in paragraph 38 to the Article 5 Commentary are as follows:

1. The ‘ Control’ test

The Control test essentially mirrors the general principles of agency law [5] .

The OECD Model Tax Code presents a number of factors that are to be used when considering the extent of principal control over the agent. Firstly, under paragraph 38. 3, the agent will only be responsible to the principal for the portion of the work carried out on the behalf of the principal and all other considerations, such as employees, hours and conduct are in the hands of an independent agent.

Interestingly, any exerted authority on the scale of the agent’s business by the principal will not, on its own, indicate dependence [6] but where permission is sought for ‘ the manner in which the business is conducted [7] ’ dependence will be indicated.

In addition, dependence is obvious where the economic control over the business of the agent is in the hands of the principal [8]

2. The ‘ Number of Principals’ test

A further test is to establish independence via the number of principals whereby ‘ several’ would suggest more of a client/contractor relationship in which the immediate conclusion would be independence. However, the OECD Model Tax Code Commentary to Article 5 also specify that the consorted actions of several principals to control the actions of the agent cannot be overlooked as this would clearly indicate dependence.

(c) Excluded Tests

There are, in addition, criteria that are not used to establish independence. Article 5(7) excludes the interaction of parent companies and subsidiaries as binding each other to the jurisdictions of the States in which they are situated. Again, this point seems obvious given that parent companies and subsidiaries are linked exclusively by share ownership and are separate business enterprises in their own right. This means that they are therefore taxed independently of one another with the exception of provisions permitting the offsetting of losses between the parent and subsidiary. In addition, while there may be ongoing contracts between the parent and subsidiary, this relationship does in no way create any cross border tax liability.

The principles set out in the OECD Commentary to Article 5 for the establishment of the dependent agent as a fixed place of business in its own right is distinctly discursive. Indeed, the principles laid out in the Commentary are suggestive and this is in fact a wholly appropriate style for the consideration of tax liability, which, for the purpose of preventing gaping loopholes, must provide scope for a case by case analysis.

2. The ‘ Disposal’ Test

Rohagti asserts that it is a fundamental requirement that, for tax purposes, the fixed place of business is one where there exists a legal right of use for the enterprise:

“ The enterprise must have the legal right of use (de facto or legal), such that it cannot be removed from the place of business without its own consent. [9] *”*

Interestingly this contrasts with paragraph 4. 1 of the OECD Model Tax Code Commentary to Article 5, which states 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. 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…”

The fact is that Rohagti has treated the terms ‘ disposal’ and ‘ right of use’ as though they were interchangeable but, as illustrated in the OECD Model Tax Code Commentary, the two terms are entirely different. Disposal is in fact a tightening of the mere requirement for there to be a business presence and paragraphs 4. 3-4. 5 provide examples to illustrate the definition. The alternative term, ‘ right of use’ is linked to legality and it would clearly be unthinkable to determine that illegal occupation of premises

by the overseas enterprise would render it immune to tax liability by the taxing State!

The use of examples in paragraphs 4. 3-4. 5 of the OECD Model Tax Code is a clear attempt to steer away from an abstract principle that, as stated above with reference to dependent agents, would increase the risk of devastating loopholes in the law [10] . Indeed, in order to illustrate the effectiveness of the use of examples, it is wholly appropriate to simply draw from comparison of, for example, the visiting salesman and the employee of one enterprise, using the office of another. In the former there is a clear host/guest relationship whereby the discussion of the sales contract happens to be conducted face to face but could quite easily have been carried out from a distance. On the other hand, the latter is a permitted use of office facilities whereby the visiting employee is free to open drawers, use the IT and other office facilities and even store files in the course of the business of his employer’s enterprise but through the premises of the other company. The facilities are therefore, ‘ at the disposal’ of the employee.

There seems to be a very fine line drawn between the two examples and with such large consequences it is prudent to ask whether the test is fair. At this point it is however essential to realise that this is one of five tests which must all be satisfied in order to determine tax liability of the enterprise to the taxing Contracting State.

C. The ‘ Location’ Test

Article 5(2) of the Convention sets out a list of establishments that are deemed to be permanent for tax purposes but upon secondary inspection, there is equally a clear indication of ‘ fixed’ location within the jurisdiction of the taxing Contracting State:

“ 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.”

This is supported by paragraph 2 of the Commentary to Article 5 of the OECD Model Tax Code, which states that:

“ this place of business must be “ fixed”, i. e. it must be established at a distinct place…”

Further to this, paragraph 2 goes on to state that:

“ the carrying on of the business of the enterprise (is) 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."

It is clear from the simple analysis of this provision of the OECD Model Tax Code that there is no interpretative ambiguity on this matter. One question to pose however is whether a travelling place of business within the geographic area of the taxing Contract State ought to satisfy the requirements for a ' fixed place of business.' Rohagti comments on this issue by pointing out that the list is not exhaustive [11] but a second more persuasive argument in favour of the travelling office concept is that the overall concept of the Model Tax Code is to establish parameters for the fixed place of business in order to determine tax liability and it would seem absurd that mobile administration should form a convenient loophole.

D. The ' Permanence' Test

Article 5(3) of the Convention states that:

" A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

The Commentary refers to the notion of ' a certain degree of permanence.'

In Consolidated Premium Iron Ores Ltd [12] , Van Fossen, J stated that:

" The descriptive word ' permanent' in the characterization ' permanent establishment' is vital in analyzing the treaty provisions. It is the antithesis of temporary or tentative. It indicates permanence and stability. [13] *"*

E. The ‘ Business Activity’ Test

The requirement for there to be business activity is an essential requirement which is deeply rooted in the basic ethos surrounding income and tax on capital. This is that tax can only ever be attributable to profits and chargeable gains and tax is therefore strictly a fiscal contribution following realisation of a financial gain. Without business activity within the jurisdiction of the tax authority there would be no financial gain to speak of and, hence no tax liability.

In relation to Article 5(2) and the ‘ location’ and ‘ permanence’ tests, the list of establishments give rise not only to a sense of geographic placing and longevity but also to business activity. This is due to the fact that the list under Article 5(2) is of obvious commercial premises. This is further illustrated by the fact that the corresponding list of examples of premises that are deemed not to be permanent clearly shows that establishments devoid of business activity will not fall within the definition of fixed place of business. This list is found in Article 5(4) and includes such items as, the use of facilities solely for the purpose of storage, display or delivery of goods belonging to the enterprise [14] ; processing [15] collecting information [16] , any other activity of a preparatory or auxiliary nature [17] .

This concept is also evident from the early case of Consolidated Premium Iron Ores Ltd [18] in which the Canadian company in question had a postal address within the US but no office, telephone listing, no staff, bank accounts or audited accounts. The Court held that this postal address therefore could not constitute a permanent establishment as the term implied the existence

of an office that was staffed and capable of carrying out day-to-day business. Van Fossen J Stated:

“ The term ‘ permanent establishment’ normally interpreted suggests something more substantial than a licence, a letterhead and isolated activities. It implies the existence of an office staffed and capable of carrying on the day-to-day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity. [19] *”*

Part Two: Harmonisation and the Politics of Taxation!

(a) Civil versus Common Law principles of agency law!

The principle of distinguishing the dependent from the independent agent, for tax purposes is related the employment status of the agent. The dependent agent is merely a member of the enterprise’s personnel and therefore forms a remote extension of the business activity of that enterprise into the fiscal territory of another Contracting State. The general civil law is used throughout the OECD Convention which departs from the Common law principles on one key point; namely, that under Civil Law, where the principal is undisclosed, his agent cannot bind him to a transaction with a third party [20] . This directly contrasts with the opposite common law point [21] .

The problem however is that common law jurisdictions are free to interpret their own principles of agency law into the OECD Model Tax Code when determining a case falling within their own jurisdiction. Where this occurs, there is a clear departure from the harmonising objective of the OECD Model

Tax Code and, consequently, tax consequences will differ between Contracting States. This was the finding of the legal department of the International Monetary Fund in 2004 [22] .

An additional finding of the IMF was the different treatment of managing partners under the two types of jurisdiction. In Civil jurisdictions, managing partners are not agents whereas, under the Common Law, the opposite holds true. This leads to yet another fundamental flaw in the harmonising objective of the Model Tax Code. The IMF failed in their observations to publish any critique on the matter but two points are raised by the issue.

(i) Increasing the Success of Harmonisation

The first is the wide implication of the success of harmonisation of laws of which this Convention is merely an example. Clearly one solution to the issue of whether to adopt the Civil or Common law approach is to simply pick one and announce its application. An example of this is found under Article 25 of the 1980 Vienna Convention for the International Sale of Goods (CISG), which has adopted the extremely onerous, Civil test of ‘ fundamental breach’ as opposed to the Common Law principle of ‘ material breach’ of a term of the contract. By virtue of UK dominance in the history of international carriage of goods, the latter is widely used in contracts of carriage by sea.

Therefore, the adoption of the Civil approach in the harmonising Convention is one of the reasons why the UK is not a party to the CISG and indeed why many states expressly contract out of this convention and opt instead for English law as the governing law of their contracts. This therefore suggests

that harmonisation should not aim for a single principle of law across the globe but should aim for the less daunting objective of creating international certainty with limited bilateral deviances.

This less invasive option would be easily carried out in the current Model Tax Code into which the Contracting States are free, within their bilateral discussions, to fill in the blanks in the course of their own negotiations.

2. Tax and Politics

It cannot be denied that taxation policy is one of the most politically entrenched subjects given that the social persuasions of the Government of the day will have a profound impact on rates of tax. In simple terms, capitalist States such as the USA will invoke low taxation as a means to encourage investment and increased entrepreneurial risk taking. By contrast, socialist ideologies of States such as Germany incur higher rates of tax due to the ethos that enterprises are obligated to contribute heavily to the infrastructure of the jurisdiction in which they operate. In addition, taxation of foreign enterprises is highly sensitive given the implications of the Contracting States as regards their Foreign Direct Investment (FDI) policies and this in turn has huge implications for the entire economy.

Taken as a whole it is clear that any move to harmonise international tax policies is a mammoth undertaking in its own right and legal interpretative differences under the law of agency is an inevitable compromise towards the wider goal of creating global certainty in bi-lateral tax agreements.

Footnotes

[1]

[2] See Volume II of the loose-leaf version of the OECD Model Tax Convention, at page R(3)-1.

[3] The Convention, Article 5(5)

[4] K. Vogel, January 2003, *Double Taxation Conventions* , 3 rd Edition, Kluwer Law International, OECD, at p 342

[5]

[6] Commentary, paragraph 38. 4

[7] ibid

[8] ibid, paragraph 38. 7

[9]

[10]

[11] at p 76add

[12] (1959) US 28 TC 127 (US)

[13] ibid at p 152

[14] The Convention, Article 5(4)(a)

[15] The Convention, Article 5(4)(c)

[16] The Convention, Article 5(4)(d)

[17] The Convention, Article 5(4)(e)

[18] (1959) US 28 TC 127 (US)

[19] ibid at pa 152

[20] For further insight see, J. F. Avery Jones and D. A. Ward, 1993, *Agents as Permanent Establishments Under OECD Model Tax Convention* , British Tax Review 341

[21]

[22] December 2004, *Tax Law Note: What is meant by the Concept of ' Agent' in Tax Legislation?* [Available Online] At: http://www. imf. org/external/np/leg/tlaw/2004/notes/eng/agent. htm