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Taxation of Extractive Industries

**Proposed Guidance on Permanent Establishment in the  
Extractive Industries**

*Summary*

**This is an updated version of the Permanent Establishment guidance note presented as CRP 3, Attachment D, during the 12<sup>th</sup> Session of the Committee of Experts in Geneva. The note is for further consideration and approval at the Thirteenth Session of the Committee of Experts in December, with a view to its being incorporated in the 2017 Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries. Please refer to the Twelfth Session Coordinator's report, by Committee Member Mr. Eric Mensah (E/C.18/2016/CRP.3) for an overview of the Subcommittee's work.**

# Guidance Note on Permanent Establishment Issues for the Extractive Industries

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## A.- Executive Summary

- 1.1. This Note examines the concept of permanent establishment (referred to as PE hereafter) in the extractive industries. In this respect, it focuses on the main PE taxation issues relating to the extractive industry taking into consideration the relevant provisions and Commentaries established in the United Nations Model Convention (2011)<sup>1</sup>, the OECD Model Convention (2014) and the US Model Convention (2016)<sup>2</sup>.
- 1.2. While reference is made to the mining sector as required, the Note mainly deals with the PE concept in the oil and gas (hereinafter referred to as O&G) sector where a wide array of taxation issues arise. This paper elaborates on the implications of recognizing the presence of a PE, distinguishing the tax consequences for the contractor and subcontractors' as a result of the particular business features and different activities performed in a country.
- 1.3. The PE concept is one of the central elements of international taxation, particularly the law of tax treaties, and is primarily used for the purpose of the allocation of taxing rights when an enterprise of one State derives business profits from another State. The concept of PE is used in tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. Specifically, the profits of an enterprise of one State are taxable in the other State only if the enterprise maintains a PE in the latter State and only to the extent that the profits are attributable to the PE.
- 1.4. Despite the fact that the concept of PE has a long history, its practical application still raises a number of issues as reflected by the numerous articles, case law and disputes between taxpayers and tax authorities on what constitutes a PE. Questions have been posed about whether the current wording of PE provisions in the tax treaty Models and Commentaries remains sufficient to establish the proper allocation of taxing rights between the source State (State of the PE) and the residence State (State of the head office of the company itself). For example, the OECD has proposed updates to the PE notion and proposed changes to the commentaries under the Base Erosion and Profit Shifting Project, to prevent the artificial avoidance of PE status<sup>3</sup>.
- 1.5. Notwithstanding its strong physical presence in the source country which leads to the existence of a PE, the extractive sector, and particularly O&G activities comprise different phases and quasi-unique features and activities<sup>4</sup> which need to be examined on a case by case basis to determine the existence of a PE, based on the facts and circumstances involved.

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<sup>1</sup> The Committee is working on the next revision of the UN Model, expected in 2017.

<sup>2</sup> The relevant PE provisions of the OECD Model are broadly included in the UN Model, with certain exceptions which are highlighted in this note.

<sup>3</sup> OECD BEPS (Base Erosion Profit Shifting) Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7, 2015 Final Report of 5 October 2015.

<sup>4</sup> Exploration and Production of hydrocarbons is characterized as highly intensive in capital investment with a low level of success in locating raw materials and therefore, with a high level of risk.

- 1.6. In general, States enter into negotiations with O&G companies (contractors) regarding the primary economic aspects of the contract that defines extractive operations to be performed, i.e., the work commitment (i.e. bonus, seismic acquisition and number of wells to be drilled) [See also the Guidance Note on Negotiation and Renegotiation of Contracts] and, very frequently, the fiscal regime that governs the allocation of revenues resulting from O&G activity (e.g. royalties, cost recovery, taxes, and government participation<sup>5</sup>) applicable to such operations [See also the Note on Fiscal Take]. These contracts generally grant legal rights for exploration and production in a given delimited acreage (hereinafter referred as contract or contractual area), which is normally managed by several O&G companies under a Joint Operating Agreement (consortium or association) with normally one company appointed as the operator.
- 1.7. An additional important aspect of the O&G sector is that a great number of subcontractors are normally hired by the company appointed as the operator in the JOA. The use of many subcontractors is driven by the specialized and diverse types of works required to be performed at the site where E&P activities take place (e.g. seismic, drilling, casing, catering, logistics, Health, Security, and Environment (HSE)). PE issues with respect to drilling rigs deserve particular attention.
- 1.8. This Note also makes reference to other aspects of PE's in the extractive industry which might be relevant for determining whether a PE exists and should be taxed. For example, the "services permanent establishment" (services PE) where a PE exists when an enterprise furnishes services within a source country through its employees or other personnel under certain conditions.
- 1.9. Accordingly, this note is structured in three main parts; i.e. the first part discusses the different sections of the UN Model applicable to the O&G industry and how those provisions impact the different phases of the O&G production chain; the second part focuses on the construction work clause and how this clause applies to different relevant services performed by subcontractors; and the final part, structured under several issues, identifies other elements of the UN Model or activities in the sector that need to be taken into consideration when drafting a regulatory framework for the O&G industry.

## **B.- Purpose**

- 2.1. The purpose of this note is to provide an overview of some of the most prominent aspects of PE taxation as applied, in particular, to the O&G sector. The issue at hand, the PE concept, is a very complex subject and the chapter only attempts to assist policy-makers and administrators in developing countries in evaluating the different tax options available to

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<sup>5</sup> Many systems provide an option for the National Oil Companies to participate in development projects.

them, taking into consideration overall implications of their decisions, with respect to some of the PE issues which tend to arise in the O&G sector.

- 2.2. In this respect, the United Nations Model Double Taxation Convention between Developed and Developing countries is the only source that has received the Committee of Experts full endorsement. In case of conflict of interpretation between the note and the UN Tax Model, the latter is always to be considered to have higher value and superior technical accuracy.

## C.- Terms Used

### [DEFINITIONS TO BE UPGRADED AND TO BE ALIGNED WITH OVERVIEW NOTE]

- 3.1. The following terms are used in the Note:

**Contractual area:** The O&G activities are related to the geographical areas delineated in the Petroleum contract. They could also be identified, in general and depending on the country, as the “field” or “block”.

**Joint Operating Agreement (JOA):** an association or consortium of two or more O&G companies engaged in a business enterprise regarding a contractual area without actual partnership or incorporation. The JOA regulates the management of the operation and decision making.

**Petroleum contract:** Legal document signed between the government and the contractor giving title (mining domain) and E&P rights to the Contractual assigned area. There are several configurations, even in the same country, in terms of the rights and obligations assigned to the parties. These contracts can be classified as follows: (i) concession or license contracts, (ii) Production Sharing Agreements or Contracts (PSC), or (iii) service contracts.

**Operator:** In the JOA the participating O&G companies appoint one company as the “operator”. The operator is in charge of the current and ordinary activities and in implementing the decisions made by the parties through the management committee. Normally, the operator can act with some freedom in all areas not specifically falling under the decision making powers of the committee formed by the partners.

**Non-operator:** In the JOA the participating O&G companies, other than the operator.

**Ring-fence:** tax treatment attributed to some contracts whereby each contract is treated as an independent and autonomous unit. As a result, in general, losses from one contractual area cannot be offset against profits from another contractual area, even if both contractual areas are participated by the same contractor.

## D.- Background

- 4.1. When entering a country, O&G companies often structure their investment using a PE rather than incorporating a subsidiary. The main reason is generally based on non-fiscal motivations as a PE provides more flexible commercial features than subsidiaries. As a general rule, a PE

can be easier to set up and close down, making this structure more convenient for O&G companies that frequently enter into new countries lacking full knowledge of and experience in their markets. If the investment turns out to be unsuccessful (e.g. when there is no commercial finding during the exploration phase), the O&G company needs to smoothly withdraw from the block or contract area, sometimes leading to de-registering the branch.

- 4.2. Article 7(1) of the UN Model Convention provides that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a PE to which the profits are attributable. According to the Commentaries to the UN Model Convention, this Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention<sup>6</sup>. It incorporates the basic principle that unless an enterprise of a Contracting State has a PE situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State.
- 4.3. Article 5 of the UN Model Convention, which includes the definition of PE, is therefore critical to the determination of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. If economic activities do not fall within the definition of what constitutes a PE, the profits from such activities may only be taxed in the country of residence.
- 4.4. The UN Model Convention contains few specific provisions or commentaries dealing with issues related to the tax treatment of PEs in the extractive industries. The general rules contained in various articles of tax treaties have, however, been applied by countries to specific situations in the O&G industry, giving rise to different interpretations about the existence of a PE in this respect. Furthermore, due to its special nature and a desire to preserve taxation on O&G activity performed within their jurisdictions, several resource rich countries have opted to include specific provisions regarding extractive industries in their tax treaties<sup>7</sup>.
- 4.5. Before the OECD released its final reports regarding BEPS on 5 October 2015<sup>8</sup>, the definition of PE had not been subject to major changes since its adoption by the League of Nations in the 1920s<sup>9</sup>. On the contrary, OECD Commentaries on the articles of the OECD Model, mainly reproduced by the UN Model Convention, have been changed on different occasions in respect of PE in order to, for example, create specific rules for a characterization of a services PE or due to the progressive evolvement of e-commerce (OECD 2008 Model Convention), which reflected the outcome of the “Technical Advisory Group” created in 1999.

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<sup>6</sup> Para. 1 of Commentaries on Article 7 of the UN Model Convention.

<sup>7</sup> See for example Article 21 of the Nordic Convention. A special Article for the exploration and extraction of hydrocarbons can be found in the treaties of Argentina, Australia, Denmark, Greece, Malta, the Netherlands, the United Kingdom, Ireland, Latvia, Norway, the United Arab Emirates and the United States.

<sup>8</sup> In particular, BEPS Action 7: Preventing the artificial avoidance of PE status.

<sup>9</sup> Double Taxation and Tax Evasion Report, League of Nations Doc. C.216.M.85 1927 II (1927)

- 4.6. Notwithstanding the unchanged definition of PE in the OECD Model, divergent interpretations of the meaning of this term can be found for similar situations in different countries. Reasons for this could be due not only because of their different fiscal interest or their capacity to develop the natural resources with companies established within the country (e.g., countries without the technology and know-how necessary to explore and exploit their resources versus those having such expertise and skills) but in general because the concept of PE can give rise to different interpretations due to the language used in tax treaty models.
- 4.7. Exploration and production (hereinafter referred as E&P)<sup>10</sup> activities are usually carried out by O&G companies. Such entities are either granted a license to explore and develop O&G in a delimited area within a country or enter into agreements with the governmental authorities of a country to explore and exploit in a designated area in such country<sup>11</sup>.
- 4.8. The numerous kinds of contracts or fiscal arrangements (hereinafter referred as petroleum contracts) can generally be divided in concession or license contracts, pursuant to which the hydrocarbon belongs to the O&G company, production sharing agreements or contracts (PSCs) in which the State shares the results of the operation (government take) with the O&G company, or services agreements in which the State is the owner of the results of the operation but pays a fee to the O&G company for the services provided<sup>12</sup>.
- 4.9. While the ownership of the hydrocarbon is the fundamental distinction between a concessionary and contractual system, today most of these petroleum contracts grant O&G companies the right to explore, develop, produce and market natural resources, for a given delimited area and duration. The contractual area comprises a geographical area identified and delineated in the petroleum contract (i.e., the block or field).
- 4.10. As far as the extraction (production) of O&G is concerned, there is no doubt that the permanent character of this activity constitutes a PE. The problem generally concerns various other activities carried out in connection with exploration and exploitation of the natural resources. In this respect, amongst others, the following issues and their PE implications will be further developed in this Note (not in the order specified):

- the illustrative list of PEs (*“positive list”*)<sup>13</sup>,

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<sup>10</sup> Exploration & Production (E&P): is the process that includes searching for and extracting oil and gas under water or underground. It is generally known as the Upstream Process.

<sup>11</sup> Governments and O&G companies normally negotiate their interest in one of two basic systems: concessionary and contractual, being the ownership (of the hydrocarbon) the fundamental distinction. Under the concessionary system, the O&G company has title to the hydrocarbon produced and under the contractual system, the government retains title to the resources. However, both systems may coexist in one jurisdiction (for the mining and the O&G sector or, even, for the O&G sector) or mixed systems (a system that share features of both systems) apply.

<sup>12</sup> For more detailed information about contractual arrangements, please refer to the Guidance Notes on “Negotiation and Renegotiation of Contracts” and “Government Take”.

<sup>13</sup> UN Model Art. 5(2) (f): “a mine, an oil or gas well, a quarry or any other place of extraction of natural resources”.



- joint studies or reconnaissance permits,
  - exploration activities,
  - the existence of more than one PE,
  - the registration of a branch,
  - the representation office used for market research,
  - the office used for supporting activities, and
  - the consideration of non-operators as a PE.
- 4.11. Investors generally share the high investments and high risks involved in these projects by signing a JOA with other partners to carry on activities in the contract area. Under the JOA, one of the partners is designated the operator of the block being responsible for contracting for the resources and subcontractors necessary to carry out the activities committed with the State under the petroleum contract. The other partners in most cases make cash contributions in proportion to their interest in the joint venture.
- 4.12. A very important aspect of PE relates to those companies (that are subcontractors) contracted by the contractor to perform a wide range of activities at the source country. These subcontracting companies are characterized by their high degree of mobility and the short-term of the activity performed as relates to, for example, seismic, drilling, testing, maintenance, catering, engineering or consultancy services. In principle, if not already established, their presence in a country will be temporary with no aim or need to continue once they have finished their work. The construction or installation PE clause<sup>14</sup> and its relevance in respect, for example, of drilling rigs, support vessels and other related services will be the object of analysis.
- 4.13. Long-distance pipelines are used to transport oil and gas, sometimes crossing other countries and territories. The product is moved by pump stations along the pipeline. The PE tax treatment of this service of transport is also described in this guidance note.
- 4.14. Certain countries have included specific provisions (*“offshore clauses”*) in their tax treaties which allow source-state taxation to a greater extent than the ordinary PE concept does. In this context, it should be noted that several member States of OECD have recorded reservations to offshore hydrocarbon exploration and exploitation and related activities and reserved the right to insert in a special article provisions related to such activities<sup>15</sup>.
- 4.15. Finally, mention will be made of the alternative *“services PE”* provision and to a newly incorporated Article [16] in the UN Model Convention on *“fees for technical and other*

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<sup>14</sup> UN Model. Art. 5(3): *“The term ‘permanent establishment’ also encompasses:(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months”*.

<sup>15</sup> Para 47 of the Commentaries on Article 5 of the OECD Model.

*services*” approved at the eleventh session of the Committee of Experts on International Taxation in Tax Matters held in Geneva (19-23 October 2015).

- 4.16. Countries should balance the pros and cons of all above mentioned provisions, their adoption and application, according to their tax and economic policy and taking into consideration the country’s overall fiscal system. For example, if developing countries consider that introducing an “offshore clause” in their tax treaties is favorable as it extends the scope of PE taxation, they should also assess the cost-benefit balance of managing a greater number of PEs derived from the increased number of subcontractors that would fall under the conditions established in this clause.
- 4.17. Other means of achieving taxation on income obtained from activities that have reached a certain level of performance in the source country could be examined by developing countries. For example, a withholding tax could be imposed on cross-border payments (gross), that are deductible by the payer in determining tax on income. This system, which lies in a simpler and easier way of enforcement, reduces tax compliance costs for both the subcontractor and the source jurisdiction, but still requires a definition of a level of business required to trigger such withholding and the rate of withholding tax applicable to the payment. Other issues may be the fact that such payments could not be immediately deductible, not be-deductible (cost-oil) and that the payer may be required to be responsible for collecting and remitting the withholding tax.
- 4.18. It should be noted that to apply the appropriate taxation, income must first be characterized in the appropriate category. As mentioned above, several Articles of the UN Model Convention might become relevant and disputes may arise between the taxpayer and the tax authorities on which would be the applicable treaty provision. For example, in a case related to the income tax treaty between India and the Netherlands, it was questioned whether the consideration paid by the Indian company to the Dutch company in respect of the performance of an airborne geophysical survey fell within the definition of “fees for technical services” under Article 12 of such tax treaty<sup>16</sup>.
- 4.19. In summary, the UN Model Convention provides a number of provisions that allow States to design a competitive tax system aimed at the extractive industries, taking into account that several factors determine such competitiveness; e.g.: structure and rate of taxes, cost recovery of business investment, tax rules for foreign earnings and the administrative cost for tax administrations and businesses (e.g. registration and de-registration procedures for tax purposes, filing tax returns on time, reporting tax liabilities, payment of taxes on time, auditing of returns, and effective and timely resolution of disputes).

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<sup>16</sup> De Beers India Minerals Pvt. Ltd. v. ITO, (2008) 113 TTJ (BANG) 101.

## E.- The Basic Rule of Permanent Establishments

- 5.1. Article 7(1) of the UN Model establishes that *“the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”* It is noted that paragraph 6 of Article 7 lays down a rule of interpretation in order to clarify the scope of application of this Article in relation to the other Articles dealing with a specific category of income. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles on dividends, interest, royalties and other income which under paragraph 4 of Articles 10 and 11, paragraph [4] of Article 12 and paragraph 2 of Article 21 [...]. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States.
- 5.2. The requirement for a PE or fixed base is, therefore, a threshold that needs to be satisfied before a source country can tax residents of other treaty countries on business profits. Unlike electronic commerce, the extractive industry cannot be carried out remotely. Extractive industry activities require a fixed place of business or the physical presence of the contractor (e.g., the O&G company) and most subcontractors in the source country.
- 5.3. Under the UN model, the examples of PE based on physical presence commonly include: a place of management, branch, office, factory, workshop, mining site, farm or forest, or long-term building site. The examples of PE based on activity in the jurisdiction: include the use of substantial equipment over an extended period, supervisory activities carried on over an extended period and the presence in the jurisdiction of an employee for an extended period.
- 5.4. However, the PE concept does not have a harmonized application in practice and countries have applied and interpreted the PE thresholds differently with respect to taxing the extractive industries depending, in general, on the fiscal interests of the country<sup>17</sup> and the means available to collect the tax effectively<sup>18</sup>.
- 5.5. Under the definition included in Article 5(1) of the UN Model Convention (basic general rule), which is the same as Article 5 (1) of the OECD Model Convention, *“(…), the term ‘permanent establishment’ means a fixed place of business through which the business of the enterprise is wholly or partly carried on”*.
- 5.6. Article 5(2) of the UN Model Convention, which is the same in the OECD Model, sets forth a non-exhaustive list of concepts which often constitute a PE in the State in which they are

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<sup>17</sup> Arvid A. Skaar. “Permanent Establishment. Erosion of a Tax Treaty Principle”. Series of International Taxation. Kluwer Law and Taxation Publishers. Deventer. Boston. 1991. (page 3).

<sup>18</sup> Brian J. Arnold. “Threshold requirements for taxing business profits”. The taxation of business profits under tax treaties. Canadian Tax Foundation 2003. (page 56).

located: *“The term “permanent establishment” includes especially: (a) a place of management, (b) a branch, (c) an office, (d) a factory, (e) a workshop, (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.”* However, according to the Commentaries to the UN Model Convention, it is assumed that States interpret the terms listed *“in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1”*<sup>19</sup>.

- 5.7. Accordingly, the following conditions a priori must be fulfilled to determine the existence of a PE.

### The “place of business” test

- 6.1. A distinguishing feature of the PE for source-taxation based on the enterprise’s trade or business is the requirement of a *“fixed place of business”*. Article 5 (1) of the UN Model defines the term PE emphasizing its essential nature as a *“fixed place of business”* with a specific *“situs”*. Although there is no definition of *“fixed place of business”* as such in the UN Model Convention, the test is composed of three elements:
- the existence of a *“place of business”*, i.e., a facility such as premises or, in certain instances, machinery or equipment;
  - this place of business must be *“fixed”*, i.e., it must be established at a distinct place with a certain degree of permanence; and
  - the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons (personnel) not *“independent”* of the enterprise conduct business in the State in which the fixed place is situated.
- 6.2. 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<sup>20</sup>. The place of business, however, has to be a *“fixed”* one. Thus following the Commentaries to the UN Model Convention, there has to be a link between the place of business and a specific geographical point. However, no physical attachment to the soil is necessary, something that may be pertinent for assets that can be regarded connected to a certain site, as may be the case for drilling-rigs<sup>21</sup>.
- 6.3. It is widely accepted that a PE is constituted only if the place of business remains at a *“distinct”* place, or a particular site. An extractive industry example referred to in the Commentaries provides: *“A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business.”* Companies involved in the extractive industries often span a large geographical area. However, mining

<sup>19</sup> Para 4 of Commentaries on Article 5 of the UN Model Convention.

<sup>20</sup> Para 3 of Commentary on Article 5 of the UN Model Convention that reproduces para 4 of the OECD Model Convention.

<sup>21</sup> Para. 3 of Commentary on Article 5 of the UN Model Convention that reproduces para 5 of the OECD Model Convention.

over a delimited area should constitute a single place of business, and the work done in that area should be considered to be taking place in a particular geographical location.

- 6.4. According to the Commentary on Article 5 of the UN Model Convention,<sup>22</sup> in order to have a single “*place of business*”, both geographical and commercial coherence is required. In this respect, the geographical and commercial coherence is normally defined by each of the contractual areas where O&G companies perform their activities through different joint ventures within a country. For a more comprehensive explanation of the “geographical and commercial coherence test, please see point J “The geographical and commercial coherence test” of this note.
- 6.5. It should be noted that E&P activities in a country are normally established by O&G companies signing a single contract per geographical area with the corresponding governmental authority. Each geographical area subject to the exploitation, (i) is usually separated and isolated from the other; (ii) may contain a different type of hydrocarbons (e.g., oil or gas), (iii) is participated in by different partners associated in a joint venture or association which is governed by a JOA; and (iv) often has different legal and tax regimes applicable to each petroleum contract depending on the date signed, as certain tax stability clauses may apply. Further, some countries establish a “*ring fence*” rule by which profits in one area may not be offset against losses in another area.
- 6.6. The joint venture’s partners appoint one member as the operator of the area to carry out the E&P activities and execute the commonly agreed decisions. Every joint venture (i) performs the activity within the area in a self-standing manner, (ii) has its own accounting, independent from other contract areas, and (iii) has its own employees, equipment, work procedures and techniques. The head office registers its assets, liabilities, income, and losses attributable to the joint venturers in accordance with their percentage of the participation.
- 6.7. In this respect, it is anticipated that every contractual area can be considered an independent PE, and, if ring-fencing applies under local law on the same basis, the investor would not be able to offset profits and losses from different contractual areas (e.g. where one area is incurring losses because it is under exploration and other area is obtaining profits because it is already in production). Some countries permit the consolidation of profit and losses from different contract areas (i.e. from different PEs) to make their regime more attractive for investments.

### Permanence test

- 7.1. In order for a place of business to be “*fixed*”, it is also necessary that the presence of the business is not of a temporary nature. According to the Commentary on Article 5 of the UN

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<sup>22</sup> Para. 3 of Commentary on Article 5 of the UN Model Convention that reproduces para 3 to 11 of the OECD Model Convention.

Model Convention,<sup>23</sup> a six-month time limit is normally considered long enough to be considered to be “fixed” it is though recognized that a PE may exist even for a short period of time under certain circumstances<sup>24</sup>. However, States and domestic courts diverge when it comes to determining the minimum period of time needed to establish a PE.

- 7.2. In any event, the “fixed place” in Article 5(1) is normally complied with for O&G companies as most countries require a local presence for performing E&P activities and, given the expected timeline for E&P operations, that presence normally exceeds a year<sup>25</sup>. This test becomes more relevant in respect of subcontractors due to the shorter period they normally spend in the source country.

### The “right of use/at the disposal test”

- 8.1. Paragraph 3 of the UN Commentary on Article 5 (citing paragraphs 4 to 4.2 of the OECD Commentary on Article 5) explain that a place of business may constitute a PE of an enterprise if that place is “at the disposal of” the enterprise. Following the UN Commentaries, “no formal legal right to use that place is [...] required”. The Commentaries further clarify that “Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise.”
- 8.2. It is, therefore, generally accepted that no legal title is required to use a particular place of business. The Commentary on Article 5 of the UN Model notes, in particular that “It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise.”
- 8.3. However not formally implemented in the 2014 OECD Model, it is interesting to note that in 2012 the OECD proposed changes to the Commentaries on the term “at the disposal”<sup>26</sup> to emphasize the fact that where an enterprise has an exclusive right to use a particular location, which is used for carrying on the enterprise business, that location is clearly at the disposal of the enterprise, therefore leading to a PE.

<sup>23</sup> Para 3 of Commentary on Article 5 of the UN Model Convention that reproduces para. 6 of the OECD Model Convention.

<sup>24</sup>Supra.

<sup>25</sup> A typical schedule would provide 6 to 8 years for exploration in 3 exploration periods. Duration for production should be a minimum of 25 years for oil.

<sup>26</sup> Discussion draft of 19 October 2012 on “Revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment).”

**2012 OECD changes to Commentaries on the term “at the disposal”**

4.2 [...] ***Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This is illustrated by the following example. Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise.***

- 8.4. As mentioned above, the signature of a petroleum contract between the O&G company and the government is, in general, the starting point that leads to physical presence in a country. Such contract entitles the O&G company to carry out E&P activities within a delineated geographical area. Notwithstanding the 2012 OECD changes addressing legal rights as an element that satisfies the “at the disposal” test, certain tax treaties had already considered that the conferral of legal rights towards the exploration or extraction of natural resources gives rise to the existence of a PE:

**Examples of tax treaties referring to legal rights related to the extractive industry as a PE**

**Protocol to tax treaty between the Netherlands and Oman of 5 October 2009**

*“VI. Ad Articles 5, 6, 7 and 13*

*It is understood that, for the purposes of this Agreement, **the rights** to the exploration, exploitation or extraction of natural resources granted by a Contracting State according to the laws of that State shall also be deemed to be a permanent establishment in that State, without prejudice to the laws of the Contracting States relating to the natural resources or the exploration, exploitation or extraction of those resources.”*

**Protocol to tax treaty between the Netherlands and United Arab Emirates of 8 May 2007**

*“V. Ad Articles 5, 6, 7 and 13*

*It is understood that exploration and exploitation **rights** of natural resources, including rights to interests in, or to the benefits of, assets to be produced by such exploration or exploitation, shall be regarded as immovable property situated in the Contracting State the sea bed and sub-soil of which they are related to, and that these rights shall be deemed to pertain to the property of a permanent establishment in that State and the profits attributable to the permanent establishment shall be taxable in accordance with the national tax laws and regulations of that State.”*

### The “business connection test”

- 9.1. An enterprise performing a “business activity” and maintaining a fixed place of business in another country may still not have a PE in such country. The PE definition establishes that the business activities must be carried on “through” a fixed place of business.
- 9.2. According to the UN Commentaries on Article 5, “the words ‘through which’ must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business ‘through’ the location where this activity takes place.”<sup>27</sup>
- 9.3. To apply the “business connection test” it is important to identify the party whose business is served by the place of business. In the extractive sector the activity performed through the place of business may not be the business of the contractor, but of the subcontractors. This may give rise to one or more overlapped PEs in the same situs. One from the contractor (each contractual area is independently managed through the corresponding JOA) and, subject to its own tests, a PE of the subcontractor or subcontractors performing activities in the contractual area. For example, the subcontractor itself would have a PE at the site if its activities there last more than [six] months.
- 9.4. Even though the JOA appoints one of O&G partners as the operator of the block, non-operator partners would also be deemed to have a PE in the source country because the business activity carried out at the contractual area is regarded to be a joint business activity. It is important to note that normally all partners have signed the petroleum contract with the corresponding authority, normally being jointly responsible according to their participating interest and having their corresponding legal rights regarding to the delimited acreage established in such contract. Therefore, non-operators will be regarded as having a PE and generally will pay their income taxes based on the financial information provided by the operator.

### Exceptions to the notion of PE

- 10.1. Article 5 (4) of the UN Model Convention lists a number of business activities which are treated as exceptions to the general definition of PE laid down in paragraph 1 and which are not PE (“negative list”), even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities and the reason for their exclusion could be found in the difficulties connected with the attribution of profits to such marginal business activities (that in most cases are cost centers).

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<sup>27</sup> Para 3 of the Commentary on Article 5 of the UN Model Convention that reproduces para 4.6 of the Commentary to Article 5 of the OECD Model Convention.



- 10.2. The OECD Model Convention classifies as auxiliary or preparatory, *inter alia*, the activity of keeping a stock of goods and merchandise for storage, display, delivery or processing by another enterprise, as well as purchase of goods or merchandise and collecting of information for the use of the headquarters abroad<sup>28</sup>.
- 10.3. In this respect, Article 5 (4) of the UN Model reproduces Article 5(4) of the OECD Model Convention with one substantive amendment: the deletion of “*delivery*” in subparagraphs (a) and (b). The deletion of the word “*delivery*” reflects the majority view of the UN Committee that a “*warehouse*” used for that purpose should, if the requirements of paragraph 1 are met, be a PE. Where an exclusion does apply, it is required that the activities be limited to the excluded activities. If an excluded activity is combined with a core business activity performed through the same place of business, a PE is created.
- 10.4. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which do not. The decisive criterion is whether the activity of the business in itself forms “*an essential and significant part of the activity of the enterprise as a whole*”<sup>29</sup>. Each individual case will have to be examined on its own merits<sup>30</sup>.
- 10.5. Typical PE issues that may arise concerning the application of Article 5(4) of the UN Model Convention in the extractive sector are those related to representative offices, warehousing and pipelines, which are discussed later.

### Application to phases of extractive industries project life cycles

- 11.1. The stages of a typical extractive industry project can be divided into the following phases: (i) licensing, (ii) exploration, (iii) appraisal; (iv) development; (v) production; (vi) abandonment and (vii) activities to be performed after abandonment (primarily decommissioning). Each of

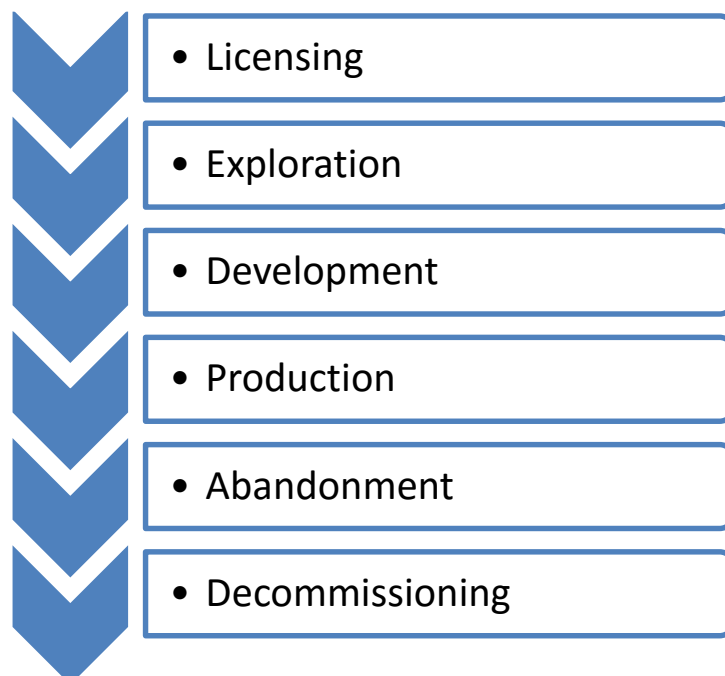
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<sup>28</sup> “Notwithstanding the preceding provisions of this Article, the term “*permanent establishment*” shall be deemed not to include: (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display; (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. (f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

<sup>29</sup> Para 24 of the Commentary on Article 5 of the UN Model that reproduces the same para of the Commentary to Article 5 of the OECD Model.

<sup>30</sup> In this regard, the Report on BEPS Action 7 has proposed to add to the Commentaries that, “*As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. [...] An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole.* (Para 21.2, replacing para 24 of the existing Commentary on Article 5 of the OECD Model).

these phases has a particular level of uncertainty (e.g., geological, financial and political) associated with it.



## A) Licensing activities

### Representative Office

- 12.1. It is quite common for O&G companies initially to establish a representative office instead of or prior to registering a branch. The representative office normally performs market research, coordination or other limited “*non-income*” generating activities. In this regard, many representative offices are established to look for oil and gas opportunities (i.e. collect information) in the country of establishment or in other countries within the region.
- 12.2. Jurisdictions may adopt different views with regard to the nature of the activities performed by representative offices. To the extent that representative offices do not sell goods or services generating income, many countries do not regard them as PEs and, accordingly, they are not subject to corporate income tax due to the presumed non-income nature of their activities. However, other countries consider, under their domestic law, that a representative office does constitute a PE and, therefore, is subject to tax.
- 12.3. It should be noted that the representative office may operate over a protracted period of time and representative offices might become branches (in the countries which do not automatically regard them to be PEs) if the activities ultimately go beyond those of a mere auxiliary and preparatory nature.

### Joint Studies/Reconnaissance contracts

- 12.4. Market surveys and the collection of other information about a foreign country is normally the first step towards a more substantial engagement. Many countries sign certain types of contracts (“*joint studies*”, “*reconnaissance contracts*”, etc.) with O&G companies which allow for geological surveys in a delimited area. These contracts are precursors to the government offering petroleum contracts, with study participants having certain priority rights, e.g. the right to match the highest bid for any resultant petroleum contact in an area wholly or partly overlapping the area of the survey.
- 12.5. According to the Commentaries to Article 5 of the UN Model Convention<sup>31</sup>, should preparatory activities lead to core business activities, a PE could be constituted retrospectively from the date it started the first activities. A PE begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that the preparatory activities differ substantially from the activity for which the place of business is to serve permanently.
- 12.6. In this regard, certain countries have considered that geological surveys that lead to signing a petroleum contract by the same participants would be a PE from the start of the survey. Other countries have considered that each type of contract (the geological survey and the petroleum contract) has a different scope and that it cannot be inferred that the survey contract directly led to the award of the petroleum contract (since the survey contract only grants a priority right and the contractual area does not always completely overlap the whole survey area). In the latter case, in those countries the PE only begins to exist when the petroleum contract is signed and expenses incurred during the survey normally cannot be set off against future profits derived by the PE.

### B) Place of management, branch and office

- 12.7. The “*positive list*” in Article 5(2) of the UN Model Convention (a), (b) and (c) examples of PE with a characterization of the enterprise’s use of the place. This is the case of branches, offices and places of management.
- 12.8. Once an O&G company has been awarded a petroleum contract, and sometimes even before, as required by domestic legislation, a branch is registered. The registration does not create presence by itself, but the O&G company usually sets up an office in a main city of the country in order to represent the company before the corresponding authorities as well as to provide

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<sup>31</sup> Para 3 of the Commentary to Article 5 of the UN Model Convention that reproduces para. 11 of the OECD Model.

certain support to the E&P activities carried out within each particular area. The activities provided by the office are typically those carried out by a coordination center, which includes corporate functions, i.e. accounting, administration, finance, human resources, treasury, information and communication, technical support, and supervision activities<sup>32</sup>.

- 12.9. In general, domestic legislation requires the registration of branches, but the relevant element for determining the existence of a PE is whether the branch has an office. This office is usually registered as a branch and, therefore, the office is designated as a branch office in the country. The same applies in certain countries to contractual areas that likewise are registered as branches.
- 12.10. The place of management is a place where the business of the whole or part of the enterprise is conducted. When the business is conducted from various places, each place may constitute a place of management. It normally presupposes an office or other facilities following the Commentaries to the UN Model Convention<sup>33</sup>, but must not be confused with the term “*place of effective management*”, which is the absolute center of management of the enterprise. Therefore, a place of management can be identified as the part of the enterprise where certain key decisions are made, but not to the extent that all important decisions for the business are made through such an establishment.

### C) Exploration activities

- 12.11. Article 5 (2) (f) of the UN Model also lists as examples of places that will often constitute a PE: a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
- 12.12. In discussing this subparagraph (f) the Commentary states that “*the term ‘any other place of extraction of natural resources’ should be interpreted broadly*” to include, for example, all places of extraction of hydrocarbons whether on or offshore.
- 12.13. While the example makes reference to oil or gas wells, O&G companies ordinarily operate within delimited areas which are geographically identified in the petroleum contract signed with the State’s government. The commitments included in the petroleum contract could vary from drilling no wells (e.g. just seismic works) to drilling one or more exploration wells during the exploration phase. Following the Commentaries in the sense that a broad interpretation should be given of the term “*place of extraction of natural resources*” and, therefore, the PE, in the O&G sector the PE will normally be the contractual area where activities are performed

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<sup>32</sup> Jan de Goede and Ruxandra Vlasceanu. “Permanent Establishment Implications for Coordination Centres in the Oil and Gas Industry”. IBFD Bulletin for International Taxation, September 2013. (page 466).

<sup>33</sup> *Para 24 of Commentaries to Article 5 of the UN Model Convention: “a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2”.*

through a joint venture or association which is governed by a JOA, rather than each of the wells drilled within such contractual area.

- 12.14. While “*exploitation*” activities would always be taxable in the source country under Article 5 of the UN Model, exploration activities are not mentioned in subparagraph (f). In this regard, Article 5(1) of the UN Model will govern whether exploration activities are carried on through a PE.
- 12.15. The UN Model reproduces the OECD Commentary<sup>34</sup> that states that Contracting States “*may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State: a) shall be deemed not to have a permanent establishment in that other State; or b) shall be deemed to carry on such activities through a permanent establishment in that other State; or c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time. The Contracting States may moreover agree to submit the income from such activities to any other rule.*”
- 12.16. In this respect, many treaties just literally reproduce Article 5(2) of the UN Model Convention without specifying whether “*exploration*” activities are considered a PE. In such cases, as mentioned above, the basic rules contained in paragraph 1 of Article 5 of the UN Model shall govern whether exploration activities are carried out through a PE.
- 12.17. Examples with respect to “*case b)*” of the above mentioned Commentary that expressly include exploration activities in Article 5 of the treaty are widely found in tax treaties signed between different countries:

***Examples of treaties that expressly include “exploration” in the definition of PE***

***Article 5 (1) (f) of the tax treaty between Gabon and Canada of 14 November 2002***

*“a mine, an oil or gas well, a quarry or any other place relating to the exploration for or the exploitation of natural resources.”*

***Article 5 (1) (f) of the tax treaty between Iran and the Slovak Republic of 19 January 2016***

*“a mine, an oil or gas well, a quarry or any other place of exploration, exploitation and/or extraction of natural resources.”*

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<sup>34</sup> Para. 5 of the Commentaries to Article 5 of the UN Model Convention that reproduces Para 15 of the Commentaries to Article 5 of the OECD Model Convention.

12.18. Other countries have preferred to include the alternative proposed under “case c)”, which considers a PE to exist if exploration activities last longer than a specified period of time:

***Example of treaties that consider “exploration” activities as a PE if such activities last longer than a specified period of time***

**Article 5(3) of the tax treaty between Spain and Kuwait of 26 May 2008**

*“The term permanent establishment also encompasses any place relating to the exploration of natural resources, provided such activities exists for a period or periods aggregating more than six months within any twelve-month period.”*

12.19. A particular case is Article 5(3) of the US Model that departs from the UN Model and the OECD Model in that includes an express rule for drilling rigs and ships used for the exploration of natural resources for a period of longer than 12 months:

**Example under the US Model**

**Article 5(3) tax treaty between the United States and Malta of 8 August 2008**

A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration of natural resources, constitutes a permanent establishment only if it lasts, or the exploration activity continues for more than twelve months.

12.20. Under an E&P project (new ventures and business development, exploration, development and production), the exploration does not always result in a hydrocarbon discovery that is followed by a development and production phase. As a result, the activity is frequently discontinued with no income having been generated. The associations, joint ventures or consortiums set up by the companies that participate in each contractual area, after a technical and economic analysis, take the decision to terminate the exploration of the contractual area or let the contract expire. Discontinuation or transfer to a third party of an exploration and production (E&P) related PE will be considered to cease the existence of the EP for the O&G company at the time the decision on the termination of the exploration was taken and notified to the relevant authorities<sup>35</sup>. The notification to the authorities is also the moment the E&P company’s right of disposal of the contractual area ends, since following that the government could offer such area for new investors.

<sup>35</sup> For example, binding tax ruling of 9 December 2015, of the Spanish General Directorate of Taxes (number V3926-15) under which the discontinuation of a PE of an O&G company occurred at the time the decision on the termination of the exploration was taken, and such decision was notified to the relevant authorities.

## D) Development

12.21. When an exploration prospect results in a commercial discovery, the development phase starts. Unlike the exploration phase where other companies may typically join the project (*farm-in/farm-out agreements*) paying a prorated share of exploration costs or providing a carry of certain future exploration costs<sup>36</sup> to the initial exploration company, once a commercial discovery is realized the value of the project increases. While farm-in/farm-out arrangements are still possible in the development phase, depending on a country's tax laws, such arrangements, and especially outright sales of interests in the license, may give rise to capital gains attributable to a disposition of immovable property and business assets used in a PE situated in the source country [See the "Capital gains taxation and indirect sales" note]. The same treatment would follow under the production phase as a PE exists.

## E) Production

12.22. After development is completed, production activities begin in which hydrocarbons are extracted from the reservoir, refined and sent to market by pipeline or ship. The productive life can last decades and the reservoirs are continuously monitored to optimize production. The extraction of hydrocarbons could take place onshore or offshore, being the onshore production more economically viable as is less elaborate and more cost-effective. A whole range of different structures is used offshore, depending on size and water depth.

12.23. No doubt that the O&G company will have a PE during the production stage, while the different subcontractors that perform activities at the site would have a PE depending on their specific facts and circumstances.

## F) Abandonment

12.24. In general, a site continues to exist until the work is completed or permanently abandoned<sup>37</sup>. Therefore, the PE will continue to exist for the O&G company during the development and production phases until "Completion of Production" (COP) has been declared and the "Well Plug and Abandon" operations have been performed. However the O&G may continue to have a PE during the decommissioning phase as it is explained below. It should be noted that no income will arise during the decommissioning phase, but depending on the tax regime it could be relevant for the O&G company or the source country maintain the existence of a PE.

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<sup>36</sup> The explorationists are able to get reimbursement on a portion of past costs, typically geological and geophysical work (G&G).

<sup>37</sup> Para 11 of the UN Model Convention that reproduces para 19 of the OECD Model Convention.

## G) Decommissioning

- 12.25. As the O&G reservoirs become depleted, however, the facilities require decommissioning and remediation [See the “Taxation guidelines for worldwide decommissioning” note]. During this phase, even if the O&G company may have returned the block to the government, it is normally responsible for the decommissioning and remediation work.
- 12.26. With respect to subcontractors hired to perform the decommissioning work, it seems clear that they will have PEs at the site if their activities there last more than [six] months as established in the Construction work clause [See part F “The Construction Work Clause” below].
- 12.27. With respect to the O&G company, the existence of a PE could derive from the Commentary to the UN Model, which states *“If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project”*. It is pertinent to note that due to its complexity and size, the contractor normally performs “supervisory activities”, which are expressly included in the PE concept under Article 5 (3) (a) of the UN Model: *“A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months”*.

## F.- The Construction Work Clause

- 13.1. Following Article 5 (3) (a) of the UN Model Convention the term PE also encompasses *“a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months”*.
- 13.2. Article 5(3) of the UN Model covers a broader range of activities than Article 5 (3) of the OECD Model Convention, which states, *“A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months”*. In addition to the term *“installation project”* used in the OECD Model Convention, subparagraph (a) of Article (3) of the UN Model Convention includes an *“assembly project”* as well as *“supervisory activities”* in connection with *“a building site, a construction, assembly or installation project”*. However, while the OECD Model Convention uses a time limit of 12 months and the UN Model Convention reduces the minimum duration to 6 months, these periods could be reduced in bilateral negotiations, generally to not less than three months.



- 13.3. The period of time under the construction Article may, accordingly, be agreed by contracting States and vary from one treaty to another:

**Examples of tax treaties with a different time period under the construction clause**

**Article 5(3) treaty between Morocco and the United Arab Emirates of 9 February 1999**

*“The term “permanent establishment also encompasses:*

*(a) a building site, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than eight months;”*

**Article 5(1)(g) treaty between Jordan and Romania of 10 October 1983**

*“a building site or construction or assembly project which exists for more than seven months.”*

**Article 5(3) treaty between Austria and South Africa of 4 March 1996** *“A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.”*

- 13.4. The Commentary on Article 5 (3) of the OECD Model, reproduced by the UN Model Convention, extends the scope of the definition of construction to *“the laying of pipe-lines and excavating and dredging”*. Likewise, as mentioned above, drilling activities are treated as construction work with a similar *“duration test”* in many treaties which adopt rules similar to that in the US Model Convention.
- 13.5. The difference between the basic rule in Article 5 (1) and Article 5 (3) of the UN Model is that the latter provides an explicit definition of the duration, turning the *“permanence test”* of the basic rule into a *“duration test”*, as a construction site is by its very nature temporary.
- 13.6. The purpose of this provision is to allow taxation of PE’s activities that do not last for an indefinite period of time. In this respect, a construction site is by definition not intended to be permanent. In addition, while construction tasks usually have an undisputable location, certain works will not be performed at one specific place, because the site will be moved as the work proceeds (e.g. road construction or pipeline laying). However, as mentioned by the Commentaries on Article 5 (1) of the UN Model Convention<sup>38</sup>, the words *“through which”* must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.

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<sup>38</sup> Para 3 of the Commentaries on Article 5 of the UN Model Convention that reproduces Para 4.6 of the OECD Model Convention.

- 13.7. As previously discussed, it is not generally significant for O&G companies whether Article 5(1) or the construction work clause established in Article 5(3) of the UN Model Convention applies. E&P activities of O&G companies by definition have local presence that constitutes a PE or more than one PE within the source country and, in any case, would exceed the time thresholds of most construction clauses.
- 13.8. But, as noted, many subcontractors perform their activities in the contractual area. The type of services and supplies rendered are of a very different nature and generally separate contracts are signed with each of the subcontractors, the most important being the drilling activity.
- 13.9. Identification of construction works has been a concern for many countries in order to protect the taxable base. Such identification can be justified if different works form a commercially and geographically coherent whole. Both the commercially and geographically whole tests need to be met as, under the UN Model Convention commentaries *“where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business”* and *“coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business”*.
- 13.10. As further explained below, the UN Model Convention includes a subparagraph (b) in Article 5 (3) providing a specific provision in relation to the furnishing of services by an enterprise through employees or personnel engaged for that purpose<sup>39</sup>. According to the Commentaries, the reason for including the rationale of this subparagraph is that *“Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits.”*
- 13.11. The Commentaries on Article 5 of the UN Model deal in paragraphs 11 and 12 with those situations where *“taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects”*.
- 13.12. It should be mentioned that certain countries have included in their tax treaties special provisions which state that the O&G offshore activity constitutes a PE if it lasts for more than 30 days, notwithstanding the other provisions of the treaty. This specific *“offshore clause”* does not require the geographical test as any activity performed within the offshore area could lead to the existence of a PE.

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<sup>39</sup> *“The furnishing of services, including consultancy 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 in any 12-month period commencing or ending in the fiscal year concerned”*.

## Drilling activity

- 14.1. Many types of platforms exist depending on the circumstances. In general, platforms may be fixed to the ocean floor or may float. Fixed platforms are fixed to the same geographical area for long periods of time and, therefore, satisfy the “fixed” test. Whether mobile drilling rigs are considered to comply with the “fixed” test should be considered on a case-by-case basis. Drilling rigs can remain in the same spot for a long period of time or just a couple of months. It could also happen that more than one well is drilled in the same contractual area of the O&G company, either on a back-to-back basis or in different time periods.
- 14.2. Following the criteria that each contractual area (field or block) constitutes a PE of the O&G company and complies with the geographical and commercial coherence test, a drilling rig moving around in the same oil field would, therefore, satisfy the conditions of a PE if the activity last more than 6 months under the UN Model Convention definition. The actual duration, not the intended one, should be the relevant standard and, therefore, if a drilling activity is intended to last 4 months but ultimately lasts for more than 6 months, the activity should be considered to meet the PE timing criteria.
- 14.3. A general point of clarification is given by the Commentaries on Article 5 of the UN Model Convention, that reproduce the OECD Commentaries<sup>40</sup>: *“no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it.”*
- 14.4. It can normally be assumed that works conducted under the same contract will be considered a coherent whole, but to address any possible abuse derived from signing several contracts with different durations, the UN Model reproduces what the OECD Commentary observes, with changes noted in parentheses to take account of the different time periods in the two Models: *“The [six]-month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.”*<sup>41</sup>
- 14.5. The start of the duration test is relevant in this short-term works context where a single day’s difference could lead to the establishment of a PE. The issue is to decide when a construction or installation actually starts and terminates. With respect to drilling rigs, normally its relevant

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<sup>40</sup> Para 11 of the Commentaries on Article 5 of the UN Model Convention.

<sup>41</sup> Ibid.

work commences at the well “*spud day*”, when the process of beginning to drill a well starts, and ends when the well has been completed.

- 14.6. Owners of rigs may provide drilling services by way of a time charter, whereby the owner provides the rig with full crew to operate the rig, or on a bareboat basis, just renting the rig itself, often to a related company. If rent for equipment is classified as a royalty under a treaty definition (the UN models define royalties to include payments for the rental of industrial, commercial, or scientific equipment<sup>42</sup>), the royalty provisions apply unless the rent is beneficially owned by a resident of the other contracting state that carries on business in the source state through a PE in that state and the rent is effectively connected to that PE.

**Article 12 (Royalties) of the tax treaty between Canada and Denmark of 17 September 1997.**

4. *The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright, patent, trade mark, design or model, plan, secret formula or process or for the **use of, or the right to use, industrial, commercial or scientific equipment**, or for information concerning industrial, commercial or scientific experience, and includes payments of any kind in respect of motion picture films and works on film or videotape or other means of reproduction for use in connection with television.*

- 14.7. In a Norwegian case dealing with leasing out of equipment in the offshore industry<sup>43</sup>, the Supreme Court (HR) held that the rental of a drilling rig on bareboat terms was insufficient to cause the rig owner to be taxable in Norway as the rig owner did not take part in the risk of operating the rig. The case refers to two foreign companies, Tric and Trag, that were controlled by the same owners. Tric (resident in Liberia) was the owner of a drilling rig which was hired out on a bareboat charter to Trag, and Trag (resident in Switzerland) operated the rig on the Norwegian Continental Shelf and was liable to tax in Norway for that activity. The tax authorities argued that Tric and Trag carried out joint activities in Norway and that Tric took part in the business activity that was taxable in Norway. For its part, Tric argued that it merely hired out the rig to Trag and that hiring out equipment to a Norwegian entity did not constitute taking part in joint business activities in Norway.
- 14.8. It was undisputed that Trag engaged in a business activity that was taxable in Norway as a PE under the offshore clause. However, as Norway does not have a tax treaty with Liberia, the dispute in respect of Tric was decided only on the basis of Norwegian domestic law. In this case, the Supreme Court ruled in Tric’s favor as considered that the mere lease of a rig on a bareboat charter for use in Norwegian waters did not constitute participating in an activity in Norway and the activity was not performed for the joint account and under the joint liability

<sup>42</sup> In 1992, the OECD Model Convention was revised to remove equipment rentals from the definition of royalties. However, some OECD member countries entered reservations to Article 12 of the Model to maintain a limited right to tax royalties at source, including rents paid for the use of equipment.

<sup>43</sup> NO: HR, 1997, Tric/Trag, Rt 1997, at 1646.

of the parties, irrespective of the close cooperation between both companies. Consequently, Tric was not considered to have a PE in Norway.<sup>44</sup>

- 14.9. In another case, the Canadian Income Tax Rulings Directorate, Legislative Policy and Regulatory Affairs Branch of Canada concluded in an advance income tax ruling<sup>45</sup> that entering into a bareboat agreement for a ship to be used in Canadian waters could not be regarded as PE.
- 14.10. In some tax treaties, the use of “*substantial equipment*” in the source country has been included in the definition of a PE. In these cases, bareboat agreements could lead to the existence of a PE. Examples of treaties that have included in the definition of PE the “*use of substantial equipment*” can be found below:

**Article 5(4) of the tax treaty between Australia and South Africa of 1 July 1999 (as amended 2008)**

“... where an enterprise of a Contracting State:

(b) carries on activities (**including the operation of substantial equipment**) in the other State in the exploration for or exploitation of natural resources situated in that other State for a period or periods exceeding in the aggregate 90 days in any 12 month period; or

(c) operates **substantial equipment** in the other State (including as provided in subparagraph (b)) for a period or periods exceeding 183 days in any 12 month period, such activities shall be deemed to be performed through a permanent establishment that the enterprise has in that other State, unless the activities are limited to those mentioned in paragraph 6 and are, in relation to the enterprise, of a preparatory or auxiliary character.”

- 14.11. As mentioned, in the US Model, drilling rigs and ships are expressly included in the construction PE definition, insofar as these are used in exploration for natural resources for a period of longer than 12 months. Recall however that the construction clause can be applied to offshore exploration and drilling even if the tax treaty does not contain an express reference.
- 14.12. It should be also noted that the definition of royalties in Article 12 of the UN Model Convention includes “... *payments of any kind received as a consideration for the use of, or the right to use*

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<sup>44</sup> Eirik Jensen, Supreme Court Barrister, “Permanent Establishments and Allocation Questions Pertaining to Them – Judgements of the Norway Supreme Court”. IBFD Bulletin for International Taxation, August/September 2002, pages 394 - 395.

<sup>45</sup> CA: ITRD, Advance Income Tax Ruling, 2006-0211991.

... *industrial, commercial or scientific equipment*<sup>46</sup>. Many countries include these payments in the definition of royalties in their tax treaties:

**Article 12(3)(c) of the tax treaty between Australia and Chile of 10 March 2010**

**3. The term "royalties" in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for:**

(...)

(c) **the use of, or the right to use, industrial, commercial or scientific equipment;**

- 14.13. This means that a bareboat of equipment, i.e. drilling rigs, vessels or other equipment, may result in the imposition of withholding tax under article 12 of these tax treaties if domestic legislation imposes withholding tax on such payments, as long as the activity does not constitute a PE.

## Service and supply ships

- 15.1. A number of service and supply ships operate by supporting O&G companies during drilling campaigns. The most prevalent are platform supply vessels (PSV) used for transporting supplies to the rig from port facilities. Other vessels are used for towing and anchor handling, construction support, multi-purpose support, and specialized HSE<sup>47</sup> services, their common character being their mobility.
- 15.2. The issue presented is to what extent personnel and supply transportation vessels, and other auxiliary vessels, fall under the PE concept, taking into consideration that they are not geographically fixed to a place. Notwithstanding that the general understanding is that a moving ship would typically not constitute a fixed place, the OECD proposed in 2012 adding a new paragraph 5.5 to the Commentary on Article 5 which considers ships to be a PE.

**New paragraph 5.5 in the OECD Model (2012)**

*"5.5 Similarly, a ship or boat that navigates within territorial waters or in inland waterways is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship or boat, such as a shop or restaurant, must be treated the same way."*

<sup>46</sup> Up to 1992, the definition of royalties in article 12 of the OECD Model (1977) also included the right "to use industrial, commercial or scientific equipment", however some countries have made reservations to maintain such taxation right.

<sup>47</sup> Health, Safety and Environmental.

- 15.3. If a vessel operates in areas that are considered to be geographically and commercially coherent, the fixed test may be satisfied. The commercial coherence test is very ambiguous and could be interpreted in different ways. In considering this question, several factual issues, such as whether the services are done under the same contract, for identical or different clients, and invoiced under the same or different work orders or invoices, should be taken into account.
- 15.4. Please note that certain tax features of these services have been covered in the Drilling activity section above.

### Pipelines

- 16.1. The Commentary on Article 5 of the UN Model Convention<sup>48</sup>, states when referring to cables or pipelines that “(...) income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6.”
- 16.2. Apart from the fact that income derived by the owner or operator of cables or pipelines is covered by Article 6 if considered as immovable property by the domestic law of the source State, the issue is whether any exception listed in Article 5(4) related to activities of an auxiliary or preparatory nature applies and, therefore, they are not considered a PE. In this respect, each case is to be considered in light of its particular circumstances: (a) If these facilities are used to transport goods owned by third parties, then they are considered to be a PE with respect to the owner/operator of the pipeline, and neither Art. 5(4)(a)<sup>49</sup> (which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility) nor Article 5(4)(e)<sup>50</sup> (since the cable or pipeline is not used solely for the enterprise and given the nature of the business) applies; (2) If these facilities transport goods owned by the owner/operator of the pipeline, Article 5(4)(a) would be applicable if such transport is merely incidental to the business of the enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of the country solely to transport its own oil to its refinery located in another country.
- 16.3. As above mentioned, cables or pipelines that cross the country would be considered to be a PE if these facilities are used to transport property belonging to other enterprises. For the customer of the operator of the cable or pipeline (the enterprise whose product is transported from one place to another) who does not have the cable or pipeline at its disposal, the cable or pipeline cannot be considered a PE.

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<sup>48</sup> Para 18 of the UN Model Convention that reproduces para 26.1 of the OECD Model Convention.

<sup>49</sup> (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

<sup>50</sup> (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

- 16.4. In a decision of the German Bundesfinanzhof (Federal Tax Court) in the Pipeline Case (No. IIR 12/92 dated 30 October 1996), a Netherlands company owned an underground pipeline for transporting third-party customers' crude oil and petroleum products. That pipeline was situated in the Netherlands and Germany. The pipeline was operated by the Netherlands company remotely from the Netherlands, without having any personnel in Germany. The Court concluded that since transportation of crude oil and petroleum products was the core business of the Netherlands company, the said transportation activity could not be regarded as an auxiliary activity for the purposes of determining the Netherlands company's PE in Germany and as a consequence the Dutch company had a PE in Germany in respect of the portion of the pipeline crossing German territory. In the Court's view, for a PE to exist, it was not necessary that the pipeline had to be operated by personnel belonging to the Dutch company in Germany. Even a fully automated installation could be regarded as a PE.
- 16.5. The German decision is relevant as confirms that a pipeline can be considered a PE of a company whose business is to transport oil and petroleum products, even if the company has no personnel in the jurisdiction in which the pipeline is located.

## G.- Territory of tax treaties

- 17.1. Article 29<sup>51</sup> of the UN Vienna Convention on the Law of Treaties of 23 May 1969, establishes that *"Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory."* Since many countries include the definition of "Contracting States" in Article 3 of tax treaties<sup>52</sup>, this definition determines the geographic scope of the application of the tax treaty. Such definition may include the notions of territory and territorial waters, which would be automatically included in the notions of State territory.
- 17.2. On the other hand, according to Article 77 of the UN Convention on the Law of the Sea (UNCLOS), coastal States may exercise "sovereign rights" for the purposes of exploration and exploitation of some of its natural resources over the continental shelf<sup>53</sup>. These rights are exclusive in the sense that if the coastal State does not explore the continental shelf or exploit its natural resources, no one may undertake these activities without the express consent of the coastal State.

<sup>51</sup> On the territorial scope of treaties.

<sup>52</sup> Article 3 of the United Nations Model Convention is the same as Article 3 of the OECD Model Convention, except that Article 3 of the OECD Model Convention defines the terms "enterprise" and "business" in subparagraphs c) and h) of paragraph 1 while Article 3 of the United Nations Model Convention does not. This is because the OECD Model Convention has deleted Article 14 (Independent Personal Services) while the United Nations Model Convention still maintains it.

<sup>53</sup> Article 76 of the UN Convention on the Law of the Sea (UNCLOS) defines the continental shelf as *"the seabed and subsoil of the submarine areas that extend beyond its territorial sea throughout the natural prolongation of its land territory to the outer edge of the continental margin, or to a distance of 200 nautical miles [370.4 Km] from the baselines from which the breadth of the territorial sea is measured where the outer edge of the continental margin does not extend up to that distance."*



17.3. Therefore, taxing jurisdiction of a State may be extended to include exclusive economic zones or outer continental shelf if the activities are connected to exploration or exploitation of natural resources, within which the States may exercise taxing rights in accordance with international law.

17.4. In this respect, many States have extended the operation of the tax treaties into the same area outside their territory in which such States purport to extend their taxing power. Accordingly, the terms “a Contracting State” and “the other Contracting State” normally include a reference to the “continental shelf”:

**Canada’s Section 5 of the Income Tax Conventions Interpretation Act, RSC 1985, c. I-4, as amended.**

Canada means the territory of Canada, and includes

(a) every area **beyond the territorial seas of Canada** that, in accordance with international law and the laws of Canada, is an area in respect of which Canada may exercise rights with respect to the seabed and subsoil and their natural resources, (...)

**Article 3 (b) of the tax treaty between United Kingdom and Russia of 15 February 1994**

b) The term “the Russian Federation”, when used in the geographical sense, means its territory, including its territorial waters as well as economic zone and **Continental Shelf** where this State exercises sovereign rights or rights and jurisdiction in conformity with international law and where its tax laws are effective;

17.5. However, some treaties, normally old treaties signed when the development of natural resources on the continental shelf was not technologically feasible, do not expressly cover the continental shelf.

17.6. Different interpretations about the application of a tax treaty can arise in such a case. It could be argued that the tax treaty applies in the same area as the domestic tax legislation of the two contracting States and, the continental shelf would be covered if domestic legislation also includes under its scope the natural resources in the seabed. Another interpretation would be that the tax treaty only applies within the territorial area specifically referred to in the tax treaty, regardless of the domestic tax legislation<sup>54</sup>.

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<sup>54</sup> Maja Stubbe Gelineck. “Permanent Establishment and the Offshore Oil and Gas Industry- Part 1. IBFD Bulletin for International Taxation. April 2016. Page 209.

- 17.7. A case arose in Norway under the Norway-Switzerland treaty of 7 December 1956, which did not expressly extend to Norway's continental shelf area. The decision of the Supreme Court of Norway<sup>55</sup> held that the tax treaty did not apply to the Norwegian "continental shelf" area, as was also agreed between the competent authorities of the two countries in 1982<sup>56</sup>. As a consequence, tax liability in Norway with respect to business activities carried out in the "continental shelf" area could be decided on the basis of Norwegian law.
- 17.8. Therefore, it is advisable that the issue of whether or not include specific reference to particular geographical areas in tax treaty should be discussed during the treaty negotiations, and if necessary addressed in the text.

#### **H.- "Source-state taxation" the offshore clause of other resource-rich states with a coast line**

- 18.1. The economic importance of the offshore petroleum industry in some coastal States resulted in a special clause in their bilateral negotiations which assumes the existence of a PE if a hydrocarbon-related business activity is performed on their continental shelf. This is the case, for example, of Norway or the United Kingdom.

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<sup>55</sup> Heerena Marine Contractors SA v. Ministry of Finance, of 9 November 1992, 122/1992.

<sup>56</sup> In an exchange of letters of 29 November and 14 December 1982.

18.2.

**Article 21 (Offshore activities) of Norway-South Africa Income Tax Treaty of 12 February 1996**

1. *The provisions of this Article shall apply notwithstanding any other provision of this Convention.*
2. *A person who is a resident of a Contracting State and carries on activities offshore in the other Contracting State in connection with the exploration or exploitation of the seabed and subsoil and their natural resources situated in that other State shall, subject to paragraphs 3 and 4 of this Article, be deemed in relation to those activities to be carrying on business in that other State through a permanent establishment or fixed base situated therein.*
3. *The provisions of paragraph 2 shall not apply where the activities are carried on for a period not exceeding 30 days in the aggregate in any period of twelve months commencing or ending in the fiscal year concerned. However, for the purposes of this paragraph, activities carried on by an enterprise associated with another enterprise, within the meaning of Article 9, shall be regarded as carried on by the enterprise with which it is associated if the activities in question are substantially the same as those carried on by the last-mentioned enterprise, except to the extent that those activities are carried on at the same time.*
4. *Profits derived by a resident of a Contracting State from the transportation of supplies or personnel to a location, or between locations, where activities in connection with the exploration or exploitation of the seabed and subsoil and their natural resources are being carried on in a Contracting State, or from the operation of tugboats and other vessels auxiliary to such activities, shall be taxable only in the Contracting State of which the enterprise is a resident.*
5. (...)
- 6 (...)"

18.3. This alternative implies that several of the traditional features of basic PE are removed. In particular, under the offshore clause neither a “*fixed place of business*” nor a “*right of use test*” or a “*business connection test*” seems necessary to constitute a PE. In this respect, the offshore clause does not require a specific geographical location within this area, the test being the activities are to be performed within the overall offshore area.

## **I.- The “geographical and commercial coherence” test**

### **A) More than one (multiple) PEs**

19.1 As previously noted, the “geographical and commercial coherence test” provides that, in principle, any geographical area which commercially or economically constitutes a unit may be considered as a fixed place of business for PE purposes.

- 19.2 From the perspective of an O&G company, legal title by means of a petroleum contract in the form of a concession or a Production Sharing Agreement is granted over a contractual area (geographic element) which is normally governed by several partners under a JOA, one of them being designated the operator. Therefore, from a factual point of view, each contractual area (geographical element) is independently managed through a consortium (commercial element). Accordingly, when an O&G company has entitlements to more than one contractual area, it would normally be considered that it has more than one PE within that country.
- 19.3 This result is supported by many factors involving the O&G structure. As mentioned above, E&P activities in a country are normally established by signing a single contract per geographical area with the corresponding governmental authority. Each geographical area is subject to exploitation, usually separated and isolated from each other. Sometimes they contain different kinds of hydrocarbons (oil or gas) or involve different partners associated in different joint ventures or associations which are governed by different JOA's. Frequently, separate petroleum contracts have different legal and tax regimes, depending on the date signed, as certain tax stability clauses may apply.
- 19.4 It should also be noted that each joint venture, consortium or association has its own financial accounts, independent from those formed in other areas. Therefore, each contractual area is managed independently from one another, each having its own operating management. Each joint venture, consortium or association normally files income tax returns on behalf of its participants to whom they then attribute the revenue and the taxes paid.
- 19.5 In addition, many countries have established "ring fence" regulations which disallow offsetting losses from one field against profits of another. Even in countries that permit consolidation of losses between contract areas, as long as the separate contract areas are distinct in the other ways noted above, each contractual area will nevertheless normally be considered a separate PE.
- 19.6 While the E&P blocks are located in specific areas, being defined by the concession or petroleum contract signed for each of them, the office is normally established in the main city of the country, which could be far away from the mentioned blocks. Following the example provided in the Commentaries on Article 5 of the UN Model Convention<sup>57</sup> regarding a consultant performing similar activities as part of the same project to distinct branches, it may also be argued that the office constitutes a separate PE from the blocks due to lack of geographical coherence.
- 19.7 Commercial coherence takes into consideration several indicators (e.g. the contract, the client, the time factor, the functions performed, and the participants in the project). All of these factors should be analyzed on a case by case basis. Usually a decisive factor for treating different operations as one project is when one contract has been concluded. In the case of

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<sup>57</sup> Para 3 of the Commentaries on Article 5 of the UN Model Convention that reproduces para 5(4) of the OECD Model Convention.

O&G companies, since blocks are generally managed through different JOAs, each block is normally considered as an independent commercial unit.

19.8 The Commentary on Article 5 of the OECD Model<sup>58</sup> (the UN Model does not contain this Commentary) contains some additional criteria for establishing the commercial coherence of “*connected projects*” within the alternative services PE rule, which could also be considered to be relevant in addressing the commercial coherence or fixed place of business under Article 5(1). This Commentary states that the reference to “*connected projects*” is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects have a commercial coherence. The determination of whether projects are connected will depend on the facts and circumstances of each case but factors that would generally be relevant for that purpose include:

- whether the projects are covered by a single master contract;
- where the projects are covered by different contracts, whether these different contracts were concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;
- whether the nature of the work involved under the different projects is the same;
- whether the same individuals are performing the services under the different projects.

## **B) Splitting up of contracts**

20.1 The [six] month test established under Article 5(3) of the UN Model convention applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically<sup>59</sup>.

20.2 However, as mentioned above under the “Drilling Activity” section, the [six] month threshold, has given rise to abuses as has been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group.

20.3 In this respect, the UN Model Commentary observe that “Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-

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<sup>58</sup> Para 42.41 of the Commentaries on Article 5 of the OECD Model.

<sup>59</sup> Para 11 of Commentary on Article 5 of the UN Model Convention that reproduces para 18 of the OECD Model Convention.

avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations”.

- 20.4 In a similar way, OECD BEPS Action 7 specifically addresses the splitting up of construction contracts between group companies into shorter periods of time in order to benefit from the "construction site" exemption. The OECD sets out that the splitting should be prevented by applying the principal purposes test, proposed as part of Action 6 on the prevention of treaty abuse, or by a specific provision which aggregates the activities of closely related enterprises on the same site during different periods of time (each exceeding 30 days) for the purpose of determining the 12-month period. The proposed provisions read as follows:

**Paragraph 18 of the Commentary on paragraph 3 of Article 5 replaced by BEPS Action**

**7**

“18.1 (...)

*For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded,*

*a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during periods of time that do not last more than twelve months, and*

*b) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.*

*The concept of “closely related enterprises” that is used in the above provision is defined in subparagraph b) of paragraph 6 of the Article (see paragraphs 38.8 to 38.10 below).*

*18.2 For the purposes of the alternative provision found in paragraph 18.1, the determination of whether activities are connected will depend on the facts and circumstances of each case. Factors that may especially be relevant for that purpose include:*

*– whether the contracts covering the different activities 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 activities would have been covered by a single contract absent tax planning considerations;*

*- whether the nature of the work involved under the different contracts is the same or similar;*

*- whether the same employees are performing the activities under the different contracts.*

- 20.5. The E&P blocks are where the actual E&P activities are performed, and each block is generally governed under distinct petroleum contracts assigned to joint ventures with different partners governed under a JOA, while the office as a coordination centre provides administrative and technical support, and supervisory activities to each of the blocks in which the company has a participation. Therefore, the E&P blocks and the office are considered to carry on different activities, which cannot be regarded as a single project.
- 20.6. With respect to subcontractors, the individual circumstances of each case have to be considered since having signed different contracts with different clients, as long as no abusive elements are found, should not lead to an aggregation of the projects into a single project with regard to the calculation of the timing threshold established in the tax treaty.

## J.- The attribution of profits to PE

- 21.1 Once a PE is deemed to exist in the source country, its mere existence does not, by itself, mean that additional taxes are owed to the country where the PE is located. The 2008 OECD *“Report on the Attribution of Income to Permanent Establishments”* adopts a *“functionally separate entity”* approach, where the PE is treated as an entity distinct from its overseas parent for several purposes.
- 21.2 However, the UN Committee of Experts decided at its 2009 annual session not to adopt the OECD approach to Article 7 arising from the OECD’s 2008 report. The 2008 PE Report envisions taking into account dealings between different parts of an enterprise such as a PE and its head office to a greater extent than is recognized by the UN Model Convention. The Committee of Experts decided not to adopt this OECD approach because it was in direct conflict with paragraph 3 of Article 7 of the UN Model which generally disallows deductions for amounts *“paid”* (other than toward reimbursement of actual expenses) by a PE to its head office. That rule is seen as continuing to be appropriate in the context of the UN Model, whatever changes have been made to the OECD Model and Commentaries. It should also be noted that only a few countries have implemented the approach and many others have made their outright reservation and will not apply the rule.

## K.- Services PE

- 22.1 In the 2008 proposal for amendments of the Model Convention, the UN Committee already recognized the difficulties in combining Article 14 and Articles 5 and 7<sup>60</sup> and decided to retain

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<sup>60</sup> United Nations Economic and Social Council Committee of Experts on International Cooperation in Tax Matters, E/C.18/2008/CRP.4: [http://www.un.org/esa/ffd/tax/thirdsession/EC18\\_2007\\_CRP4.pdf](http://www.un.org/esa/ffd/tax/thirdsession/EC18_2007_CRP4.pdf). After considering the arguments for and against deletion of Article 14, the subcommittee concluded that retaining the combination of Article 14 and Articles 5 and 7 would continue to cause difficulties, ambiguities and uncertainty in the application that benefit neither administrations nor taxpayers. These difficulties include the uncertainties over the personal scope of Article 14, the scope of activities that fall under Article 14, the possible interpretation of a difference between the concepts of PE and fixed base, difficulties over the taxation of partnerships under

Article 14, although an alternative provision was introduced in the Commentary for States that wished to remove Article 14:

**UN ALTERNATIVE TEXT FOR COUNTRIES WISHING TO DELETE ARTICLE 14**

15.5 Article 14 would be deleted. Subparagraph (b) of paragraph 3 of Article 5 would read as follows:

*(b) the 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 within any twelve-month period commencing or ending in the fiscal year concerned;*

15.6 The changes to the version of this subparagraph in the 1999 United Nations Model Convention are minor, comprising (i) the deletion of the words “including consultancy services”, after the words “the furnishing of services”, on the basis that the wording was unnecessary and confusing, such services being clearly covered; (ii) the replacement of the six-month test with the 183 days test, (...); and (iii) the use of a semicolon rather than a period at the end of the subparagraph, with the introduction of subparagraph (c). In relation to the wording of subparagraph (b), some members of the Committee consider, however, that the words “(for the same or a connected project)” should be eliminated as no such requirement exists in Article 14.

15.7 A new subparagraph (c) of paragraph 3 would also be inserted, as follows:

(c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual’s stay in that State is for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned.

Subparagraph (c) is intended to ensure that any situation previously covered by Article 14 would now be addressed by Articles 5 and 7. The wording reflects the fact that deletion of Article 14 of the United Nations Model Convention would involve deletion of the “days of physical presence” test found in subparagraph (b) of paragraph 1 of Article 14 of that Model, which had no counterpart in the OECD Model Convention when the deletion of Article 14 was agreed for that Model.

22.2. In accordance with 3b) of Article 5 of the UN Model, the furnishing of services, including consultancy services, through employees or other personnel of an enterprise of one Contracting State constitutes a PE in the State where such services are performed, if the activities for the same and connected project continue there for a period or periods aggregating more than 183 days within any 12-month period. The UN Model goes beyond the fixed base concept, since under the rule, the mere furnishing of services as such already leads to the taxation of the enterprise by the State of source, even if the enterprise has no fixed base in that State. This extension of taxation by the State of source is of particular significance

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Article 14 (especially when of a mixed individual/company character), and in relation to the taxation of large worldwide partnerships of lawyers.



in connection with making personnel available and with providing technical assistance. Both would, under the UN Model and contrary to the situation under the OECD Model result in taxation by the State which benefits from the services.<sup>61</sup>

- 22.3. In this case, the requirements of Article 5(1) of the UN Model, described above under part E “The Basic Rule of Permanent Establishments”, do not have to be fulfilled. This provision is of particular significance in connection with making personnel available in respect of certain services or activities not covered by Article 5(3)(a) of the UN Model, explained above under part F “The construction work clause” as, for example, technical assistance or repair services.
- 22.4. In addition, it should also be noted that Contracting States may evaluate assimilate fees for technical services as royalties under Article 12 of the UN Model or under the new “Fees for Technical Services” provision describe under Part L “Fees for technical services” below, rather than assuming the existence of a PE. In such a case, the source taxation will apply a withholding tax irrespective of the duration of the services.
- 22.5. In 2000 the OECD Model deleted Article 14 related to “*Independent Personal Services*” as it was concluded that there was no practical difference between Articles 7 and 14 or, where such differences existed, there did not appear to be any valid policy justification for them<sup>62</sup>.
- 22.6. However, in 2008 the OECD included a[] service PE alternative provision to Article 5 in the Commentary for States that believe that additional source taxation rights should be allocated under a treaty with respect to services performed in their territory<sup>63</sup>. The OECD included the provision in the Commentary and not in the Model Treaty because the Committee identified a number of compliance and double-taxation issues associated with the provision, which are explained in the Commentary.<sup>64</sup>

## L.- Fees for technical services

- 23.1. Due to the difficulties in dealing with the concept of PE in relation to technical services, and the issue of base erosion in developing countries, a new Article is added to the United Nations Model Convention of 2017 to allow a Contracting State to tax fees for certain technical and other services made to a resident of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States.
- 23.2. Until the addition of this Article, income from services, including income from technical services, derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was resident. However, if the enterprise carried on business through a PE in the other State (the source State) or provided professional or independent personal services through a fixed base in the source State, the source State was entitled to tax the

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<sup>61</sup> Klaus Vogel on Double Taxation Conventions, Wolters Kluwer, pages 310 and 311.

<sup>62</sup> OECD: Issues Related to Article 14 of the OECD Model Tax Convention, 1 April 2000.

<sup>63</sup> Commentary 42.43 (Alternative service provision) to Article 5 of the OECD Model.

<sup>64</sup> Para 42.12 of the Commentaries on Article 5 of the OECD Model Convention.

income attributable to the PE or fixed base under Article 7 or 14 respectively. In the absence of a PE or fixed base in the source State, it was thought that an enterprise resident in a Contracting State was not sufficiently involved in the economy of the source State to justify that State taxing the income. However, with the rapid changes in modern economies, particularly with respect to cross-border services, it is now considered possible for an enterprise resident in one State to be substantially involved in another State's economy without a PE or fixed base in that State and without any substantial physical presence in that State.

**Agreed Text for New Article [16] as of 21 October 2015 – Fees for Technical Services**

1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed \_\_\_ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term "fees for technical services" as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:

- (a) to an employee of the person making the payment;
- (b) for teaching in an educational institution or for teaching by an educational institution; or
- (c) by an individual for services for the personal use of an individual.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with

- a) such permanent establishment or fixed base, or
- b) business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a

Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.

6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State or a third State through a permanent establishment situated in that other State or the third State, or performs independent personal services through a fixed base situated in that other State or the third State and such fees are borne by that permanent establishment or fixed base.

7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

23.3. *Article [16] allows fees for technical services to be taxed by a Contracting State on a gross basis. Many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from services derived by non-residents. A withholding tax imposed on the gross amount of payments made by residents of a country, or non-residents with a permanent establishment or fixed base in the country, is well established as an effective method of collecting tax imposed on non-residents. Such a method of taxation may also simplify compliance for enterprises providing services in another State since they would not be required to compute their net profits or file tax returns.*<sup>65</sup>In this respect, the Commentary observes that “A precise level of withholding tax on fees for technical services should take into account several factors, including the following:

- the possibility that a high rate of withholding tax imposed by a country might cause non-resident service providers to pass on the cost of the tax to customers in the country, which would mean that the country would increase its revenue at the expense of its own residents rather than the non-resident service providers;
- the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment;

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<sup>65</sup> Para 28 of the draft commentary on new Article 16 of the UN Model Convention.

- the possibility that some non-resident service providers may incur high costs in providing technical services, so that a high rate of withholding tax on the gross fees may result in an excessive effective tax rate on the net income derived from the services;
- the potential benefit of applying the same rate of withholding tax to both royalties under Article 12 and fees for technical services under Article [16] (...)
- the fact that a reduction of the withholding rate has revenue and foreign-exchange consequences for the country imposing withholding tax; and
- the relative flows of fees for technical services (e.g., from developing to developed countries).on fees for technical services, but are concerned with the broad scope of Article [16], may consider agreeing to amend Article 12 (Royalties) to permit taxation of certain “fees for included services,” an approach that is found in a number of bilateral tax treaties between developing and developed countries”.

**Examples of Tax treaties that include technical fees**

**Italy - Vietnam Income Tax Treaty of 26 November 1996**

**Article 12**

**Royalties and fees for technical services**

1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the recipient is the beneficial owner of the royalties or of fees for technical services, the tax so charged shall not exceed:
  - (a) in the case of royalties, 10 per cent of the gross amount of such royalties;
  - (b) in the case of fees for technical services, 7.5 per cent of the gross amount of such fees.
3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.
4. The term "fees for technical services" as used in this Article means payments of any kind to any person, other than payments to an employee of the person making the payment, in consideration

for any services of a managerial, technical or consultancy nature rendered in the Contracting State of which the payer is a resident.

(...)

**Papua New Guinea - United Kingdom Income Tax Treaty of 17 September 1991**

**Article 14**

**Technical fees**

1. Technical fees arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such technical fees may also be taxed in the Contracting State in which they arise and according to the law of that State, but if the recipient is the beneficial owner of the technical fees the tax so charged shall not exceed 10% of the gross amount of the technical fees.

3. The term "technical fees" as used in this Article means payments of any kind to any person, other than an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature.

(...)

## For more information

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