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

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

In the seventh session of the Committee it was acknowledged that it is necessary to clarify the meaning of the word "connected" in Article 5 paragraph 12 to describe projects that are sufficiently related to be added together. Ms. Claudine Devillet was requested to prepare a paper for the eighth session as well as updates for the ninth and the tenth session. The meaning of "the same or a connected project" was discussed during those sessions. The changes to the UN Commentary in that respect should in particular clarify whether physical presence is required, which factors are relevant for the determination of whether projects are connected, and if the condition "for the same or a connected project" should be examined from the perspective of the enterprise or the customer. Furthermore, an additional optional provision for the calculation of the 183-days threshold for situations where different parts of the same or a connected project are performed by different associated enterprises is suggested. As paragraph 12.1 and 12.2 (as redrafted during the tenth session) were already agreed on in the tenth session, this update includes only the Secretariat's suggestions for a few editorial changes to these paragraphs. In the tenth session, it was also agreed that paragraph 12.3 should be reviewed to clarify the issues raised by simplifying the language and reducing the number of examples.

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 several sessions 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, most countries consider that only the profits attributable to the performance of services through employees or other personnel within a Contracting State during the specified time period can be attributed to a permanent establishment according to Article 5(3)(b) and are therefore taxable in the source country in accordance with Article 7. Some countries, however, have expressed the view that the term "furnishing" used in Article 5(3)(b) may imply that, where employees or other personnel are present in the source country during the specified period of time, 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 Committee has agreed during its ninth session that the UN Commentary should incorporate the interpretation shared by a large majority.

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 The Committee has agreed that the traditional interpretation of the current provision of subparagraph b) requires the physical presence in the source country of individuals, being employees or other personnel of the enterprise furnishing services, in order for a permanent establishment to exist in that State. This interpretation is in accordance 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 the following comments indicate that members from developing countries and from developed countries understood that the text retained required a physical presence in the source country:
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> > "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."

Article 5(3)(b) refers to furnishing of services, including consultancy services, by an enterprise through employees or other personnel. Some Committee members noted, however, that the development of the digital economy might create challenges for the application of that provision. The growth of the digital economy had resulted in enterprises of a Contracting State furnishing services in the other Contracting State with a limited physical presence or without any physical presence in that other State. They further noted that enterprises might now centrally manage many functions that previously required local presence, and expressed concerns about the effects of these changes on the allocation of taxing rights between the source country and the residence country. While some of those concerns may be addressed by adopting the Article on Fees for Technical Services, such an Article may not cover all services covered under Article 5(3)(b). These services may not be covered by Article 5(3)(b) if physical presence is required. Therefore, some Committee Members requested the inclusion of a minority view to the effect that a physical presence requirement is obsolete in view of the developments of the digital economy.

12.2 As, under the traditional interpretation of subparagraph b), the term "permanent establishment" only encompasses the services performed through employees or other personnel within the source country during the specified period of time, only the profits attributable to the services performed within that State are taxable in that State in accordance with Article 7. Furthermore, under that interpretation, profits attributable to activities performed outside the source country in order to furnish services in the framework of the same project or a connected project are not attributable to the permanent establishment and are not taxable in the source country.

12.3 The reference to "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 may 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 especially relevant for that purpose include whether:

- the projects are covered by a single master contract;
- the projects would have been covered by a single contract in absence of tax planning considerations;
- the contracts covering the different projects were concluded with the same person or related persons;
- the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;
- the nature of the services provided under the different projects is the same or similar;

- the same individuals engaged by the enterprise are performing the services under the different projects.

12.4 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, to avoid possibilities of abuse of this provision this condition should be examined from the perspective of both the enterprise that furnishes the services and the customer. If the activities form part of the same or a connected project from the perspective of either the enterprise or the customer, Article 5(3)(b) should apply. The provision therefore applies if the activities are part of the same or a connected project only from the perspective of the customer even though those activities are not part of the same or a connected project from the perspective of the enterprise performing the services. Only if a single project exists neither from the perspective of the enterprise nor from the perspective of the customer should projects be regarded as unconnected.

Looking at both the perspective of the enterprise and the perspective of the customer does not require examining the state of mind of the parties but rather considers what conclusions a reasonable person would draw on the perspectives of the enterprise and the customer, taking all relevant circumstances into account. The organizational structure of an enterprise should be considered but is not itself decisive. On this approach it is enough to meet the test if activities form part of the same or connected projects of either the enterprise or the customer from an objective perspective (considering the factors in 12.3).

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

Example 1: 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. The services are performed by the same employees. The contract provides for favourable conditions taking into consideration the large number of machines covered.
These services may be considered as being performed in the framework of the same project, or at least in the framework of connected projects, as the projects are connected from the perspective of the supplying enterprise. Even though the services were provided for different customers the services have been performed in the framework of a same project since it is sufficient for the activities to be within the same project of either the enterprise or the customer.

Example 2: An enterprise produces medical devices and offers a large range of support with respect to those devices. The enterprise has different departments with different employees responsible for production, maintenance and training. A nursing home buys medical devices from the enterprise and separately concludes two service contracts with that enterprise. Under the first contract, a department of the enterprise maintains

the medical devices. Under the second contract, another department trains the medical staff operating these devices.
From the perspective of the supplying enterprise those services can be considered as being performed in the framework of two unrelated projects. Separate contracts have been concluded and two different types of services are performed by different employees in different departments of the enterprise. The nature of the work is different as one contract provides for maintenance whereas the other contract provides for training.

From the perspective of the customer, however, the services provided under the two contracts could be considered as being part of the same project, or at least be connected projects. The contracts were concluded with the same person and are related to each other as they both concern the same medical devices. From an objective perspective the conclusion of one single contract would have been standard business practice.

The interpretation that both the perspective of the enterprise and the perspective of the customer have to be taken into account ensures that neither the state of mind of the parties nor the organizational structure of an enterprise are decisive factors for the determination whether activities form part of the same or connected projects.

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 seek to make what is in reality a single project, or connected projects, appear to be distinct projects, especially through the use of separate contracts and associated companies. Those apparently distinct projects cover periods of less than 183 days each and are partly attributed 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 determining whether the period of more than 183 days in any 12-month period referred to in subparagraph 3(b) has been met,*
> *a) where an enterprise performs services in a Contracting State during periods of time that do not last more than 183 days, and*
> *b) associated enterprises perform 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, during different periods of time,*
> *these different periods of time shall be added to the period of time during which the first-mentioned enterprise has performed services in that State. 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 3: Company R, a resident of State R, obtains a contract for the maintenance of equipment situated on the industrial site of Company S, a resident of State S. 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 R and Company S agree to split the project into two separate contracts:

- a first contract concluded between Company S and Company R covers the maintenance of the equipment from 1 January to 30 June (120 days); and
- another contract between Company S and Company X, a member of the same Group as Company R and a resident of State X, covers the maintenance of the equipment from 1 July to 31 December (100 days).

The tax treaties between State R and State S and between State S and State X include the alternative provision suggested in paragraph 12.5. The 120 days of activity performed by Company R through its employees and the 100 days performed by Company X through its employees are added together in applying paragraph 3(b) to Company R and Company X, so that the 183-day threshold is met. The profits attributable to the activities performed by Company R through its own employees are thus profits of Company R attributable to a permanent establishment in State S while the profits attributable to the activities performed by Company X through its own employees are profits of Company X attributable to a permanent establishment in State S.

If the tax treaty between State S and State X had not included the alternative provision, the activities performed by Company R through its employees would not be taken into consideration in applying subparagraph b) to Company X. In this case, the 183-day threshold would not be met as far as Company X is concerned. As a result, the profits attributable to the activities performed by Company X through its employees would not be attributable to a permanent establishment in State S and State S would not have the right to tax those profits even though it would have the right to tax the profits of Company R.[1]

12.7 Article 5(3)(b) addresses the situation of an *enterprise* that performs services in a Contracting State through employees or other personnel. The 183-day threshold referred to in subparagraph b) therefore applies to the enterprise and not to the different employees or other personnel through whom the activities are performed. A day will count towards the 183-day threshold if, during that day, the enterprise

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

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 is 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. [An enterprise that agrees to keep employees or other personnel available for a client who needs their services and charges the client for making such personnel available, the period during which the employees or other personnel are available to the client will count towards the threshold irrespective of the fact that they are idle during the days when they remain available.]

Example 4: Company R, a resident of State R, obtains a contract for the maintenance of several pieces of equipment situated on different industrial sites belonging to Company S, a resident of State S. Those activities are supposed to be performed through several employees and to last from 15 January to 31 October (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 R and Company S agree to split the project into two separate contracts:

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

Even though the services performed through employees or other personnel of Company X may be deemed to be performed by Company R (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 Company R and Company X. As a result, neither Company R nor Company X has a permanent establishment in State S and State S has no right to tax their profits.

12.8 Under Article 5(3)(b) a 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. 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)".

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.