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Article 5: The meaning of “connected projects”

**NOTE ON UNITED NATIONS MODEL TAX CONVENTION ARTICLE 5:
THE MEANING OF “CONNECTED PROJECTS”**

Summary

This note has been prepared by Ms Claudine Devillet in consultation with certain other Committee of Experts on International Cooperation in Tax Matters (“Committee”) Members and observers. At its seventh annual session the Committee noted in its report that: “[t]he need to clarify the meaning of the word “connected” to describe projects that were sufficiently related to be added together in paragraph 12 [of the Commentary on Article 5] was also raised and it was decided to include it in the Catalogue of Issues for future discussion.”¹ The Committee requested Ms Claudine Devillet to provide a paper on the meaning of “connected” in relation to Article 5.²

This paper was prepared by Ms Devillet in response to that Mandate.

¹ Report of the seventh annual session, E/2011/45 at paragraph 31.

² Ibid, at paragraph 118.

Article 5: the meaning of “the same or a connected project”

1. Article 5(3)(b) of the UN Model addresses the situation of an enterprise that performs services in a Contracting State through employees or other personnel in relation to “the same or a connected project”. There is no guidance in the Commentary on Article 5(3)(b) with respect to the meaning of the terms “the same or a connected project” and Contracting States may interpret these terms in different ways. Some rules and some examples could be included in the UN Commentary in order to clarify this issue.

The view has been expressed within the Subcommittee on Services that the term used in Article 5(3)(b) is the “furnishing” of services and that the entire note proceeds on the assumption that furnishing means performing activities in the source country. Indian tax administration has been of the view that services can be furnished without the physical presence in the source country.

Even if the Article uses the terms “furnishing of services”, the test provided for in the Article in order to create a permanent establishment is the presence in the source country of employees or other personnel the activities of which continue (for the same or a connected project) within the source country for a specified period of time. In order to clarify the meaning of the terms “for the same or a connected project”, I consider that it is therefore appropriate to refer to the performance of activities within the source country in relation to one or several projects.

This issue should be discussed by the Committee.

2. The following paragraphs 12.1 to 12.8 could be added immediately after paragraph 12 of the Commentary on Article 5(3). Basically, the rules in these paragraphs are in line with paragraphs 42.39 to 42.41 of the OECD Commentary on Article 5 which relate to the alternative provision proposed by that Commentary with respect to the taxation of services.

12.1. As Article 5(3)(b) deals with the furnishing of services by an enterprise, the issue of whether the activities are performed “for the same or a connected project” should be considered from the perspective of the enterprise that furnishes the services and not from the perspective of the customer.

12.2 An enterprise may provide services to a single customer pursuant to two different projects whilst those services may relate to a single project for the customer. In such case, one should not consider that the services are performed for the same project.

Example 1: An enterprise provides services for the maintenance of several medical devices used by a customer as well as services for the training of medical staff operating different devices recently sold to that customer. Two contracts have been concluded by two different departments of the supplying enterprise and two different

types of services are performed by different employees. Those services are performed in the framework of two different projects even if, for the customer, they are part of a single project that relates to the operation of its medical equipments and is managed by a same department.

The following view has, however, been expressed within the Subcommittee:

Based on paragraph 42.40 of the OECD Commentary on Article 5, in our view, the OECD perspective-of-the-supplier interpretation is produced when interpreting the meaning of the expression “same project” and not when dealing with the meaning of “connected project” (paragraph 42.41). The following modification is therefore proposed in paragraph 12.1: “As Article 5(3)(b) deals with the furnishing of services by an enterprise, the issue of whether the activities are performed “for the same ~~or a connected~~ project” should be considered from the perspective of the enterprise that furnishes the services and not from the perspective of the customer.”

The following view has, also, been expressed within the Subcommittee:

There is no justification to determine the issue as to whether the activities are performed "for the same or connected project", from the perspective of the enterprise that furnishes the services and not from the perspective of the customer. The language of the Article only requires that the project or the connected project for which the services are furnished should be in a Contracting State and rendering of services should meet the duration test. In my view if from the perspective of the supplier or from the perspective of the recipient, services are for the same or connected project and the duration test is met, the source country can assert creation of a PE. I, therefore, do not agree with the guidance suggested in paragraph 12.1 and the example given in paragraph 12.2.

I consider, however, that a same approach should be followed while determining whether an enterprise furnishes services for a same project or whether it furnishes services for connected projects. The commercial coherence should be considered from the perspective of the enterprise that furnishes the services and not from the perspective of the customer.

This issue should be discussed by the Committee.

12.3. Conversely, an enterprise may provide services to several related enterprises in the framework of a single project whilst these services relate to a different project for each of the customers. In such case, one should consider that the services are performed for the same project.

Example 2: An enterprise provides services for the maintenance of several similar machines used by a number of related companies. A single contract was signed by the director of the supplying enterprise, on the one hand, and by a representative of the parent company, on the other hand, and the services are performed by the same

employees. The contract provides for favourable conditions taking into consideration the large number of machines covered. Those services are performed in the framework of a single project.

12.4. The reference to “a connected project” is intended to cover cases where, even though the services are provided in the framework of separate projects, those projects are carried on by a single supplying enterprise and are commercially connected. This aggregation rule addresses in particular abusive situations under which the supplying enterprise would artificially divide its activities into separate projects in order to avoid meeting the 183-day threshold. The determination of whether projects are connected will depend on the facts and circumstances of each case. Factors that would be relevant for that purpose include:

- whether the projects are covered by a single master contract; the fact that the activities are covered by one or several contracts is, however, not conclusive; the interaction between the projects should be taken into account in order to determine whether or not they are connected;
- whether the contracts covering the different projects were concluded with the same person or related persons;
- whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;
- whether the projects would have been covered by a single contract absent tax planning considerations;
- whether the nature of the work involved under the different projects is the same;
- whether the same employees are performing the services under the different projects.

Example 3: A consultant has been hired to install a new computer system for a bank in State Y. That consultant’s activities will take place in the headquarters and in several separate branches of the bank within that State. All the activities are covered by two separate contracts, one of them covering the activities to be performed in the headquarters and the second one covering the activities performed in the branches. In such case, even if one concludes to the existence of two different projects, there is a commercial link between them so that they will be considered to be connected projects.

Example 4: A consultant is hired to install a particular computer system for a bank. At the end of this project, he is hired by the same company, pursuant to a separate contract, to train its employees to use new software unrelated to the computer system that he recently installed. In this case, even though both contracts are concluded between the same two parties, there is no commercial link between the two projects, which are therefore not connected.

Example 5: In June 2010, hardware company XYZ concluded a services contract with a resident of State Y. Pursuant to that contract, XYZ provides a large range of support with respect to any hardware of its own brand used by the customer. The support provided includes expert advice, maintenance and training, those services being performed by different employees. Furthermore, the services contract provides that hardware of another brand can be added to the contract as this hardware comes off support elsewhere. In July 2012, hardware of the brand TILL is added to the

contract. In this case, even though the master contract covers activities of a different nature (training and maintenance for instance) performed by different employees and even if additional activities were included later on, all the activities performed by XYZ are performed in the framework of commercially connected projects, since the large and flexible scope of its services contracts is an important sales argument for XYZ.

The following view has, however, been expressed within the Subcommittee:

I have reservation in respect of the sentence "the interaction between the projects should be taken into account in order to determine whether or not they are connected" in the proposed paragraph 12.4. This suggested paragraph primarily provides guidance to counter abusive division of activities in order to avoid meeting the 183-day threshold but the above quoted sentence introduces a new restrictive clause for creation of a PE. In my view, services can be for the same or connected project, without any interaction between the two projects because they can be connected from the perspective of the enterprise receiving the services and yet there be no interaction between the two projects. Example 4 if viewed from the perspective of the enterprise obtaining the services would find the two projects linked and, therefore, create a PE.

This issue should be discussed by the Committee.

12.5. The 183-day threshold provided for in Article 5(3)(b) may give rise to abuses. It has indeed been found that some enterprises divide a single project, or connected projects, into several parts, each covering a period or periods of less than 183 days, and attribute parts of those projects to one or more associated companies. Domestic legislative or judicial anti-avoidance rules may apply to prevent such abuses. This issue may, however, also be dealt with in Article 5 of the treaty through a specific provision, which could be drafted along the following lines:

"For the purposes of subparagraph 3(b), where an enterprise that is performing services in a Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that State for the same or a connected project through employees or other personnel who, during that period, are present and performing such services in that State, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in that State for that same or connected project through these employees or other personnel. For the purpose of the preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States."

12.6. According to this provision, the activities carried on in a Contracting State through the employees or other personnel of an associated enterprise for the same or a connected project are taken into consideration in order to determine if the 183-day threshold is met and if the activities carried on in that State by an enterprise of the

same Group are deemed to be carried on through a permanent establishment that the enterprise has in that State.

Example 6: Company LAMBDA, a resident of State X, obtains a contract for the maintenance of equipment situated on the industrial site of Company FIR, a resident of State Y. Those activities are supposed to be performed through several employees and to last 220 days. In such case, the 183-day threshold would be met and Article 5(3)(b) would apply. However, Company LAMBDA and Company FIR agree to split the project into two separate contracts:

- a first contract concluded between FIR and LAMBDA covers the maintenance of the equipment from 1 January to 30 June (120 days each year) for an annual fee of 240.000 euros; and
- another contract between FIR and Company DELTA, a member of the same Group as LAMBDA and a resident of State X, covers the maintenance of the equipment from 1 July to 31 December (100 days each year) for an annual fee of 200.000 euros.

The 120 days of activity performed by LAMBDA through its employees and the 100 days performed by DELTA through its employees are added together in applying paragraph 3(b) to LAMBDA and DELTA, so that the 183-day threshold is met. Under the alternative provision suggested in the preceding paragraph, the profits attributable to the activities performed by LAMBDA through its own employees are thus profits of LAMBDA attributable to a permanent establishment in State Y while the profits attributable to the activities performed by DELTA through its own employees are profits of DELTA attributable to a permanent establishment in State Y.

Example 7: If, under the same circumstances, DELTA were a resident of State Z and the tax treaty between State Y and State Z did not include a similar provision, the activities performed by LAMBDA through its employees would not be taken into consideration in applying paragraph 3(b) to DELTA. In this case, the 183-day threshold would not be met as far as DELTA is concerned. As a result, the profits attributable to the activities performed by DELTA through its employees would not be attributable to a permanent establishment in State Y and State Y would not have the right to tax those profits even though it would have the right to tax the profits of LAMBDA.³

12.7. Article 5(3)(b) addresses the situation of an enterprise that performs services in a Contracting State through employees or other personnel in relation to a particular project or to connected projects, and this over a substantial period of time. The 183-day threshold referred to in subparagraph 3(b) applies thus in relation to the enterprise and not in relation to the different employees or other personnel through which the activities are performed. A day will be taken into consideration for

³ In such case, the activities performed by DELTA through its employees would be taken into consideration in applying Article 5(3)(b) of its treaty with State X to LAMBDA, so that the 183-day threshold would be met as far as LAMBDA is concerned and LAMBDA would be deemed to have a permanent establishment in State Y. However, in accordance with Article 7 of that treaty, State Y would only have the right to tax LAMBDA on the profits attributable to the activities performed through its own employees and not the profits attributable to the activities performed by DELTA through its employees.

calculating the 183-day threshold provided, during that day, the enterprise performs its activities through, at least, one of its employees or other personnel or – if the anti-abuse provision suggested in paragraph 5 above is included in the treaty – one of the employees or other personnel of an associated enterprise present in that State. However, a day will count only as a single day regardless of how many employees or other personnel – of the enterprise itself or of an associated enterprise – are present in that State and performing services during that day.

Example 8: Company LAMBDA, a resident of State X, obtains a contract for the maintenance of several equipments situated on several industrial sites of Company FIR, a resident of State Y. Those activities are supposed to be performed through several employees and to last from 15 January 2012 to 31 October 2012 (i.e. 220 days of activities). In such case, the 183-day threshold would be met and Article 5(3)(b) would apply. However, Company LAMBDA and Company FIR agree to split the project into two separate contracts:

- a first contract concluded between FIR and LAMBDA covers the maintenance of equipment situated on two specific sites from 15 January to 30 June (i.e. 120 days of activity) for a fee of 240.000 euros; and
- another contract between FIR and Company DELTA, a member of the same Group as LAMBDA and a resident of State X, covers the maintenance of equipment situated on a third site from 15 January to 31 May (i.e. 100 days of activity) for a fee of 200.000 euros.

Even though the services performed through employees or other personnel of DELTA may be deemed to be performed by LAMBDA (and vice versa), all the services are performed within a period of 120 days. The 100 days during which activities are performed simultaneously through employees of both enterprises can only be counted once in applying paragraph 3(b) to LAMBDA and DELTA. As a result, neither LAMBDA nor DELTA has a permanent establishment in State Y and State Y has no right to tax their profits.

12.8 Under Article 5(3)(b) a permanent establishment also exists where services are not carried on through a fixed place of business but are performed in a Contracting State over a substantial period of time for a particular project or for connected projects. Where such is the case, the permanent establishment only encompasses the services performed for the particular project or for the connected projects and does not encompass other services carried on in that State during the relevant period. However, where other services are carried on in that State for unrelated projects and those other services do not of themselves create a permanent establishment but are of the same or similar nature as those effected through the permanent establishment, those other services may also be taxed in that State in accordance with Article 7(1)(c), which provides for a limited force of attraction.

3. While discussing the meaning of “the same or a connected project” within the Subcommittee on Services, some members of the Subcommittee have suggested adding a final sentence in paragraph 12 of the UN Commentary on Article 5, as underlined below:

12. (...) However, some countries find the “project” limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of 120 or 150 days’ duration. In order to avoid this type of manipulation and simplify the application of the permanent establishment concept to services, some countries prefer to eliminate this requirement in Article 5(3)(b) by deleting the expression: “(for the same or connected project)”.

They understand that the original main purpose of including paragraph 3(b) of Article 5 was to avoid the difficulties of applying the requirements of paragraph 1 to the service activities. The “same or connected project” requirement implies limitations that undermine this objective (e.g. the commercial coherence limitation). For these reasons they consider that this view should be clearly stated in the Commentary.
