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Article 5 (Permanent establishment) : meaning of "connected projects"

Article 5: the meaning of "the same or a connected project"

Summary

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 and E/C.18/2012/CRP.5 was discussed at the eighth annual session in 2012, as noted in the report of that annual session[2]. Following the discussions, the Committee requested that Ms. Devillet redraft the paper, in the light of issues raised. This paper was prepared by Ms. Devillet in response to that Mandate, with changes from E/C.18/2012/CRP.5 highlighted.

[1] Report of the seventh annual session, E/2011/45 at paragraph 31.
[2] Report of the eighth annual session, E/2012/45 at paragraphs 64-75.

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.

2. Besides, Article 5(3)(b) refers to "[t]he furnishing of services … by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days …". Taking into consideration that Article 5(3)(b) uses the term "furnishing" and not the term "performing", a minority view was expressed during the eighth session of the Committee that services furnished within the source country without the physical presence of personnel or employees in that country are covered by that provision if the furnishing of services within the country lasts more than 183 days. During the discussion, a large majority of those speaking considered, however, that a physical presence is required by Article 5(3)(b). The UN Commentary should clarify this issue.

3. Finally, many countries that share the view that a physical presence is required in the source country consider that only the performance of services through employees or other personnel within a Contracting State during the specified time period constitutes a permanent establishment. Consequently, only the profits attributable to the said performance are taxable in the source country in accordance with Article 7. Some countries, however, consider that the term "furnishing" used in Article 5(3)(b) implies that, where employees or other personnel are present in the source country during the specified time-period, the furnishing of services constitute a permanent establishment. Consequently, all the profits attributable to the services furnished in the framework of a same project or connected projects, including profits attributable to activities performed outside the source country, are taxable in the source country in accordance with Article 7. The UN Commentary should also discuss this issue.

4. The following paragraphs 12.1 to 12.8 could be added immediately after paragraph 12 of the Commentary on Article 5(3).

> 12.1 A large majority of countries consider that, under subparagraph b), the term "permanent establishment", only encompasses service activities if they are performed (for the same or connected project) by employees or personnel which are physically present within a Contracting State during a specified period or periods. As subparagraph (b) refers to "[t]he furnishing of services" and not to the performance of services, a minority view is, however, sometimes expressed that services furnished within a Contracting State without the physical presence of personnel or employees in that State are covered by that provision if the furnishing of services within that State lasts more than 183 days (e.g. the furnishing of remote services by electronic means during the specified time threshold to a person established in a Contracting State). Such extended interpretation is in contradiction with the intention of the Group of experts that has decided to include subparagraph b) in the UN Model (1980). The

Manual for the negotiation of bilateral tax treaties between developed and developing countries (1979) refers, indeed, to the discussions held within the Group and makes it clear that the majority view must prevail. The following comments indicate that members from developing countries and from developed countries understood that the text retained was requiring a physical presence in the State of source:

> "Concerning the time-limit established in paragraph 3, subparagraphs (a) and (b), of guidelines 5, some members of the Group from developing countries said that they would have preferred to remove the time-limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those activities; and, secondly, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. […]
>
> Most members agreed that monetary limitations, if set by analogy with those applied to services of individuals in a number of tax treaties, would be meaningless in the area of the corporate services here discussed, while other members were opposed to any monetary limitations. On the other hand, some members felt that the physical presence of representatives of a foreign corporation in the source country for a minimum period, such as six months, would be a reasonable limitation which would, as a practical matter, cover most of the important situations and would preclude administrative difficulties in the case of merely sporadic activities."

12.2. Many countries consider that, under subparagraph b), the term "permanent establishment" only encompasses the services performed through employees or other personnel within the State of source during the specified time-period. Consequently, only the profits attributable to the services performed within that State are taxable in that State in accordance with Article 7. Some countries consider, however, that the term "furnishing" used in subparagraph (b) implies that, where employees or other personnel are present in the State of source during the specified time period, the term "permanent establishment" encompasses the services furnished in that State. Consequently, all the profits attributable to the services furnished in the framework of a same project or connected projects, including profits attributable to activities performed outside the State of source in order to furnish those services, are taxable in that State in accordance with Article 7. The text of subparagraph b) is not clear in this respect and is unable to support one interpretation rather than the other. Countries should, consequently, clarify their positions and agree on this issue bilaterally.

12.3. As Article 5(3)(b) deals with the furnishing of services by an enterprise, it would seem logical to determine the issue of whether the activities are performed "for the same or a connected project" from the perspective of the enterprise that furnishes the services and not from the perspective of the customer. Some members of the Committee stress, however, the fact that the condition "for the same or a connected project" must not allow situations where an enterprise could easily split projects up into different parts and avoid the time threshold of subparagraph b). Consequently these members consider that such condition should be examined from the perspective

of both the enterprise that furnishes the services and the customer. Following that approach it would be only where it would be clear, from the perspectives of the enterprise and the customer, that no single project exists or that different projects are not connected that one should consider that activities are not performed for the same or a connected project. [The Committee is of the opinion that this approach should be favoured in order to determine if activities would be performed for the same or a connected project.]

Example 1: An enterprise provides services for the maintenance of several medical devices used by a nursing home 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 unrelated projects from the perspectives of the supplying enterprise because these projects have no commercial link from the perspective of that enterprise except the fact that the different types of services are furnished to a same customer. From the perspective of the customer, it seems difficult to argue that the two contracts are part of a same project simply because the different types of services relate to the operation of medical equipment pertaining to the nursing home (see paragraph 12.4 hereafter). Some members of the Committee would, however, consider that the services covered by the two contracts would be furnished for the same project or, at least, for connected projects from the perspective of the customer.

The following view has been expressed:

> 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."

It would be inconsistent to adopt different perspectives in order to determine if there is a single project or if there are connected projects. The note proposes therefore tentatively to take both perspectives into consideration in both cases and to depart from the approach followed under paragraph 42.40 of the OECD Commentary. If one would follow the guidelines provided under paragraph 12.4 hereafter, it seems that the result of the proposed approach would, in most cases, be similar to the result of the OECD approach. It is only if a country would consider that projects are connected simply because services activities are performed for a single customer that the proposed approach would enlarge more significantly the scope of subparagraph b).

The following view has, also, been expressed:
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.

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.

Even where the supplying enterprise provides services to different customers, these services may be considered as being performed in the framework of a same project, or at least in the framework of connected projects, from the perspective of the supplying enterprise.

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 may be relevant for that purpose include:

- whether the projects are covered by a single master contract; the fact that the activities are covered by several contracts is, however, not conclusive; the interaction between the projects covered by the different contracts should be taken into account in order to determine whether or not the projects are connected (see the following factors);
- 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.

Some members of the Committee have, however, expressed the view that services activities performed for different projects may be considered as performed for connected projects because they are performed for a single customer and that no specific interaction between the projects is required in such case.

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, based on a comparison between several estimates established by different professionals, he is hired again by the same company, pursuant to a separate contract, to train 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 interaction between the two projects, which are therefore not connected neither from the perspective of the consultant nor from the perspective of the customer. Taking into account the fact that the services activities are performed for a single customer, some members of the Committee would, however, consider that the services are performed for connected projects.

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.

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 subparagraph 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 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 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 subparagraph 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.

[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.

> 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.

5. While discussing the meaning of "the same or a connected project" some members of the Committee 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. <u>In order to avoid this issue 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)"</u>.

They understand that the original main purpose of subparagraph b) 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.

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