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More on Services PEs—What Is a Connected Project?

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PRÉCIS

Depuis les premiers jours des conventions fiscales, on admettait généralement que les bénéfices d'entreprise gagnés par un résident d'un État dans un autre État seraient imposés dans l'État source seulement si le résident gagnait ces bénéfices par l'intermédiaire d'un « établissement stable » (ES) dans cet État source. Jusqu'aux années 70, on entendait généralement par ES un établissement physique réel. Depuis 1969, les Nations Unies ont commencé à envisager d'étendre le concept d'« établissement stable » afin d'inclure la simple prestation de services pendant un certain temps. Dans la plupart des cas (mais non dans tous), les conventions qui sont étendues de cette façon exigent que les services soient fournis à l'égard d'un projet ou d'un « projet connexe ». Le présent article tente d'analyser l'historique et l'essence du terme « projet connexe ». L'article en vient à la conclusion qu'il répond à deux fins distinctes mais liées : limiter le droit d'un État source d'imposer les bénéfices gagnés par la prestation de services et empêcher les résidents étrangers de fractionner et de raccourcir artificiellement les contrats de service dans le but d'éviter de fournir des services pour la durée requise par la convention pour créer un ES.

ABSTRACT

From the earliest days of tax treaties, it was agreed generally that business profits earned by a resident of one state in another state would be taxed in the source state only if the resident earned those profits through a permanent establishment (PE) in that source state. Until the 1970s, a PE generally meant an actual, physical, establishment. Starting in 1969, the United Nations started to consider the possibility of expanding the "permanent establishment" concept to include the mere provision of services for a certain length of time. In most (although not all) cases, treaties that contain such an expansion require that the services be provided in respect of a project or a "connected project." This article attempts to analyze the history, purpose, and meaning of the term "connected project." The article concludes that the connected project requirement serves two separate but related purposes: (1) to limit a source state's right to tax profits earned from the provision of services, and (2) to prevent foreign residents from splitting up and shortening service contracts artificially so as to avoid providing services for the period of time required under the treaty to create a PE.

KEYWORDS: PERMANENT ESTABLISHMENT ■ SERVICES ■ LIMITATIONS ■ ANTI-ABUSE

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INTRODUCTION

In 1933, Mitchell B. Carroll, at that time an adviser to the US Treasury department, published his seminal study on the question of when one country ("the source state") should tax the business profits earned in that state by an enterprise of another country ("the residence state").[1] His conclusion was that, to prevent double taxation and encourage cross-border trade and investment, the source state should

1 Mitchell B. Carroll, *Taxation of Foreign and National Enterprises*, vol. 4, *Methods of Allocating Taxable Income*, League of Nations doc. C.425(b).M.217(b).1933.II.A (Geneva: League of Nations, 1933) (http://setis.library.usyd.edu.au/oztexts/parsons.html—item 5).

tax the enterprise only if, and to the extent that, the profits earned by the enterprise in the source state could be allocated to the enterprise's permanent establishment (PE) in the source state. The residence state would then provide a tax credit to the enterprise for the tax it paid to the source state on those profits.

The PE concept was adopted by the Fiscal Committee of the League of Nations in the league's early model tax treaties and by the league's successors, the Organisation for European Economic Co-operation (OEEC) and the Organisation for Economic Co-operation and Development (OECD), in their model treaties.[2] It is now used throughout the world and appears in all, or almost all, tax treaties.

However, Carroll's proposal had what some countries perceived to be a flaw. Starting in 1969, developing countries noted that, in most cases,[3] the definition of a PE required a bricks-and-mortar establishment. That meant that a foreign enterprise could provide services in the source state, even over a long period of time, and could earn significant profits from those services, without the source state being able to tax those profits, so long as the enterprise did not provide the services through a PE in the source state. This has become even more possible given the increase in mobility and virtualization in our high-tech world.[4]

In 1979, in conjunction with the objective of enhancing trade between developing and developed countries,[5] the United Nations (UN) drafted and in 1980 published a model income tax treaty[6] that contained a provision—article 5(3)(b)—that was designed to create a PE (a "services PE")[7] in such situations. Under the services PE

2 In 1958, the OEEC began to publish a model income tax convention with commentaries to explain the meaning and purpose of each article in the model. Both the OEEC and, earlier, the Fiscal Committee of the League of Nations had been working on a model treaty for many years. The OEEC was renamed the OECD in 1961. Starting in 1963, the OECD published a model income tax convention ("the OECD model treaty"). The OECD model treaty was accompanied by commentary ("the OECD commentary") on the meaning of each article in the model. The OECD model treaty and the OECD commentary have been revised frequently since then. As well, the United Nations, the United States, and other jurisdictions have followed the format of publishing a model treaty accompanied by commentary thereon, updated more or less frequently.

3 The agency PE being the exception.

4 See Michael Wichmann, "The Taxation of Services: Is the Permanent Establishment the Appropriate Threshold?" (2004) 58:5 *Bulletin for International Fiscal Documentation* 201-4.

5 For a discussion of Canada's tax treaty policy toward developing countries, including the use of a services PE provision, see Kim Brooks, "Canada's Evolving Tax Treaty Policy Toward Low-Income Countries," in Arthur J. Cockfield, ed., *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010), 189-211, at 197.

6 United Nations, Department of International Economic and Social Affairs, *United Nations Model Taxation Convention Between Developed and Developing Countries*, UN publication no. ST/ESA/102 (New York: United Nations, 1980) (herein referred to as "the UN model treaty") and the accompanying commentary ("the UN commentary").

7 The earliest tax treaty I can find that contains a services PE provision is the 1973 Indonesia-Netherlands income tax treaty. That treaty also is the earliest to use the concept of a "connected project" in this context. The earliest treaty that refers to connected projects having to form a "coherent whole" (albeit in the construction PE context) is the 1975 Singapore-Switzerland

provision, an enterprise of the residence state will be deemed to have a PE in the source state if it provides services in the source state through a single employee who is present in the source state for more than 183 days in any 12-month period, or if two or more employees are present collectively in the source state for more than 183 days in that period and provide services on the same project or on two or more "connected" projects. As has been noted, this services PE provision has the effect of lowering the degree of economic activity required to form a PE as compared with the traditional definition of a PE contained in the OECD model tax treaty.[8] Such lowering is done deliberately, to enhance the ability of developing countries to tax profits earned within their jurisdiction.

To date, the exact purpose and meaning of the concept of a "connected project" in this context has not been determined. The purpose of this article is to explore the history, purpose, and meaning of that phrase. I have attempted to identify the two key policy objectives that have been put forward to justify the use of the phrase in the services PE provision. I have also attempted to draw some conclusions as to the facts that should be taken into account in determining whether two or more projects are connected.

In brief, the idea of taxing the enterprise when it meets the 183-day threshold, not just on a single project, but even if those days are attributable to two or more connected projects, is supported by two policy objectives. The first is that the source state should not be able to tax the enterprise unless the enterprise has a substantial enough connection to the source state to justify taxation under international tax policy. Accordingly, the source state should not be able to aggregate days spent on unrelated and unconnected projects, no one of which would create a substantial enough connection, so as to reach the 183-day threshold. Seen in this light, the "connecting" requirement is a *limiting* factor on the source state; it protects the enterprise from taxation when there is no real, substantial connection to the source state, or at least not enough of a connection to justify source state taxation.

The second policy objective is to prevent abuse: the connected project concept prevents an enterprise from splitting up a project into two or more artificial components and spending less than 183 days on each component.

As discussed in more detail below, the first policy objective appears to have been the original impetus behind the connected project concept as developed by the UN. The anti-abuse policy was considered to apply by some developing countries and has been adopted by the OECD. Although these policy objectives appear to be mutually exclusive, my view is that they are not competing but are corollaries of each

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income tax treaty. The earliest Canadian income tax treaty appears to be the 1976 Canada-Pakistan treaty, which also uses the "connected project" rule.

8 See Armando Lara Yaffar and Michael Leonard, "An Introduction to the Updated UN Model (2011)" (2012) 66:11 *Bulletin for International Taxation* 590-97, at 593. Perhaps it would be more accurate to say that the services PE does not lower the degree of economic activity required to create a PE, but rather lowers the degree of (some would say, eliminates the need for a) physical connection to the source state required to create a PE.

other: both should be considered valid, and a court or a revenue authority should consider both at the same time when determining whether any two projects are connected. I have developed this theory more below.

AN EXAMPLE

To focus the discussion and to concentrate particularly on Canada's most important trading partner, assume that a US corporation ("USco") is engaged by a Canadian corporation ("Canco") to provide services in Canada in respect of several of Canco's projects. From time to time, pursuant to a services agreement between USco and Canco, USco sends its employees to Canada to perform the required services. When the employees work at Canco's Canadian offices, they are not given any designated space but must work wherever space is available, at Canco's direction. The employees' names are not listed in any phone book or other directory associated with Canco. The employees are not provided with keys to the buildings in which Canco has its offices. In short, the employees have no control over their work space, are not associated in any way with that work space, and are not permitted to carry out any business in that space other than the work for which USco has been retained for that particular project. They stay at hotels while in Canada.

Assume that no one employee works in Canada for more than 183 days in any 12-month period. However, collectively the USco employees work in Canada for more than 183 days in a 12-month period.

Is USco Taxable in Canada?

From this relatively simple scenario, numerous tax issues arise with respect to both income tax and goods and services tax/harmonized sales tax (GST/HST), but for the purposes of this article, the most important issue is whether USco is taxable on its profits earned in Canada.

The Income Tax Act

Because USco provides services in Canada to Canco under the services agreement, USco is carrying on business in Canada for the purposes of the Income Tax Act.[9] Therefore, pursuant to clauses 150(1)(a)(i)(B) and (ii)(B), USco must file a Canadian income tax return within six months after the end of its taxation year, regardless whether its business income is exempt from Canadian taxation under an income tax treaty.

Under a combination of paragraph 2(3)(b), subparagraph 115(1)(a)(ii), paragraph 3(a), and subsection 9(1), USco must report its "profit" from its Canadian business. The word "profit" is not defined in the Act; it means, essentially, the net Canadian business income of a taxpayer, computed on an accurate basis, under any reasonable method. This will equal USco's gross receipts receivable under the services agreement, minus

9 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

all of its expenses allocable to the Canadian business—that is, all expenses incurred directly or indirectly in the course of providing the services under the agreement.[10]

The Treaty

The above conclusion is based on the provisions applicable under the Act. However, those provisions may be overridden by an income tax treaty. Article VII(1) of the Canada-US income tax treaty[11] provides that a person who meets the definition of a US "resident" in article IV and who comes within the limitation-on-benefits provision in article XXIX A is not taxable in Canada on business income earned in Canada unless that income is earned through a PE in Canada, and then only to the extent of the profits "attributable" to that PE, net of expenses allocable to that PE. Article VII(2) further provides that profits and expenses are to be determined as if the PE were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with a Canadian resident and with any other person related to the resident. Article VII(7) states that the profits attributable to a PE "include only those profits derived from the assets or activities of the [PE]." Accordingly, the treaty does not have a "force-of-attraction" provision similar to article 7(1)(c) of the UN model treaty, under which the profits to be taxed may include not only profits attributable to the PE but also profits from other business activities carried on in the other state of the same or a similar kind as those effected through the PE.[12]

Article V defines a PE for the purposes of the treaty. The definition provides that a PE may exist under several different scenarios. These include a fixed place of business ("fixed-base PE"), a construction site ("construction site PE"), and a PE created through services rendered in the other contracting state.

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10 *Canderel Ltd. v. Canada*, [1998] 1 SCR 147; *Toronto College Park Ltd. v. Canada*, [1998] 1 SCR 183.

11 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein generally referred to as "the treaty").

12 The US Treasury department issues a plain-English "explanation" for each US treaty (a "technical explanation"). The technical explanations of the treaty and each of its protocols have been given significant weight by the Canada Revenue Agency (CRA) and Canadian courts in interpreting the treaty, because Canada has expressed its agreement with them. See, for example, the United States, Department of the Treasury, "Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Income Tax Convention Between the United States of America and Canada" (herein referred to as "the technical explanation of the fifth protocol"), released July 10, 2008; and Canada, Department of Finance, "Canada Supports U.S. Technical Explanation of the Fifth Protocol to the Canada-United States Income Tax Convention," *News Release* 2008-052, July 10, 2008. The absence of a force-of-attraction principle in the treaty is confirmed by the technical explanation of article VII(7) and by the CRA's *Income Tax Treaties Reference Manual* (Ottawa: CRA), 94 ITC 100, which states, "Paragraph 7 clarifies that business profits attributable to a PE shall include only those profits derived from the assets or activities of the PE. This paragraph ensures that the 'force of attraction' rules in the US will not apply since they do not meet the 'attributable to' rules of this paragraph."

On the basis of the facts in the example, it is likely that USco does not have a fixed-base PE in Canada.[13]

Under article V(3) of the treaty, a building site or construction or installation project constitutes a construction site PE "if, but only if, it lasts more than 12 months." Article V(3) does not say to whom the project must belong, but the OECD commentary on article 5(3) of the OECD model treaty suggests that the PE belongs to the non-resident contractor enterprise that comes into the country where the project is located in order to build the project. If the foreign enterprise works on a project in the source state for more than 12 months, that enterprise will have a construction site PE in the source state. In that situation, the number of employees working on the project and the number of days that they spend in the source state in the 12-month period are irrelevant.

The OECD commentary goes into some detail about what constitutes a "construction project" for this purpose. Essentially, if work is done in various places, or at various times, or by various employees, but all of the work is done to create a single "unit"—that is, a coherent whole—from a commercial and geographical point of view, then it is a single project.[14]

Even assuming that Canco has some construction projects and that USco provides services in connection with them, provided that no single project or coherently whole group of projects lasted for more than 12 months, USco would not have a construction site PE under article V(3).

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13 See *The Queen v. Dudney*, 2000 DTC 6169 (FCA). Proposed changes to the commentary on article 5 of the OECD model treaty suggest that *Dudney* was wrongly decided. See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2010); *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)* (Paris: OECD, October 19, 2012), at paragraphs 11-14; and Siobhan Goguen and Marc Darmo, "Permanent Establishment Update," paper presented at the International Fiscal Association (Canadian branch) International Tax Seminar, May 23-24, 2013, at slide 12. Nevertheless, a Canadian court would be required to follow *Dudney* on similar facts. See *Dysert v. The Queen*, 2013 TCC 57, at note 3. The OECD commentary should not be controlling: see by analogy *McKesson Canada Corporation v. The Queen*, 2013 TCC 404, at paragraph 120(2); under appeal. This is true particularly because nothing in recent amendments to the text of the OECD or UN model treaties or to the Canada-US treaty was designed to overrule *Dudney* as far as a fixed-base PE was concerned. See United States, Staff of the Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, JCX-57-08 (Washington, DC: Joint Committee on Taxation, July 8, 2008) (hereinafter cited as "JCX-57-08"), at part VI, chapter A, "Permanent Establishment by Virtue of Services."

Compare *Dudney* with *Convergys v. Director of Income Tax* (2013), 15 ITLR 939 (Delhi ITAT) and *Renoir Consulting Ltd. v. DDIT* (ITA no. 4323/Mum/2011, ITA no. 4125/Mum/2011, ITA no. 5298/Mum/2009) (April 2014). In *Renoir*, the tribunal held that there was a fixed-base PE in the client's offices, although others have suggested that the hotel was the PE. See PWC, "Hotel Stay + Business = Permanent Establishment," http://www.moneycontrol.com/news_html_files/news_attachment/2014/pwc_news_alert_22_april_2014_renoir_consulting_limited[1].pdf.

14 See paragraph 18 of the OECD commentary on article 5.

Services PE

That leaves the possibility of USco's having a services PE in Canada.[15] Article V(9) of the treaty, added by the fifth protocol in 2007, states:[16]

9. Subject to paragraph 3, where an enterprise of a Contracting State provides services in the other Contracting State, if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article, that enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:

(a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or

(b) The services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

9. Sous réserve du paragraphe 3, lorsqu'une entreprise d'un État contractant fournit des services dans l'autre État contractant, s'il est déterminé qu'elle n'a pas d'établissement stable dans cet autre État en vertu des paragraphes précédents du présent article, cette entreprise est réputée fournir ces services par l'intermédiaire d'un établissement stable dans cet autre État dans les seuls cas où :

a) ces services sont fournis dans cet autre État par une personne physique qui y séjourne pendant une période ou des périodes totalisant 183 jours ou plus au cours d'une période quelconque de douze mois et, pendant cette période ou ces périodes, plus de 50 p. 100 des recettes brutes tirées d'une entreprise exploitée activement de l'entreprise consistent en un revenu tiré des services fournis dans cet autre État par la personne physique; ou

b) les services sont fournis dans cet autre État pendant une période totale de 183 jours ou plus au cours d'une période quelconque de douze mois relativement au même projet ou à un projet connexe pour des clients qui soit sont des résidents de cet autre État, soit y maintiennent un établissement stable, et les services sont fournis relativement à cet établissement stable.

15 For a more general review of how service providers may have a PE in a source state other than pursuant to a services PE provision, see Sandra P. McGill and Lowell D. Yoder, "From Storefronts to Servers to Service Providers: Stretching the Permanent Establishment Definition To Accommodate New Business Models" (2003) 81:3 *Taxes: The Tax Magazine* 141-62.

16 As noted below, article V(9) may have been based on article 5(3)(b) of the UN model treaty. For a detailed discussion of the UN services PE provision, see Edwin van der Bruggen, "International Tax Aspects of Providing Consulting Services on the Premises of the Client" (2001) 21:2 *ABAC Journal* (Assumption University of Thailand) 1-27.

SOME PRELIMINARY THOUGHTS ON ARTICLE V(9)

Is There a Typo?

The very first question one must ask about article V(9)(b) is, "Is there a typographical error in the English version?" It says, "with respect to the same or connected project," whereas the French version says, "au même projet ou à *un* projet connexe" (for the same project or for *a* connected project—emphasis added). If a difference in meaning was intended between the two versions, it is not apparent what that difference is. It may be that the missing article "a" in the English version has led some to believe that "connected project" should be "connected projects," as it is in some treaties.[17] However, on the basis of the French version, it appears that the article was inadvertently left out of the English version.[18]

Where Does Article V(9) Come From?

As discussed in more detail below, the OECD model treaty does not contain a services PE provision, but the following wording is suggested in the commentary on article 5:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
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> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
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> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected

17 See Brian J. Arnold, "The New Services Permanent Establishment Rule in the Canada-United States Tax Treaty," in *Globalization and Its Tax Discontents*, supra note 5, 280-304, at 294. The term "connected projects" is used, for example, in the 2009 Poland-Norway income tax treaty. See Błazej Kuźniacki, "The Service PE Concept in Light of the Poland-Norway Income Tax Treaty (2009)" (2014) 54:1 *European Taxation* 16-28.

18 Most of Canada's income tax treaties that contain a services PE provision use the term "same or a connected project." Thailand uses "same or connected projects," and New Zealand uses "same project or for connected projects." Azerbaijan, Tanzania, and the United States use "same or connected project." The treaties of a number of countries (for example, Chile and Argentina) do not refer to "connected project" at all. It is interesting to note that the diplomatic notes to the fifth protocol of the Canada-US treaty (infra note 30), the technical explanation of the fifth protocol (supra note 12), and JCX-57-08 (supra note 13) all use the term "connected projects." One supposes it is possible that there are in fact three typographical errors: the use of the article "un" and the word "projet" instead of "projets" in the French version and the missing "s" in the word "project" in the English version. This seems more far-fetched than supposing that there is a missing "a" before "connected" in the English version, and one can only assume that the diplomatic notes, etc., were merely using loose language in referring to "connected projects."

> projects through one or more individuals who are present and performing such services in that other State
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> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.[19]

As can be seen, article V(9) is worded very similarly to the OECD's suggested services PE provision. While there is nothing that says so officially, it has been suggested[20] that the similarity means that the former was based on the latter and that therefore the 2008 OECD commentary is instructive in interpreting article V(9).[21] The similarity is also noted in the explanation of the fifth protocol to the Canada-US treaty that was prepared by the Staff of the Joint Committee on Taxation,[22] and published in 2008, in anticipation of a meeting of the US Senate Committee on Foreign Relations.[23] However, the foreign relations committee report notes that article V(9) is somewhat narrower than the OECD provision:

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19 Paragraph 42.23 of the commentary on article 5 of the OECD model treaty.

20 See Brian J. Arnold, "The New Services PE Rule in the Canada-U.S. Treaty Protocol" (2008) 51:2 *Tax Notes International* 189-200, at 192-93, note 25 and the accompanying text; and Arnold, supra note 17, at 283-84.

21 It is not clear which came first. It is generally assumed that article V(9) is taken from the OECD's version of a services PE provision. See Martin B. Tittle, *Permanent Establishment in the United States: A View Through Article V of the U.S.-Canada Tax Treaty* (Lake Mary, FL: Vandeplas, 2007), at 215. Indeed, as discussed in more detail below, the OECD first discussed a services PE provision as early as 2004. But the fifth protocol was being discussed as early as 1999. See Allan R. Lanthier and Kerry L. Plutte, "International Hybrids: Pitfalls and Practice," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 46:1-38, at 46:24. If indeed the OECD commentary was written after Canada and the United States had already negotiated the services PE provision in the fifth protocol, then perhaps the former was based on the latter rather than the reverse—in which case, the OECD commentary should not be relied on at all when interpreting article V(9). It is interesting to note that, in any event, the CRA has suggested that because of the difference in wording between the OECD's proposed version of the services PE provision and article V(9), the OECD commentary cannot be relied on in interpreting the treaty provision. See Giancarlo Di Maio and James A. Hutchinson, "Cross-Border Potpourri Issues for Small and Mid-Sized Businesses," in *2012 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2012), 3:1-49, at 3:6-8, note 17 and the accompanying text; and "Canada Revenue Agency and Revenu Québec Round Table," in *Report of Proceedings of the Sixty-Third Tax Conference*, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 4:1-24, at 4:2. I predict that the CRA, practitioners, and courts will not adhere to this suggestion in the future.

22 JCX-57-08, supra note 13.

23 Held July 10, 2008.

> Mr. Mundaca.
>
> I should also note that some other variants of this provision, one that the OECD is considering is broader than we have provided here. They do not have the restriction we have in our provision regarding the geographic coherence. That is, if you are not providing services in one place, our rule doesn't apply. The OECD rule is broader in that extent.[24]

It is possible that article V(9) is based on article 5(3)(b) of the UN model treaty rather than the OECD's suggested version, or at least was not specifically based on the OECD's version. Thus, while it may be instructive to have regard to the OECD commentary when construing article V(9), that commentary is not necessarily binding.

Overruling Dudney

Another preliminary matter to note is that the report of the US Senate's foreign relations committee confirms that article V(9) was inserted to overrule (or perhaps more accurately, to render irrelevant) the decision in the *Dudney* case.[25] There is no doubt that many people (mostly within the Canada Revenue Agency [CRA]) were surprised by the *Dudney* decision, and a valid argument could be made that the case was wrongly decided. As noted above, recent proposed amendments to the OECD commentary on article 5 appear to be intended to suggest that it *was* wrongly decided.[26] However, at least in Canada, the decision would have to be followed by any future court unless the Supreme Court of Canada overruled it. Canada's approach appears to have been to import a services PE provision into the treaty as a way to get around *Dudney*.[27]

Counting Days

Article V(9) requires services to be provided in Canada for 183 days. In terms of what is required to count as a day on which services are provided, the treaty does not provide any clue. It appears that physical presence of an employee in the source state is required, but days of preparation in the residence state do not count. The foreign relations committee report, in words adopted by the technical explanation of the fifth protocol, states:

> Paragraph 9 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services

24 S exec. rep. no. 110-15, 110th Cong., 2d sess. (September 11, 2008), at 123.

25 Ibid., at 4, note 5 and the accompanying text; *Dudney*, supra note 13.

26 See supra note 13.

27 See Tittle, supra note 21, at 212 et seq.

> by telephone or computer to customers located in the other State, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.[28]

Paragraph 42.36 of the 2008 OECD commentary on article 5 discusses how days should be counted for the purposes of the 183-day test in the equivalent provision to article V(9)(a). The commentary suggests that the principles applicable to the computation of days of presence for the purposes of article 15(2)(a) of the OECD model treaty (which deals with the taxation of cross-border employees) are also applicable for the purposes of the 183-day test. Under article 15(2)(a), any part of a day in which a person is physically present in the source state counts as a day.[29]

What Is an "Enterprise"?

Another introductory question is, "What is an 'enterprise' for the purposes of article V(9)?" That term used to be, but is no longer, defined in the treaty, and it is not used elsewhere in the treaty. Unless "enterprise" has a meaning that is intended to be applied only with reference to the treaty, article III(2) provides that the term should take its meaning from the law of the country that is applying it—in this case, Canada.[30] However, "enterprise" is not defined in the Act or in any related Canadian domestic tax legislation, so article III(2) is of no use here. It has been suggested that the inclusion of the term in article V(9) was a drafting mistake that arose because article V(9) was based on the OECD commentary, and because the OECD model treaty uses the term.[31] This possibility is enhanced when one notes that article V(9) applies

28 Supra note 24, at 25; technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V."

29 See Kuźniacki, supra note 17, at 24-25.

30 See Diplomatic Notes to Fifth Protocol (Annex B), which provides:

> *1. Meaning of undefined terms*
> For purposes of paragraph 2 of Article III (General Definitions) of the Convention, it is understood that, as regards the application at any time of the Convention, and any protocols thereto by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities otherwise agree to a common meaning pursuant to Article XXVI (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention, and any protocols thereto apply, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

31 See Arnold, supra note 17, at 284-85.

only if the enterprise does not have a PE under the other paragraphs in article V. But those other paragraphs are directed at determining whether a "resident" of a contracting state has a PE. Thus, in my view, in the context of article V(9), an "enterprise" simply means a "resident."[32]

If that interpretation is not correct, then the term must be defined. In previous versions of the treaty, the word "enterprise" sometimes meant an entity and sometimes meant the business carried on by the entity.[33] The CRA has opined that the term combines those two concepts:

> Our view is that the term "enterprise" refers to a resident of a contracting state but only in reference to a particular line of business carried on by such resident. Therefore where a resident of a contracting state carries on two lines of business, that resident may have a permanent establishment in the other contracting state by reference to one of such lines of business but not the other.[34]

Given that article V(9) deems the enterprise to have a PE, it appears that in this context an "enterprise" must refer to an entity itself and not merely an activity of an entity. Potentially, however, it means that it is a particular line of business of an entity, rather than the entity as a whole, that has the PE.[35]

What Are "Services"?

Article V(9) applies only if the enterprise provides "services," a term that is not defined in the treaty. As with "enterprise," unless "services" has a meaning that is intended to be applied only with reference to the treaty, the term should take its meaning from the law of the country that is applying it—in this case, Canada.

The Act does not define "services." Subsection 123(1) of the Excise Tax Act[36] defines "service" to mean

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32 See Tittle, supra note 21, at 218.

33 Brian J. Arnold and Marc Darmo, "Summary of the Proceedings of an Invitational Seminar on the Attribution of Profits to Permanent Establishments" (2001) 49:3 *Canadian Tax Journal* 525-52, at 538-39.

34 CRA document no. 2008-0300941C6, December 9, 2008. For a discussion of the term, see Marsha Reid, "The New Services PE Provision of the Canada-US Tax Treaty" (2010) 58:4 *Canadian Tax Journal* 845-96, at 865 et seq.

35 See the definition of "enterprise" in the first protocol to the 1942 Canada-US tax treaty (Convention Between Canada and the United States of America for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income Taxes, signed at Washington, DC on March 4, 1942, as amended by the protocols signed on June 12, 1950, August 8, 1956, and October 25, 1966), as discussed in *Abed Estate v. The Queen*, 82 DTC 6099 (FCA). There is a large body of work on the meaning of "enterprise" in the OECD model treaty. See, for example, Guglielmo Maisto, ed., *The Meaning of "Enterprise," "Business" and "Business Profits" Under Tax Treaties and EU Tax Law* (Amsterdam: IBFD, 2011).

36 RSC 1985, c. E-15, as amended.

anything other than

(a) property,

(b) money, and

(c) anything that is supplied to an employer by a person who is or agrees to become an employee of the employer in the course of or in relation to the office or employment of that person.

It has been suggested that this and similar definitions in value-added tax legislation are too broad for the purposes of the services PE provision.[37] With respect, I disagree.[38] Given that article V defines a PE to exist in various situations other than those involving the provision of services, it appears that article V(9) is intended to be exactly the same sort of catchall provision that the definition of "services" in the Excise Tax Act is intended to be.[39] I agree with the following discussion of "services" in a treaty context:

> Based on these broad interpretations, any process or activity which involves useful labour and gives rise to economic or commercial value for the recipient, but does not produce a tangible commodity or intangible property, will probably be considered a "service." Consequently, a "service" will not only include traditional activities, such as marketing, employee training, information technology support and acting as a broker, but it will also include financial and/or automated activities such as financial guarantees, the provision of insurance and electronically delivered services, including the transmission of communications, database access, website hosting and online gaming.[40]

37 Ariane Pickering, "General Report," in International Fiscal Association, *Enterprises Services*, Cahiers de droit fiscal international vol. 97a (The Hague: Sdu Uitgevers, 2012), 17-60, at 25.

38 Kuźniacki also appears to disagree: see Kuźniacki, supra note 17, at note 36 and the accompanying text.

39 Notably, Tittle discusses article V(9) under the heading "Services Catchall": Tittle, supra note 19, at 203.

40 Yi-Wen Hsu and Claire M.C. Kennedy, "Canada," in *Enterprises Services*, supra note 37, 169-90, at 172. Space does not permit a full discussion of the meaning of "service." Relevant authorities may include People's Republic of China, State Administration of Taxation, "Notice on Issuing the Interpretation of the Articles of the Agreement Between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Protocol Thereof," *Notice* no. 75 (2010), July 26, 2010; paragraph 42.29 of the OECD commentary on article 5; Danuše Nerudová and Marlies Steindl, "Reflections on the Service PE Concept in the Double Taxation Treaty Between Austria and the Czech Republic" (2013) 41:11 *Intertax* 604-13, at 611; Canada Revenue Agency, *Technical Information Bulletin* B-090, "GST/HST and Electronic Commerce," July 2002 under "Characterization of Supplies"; United States Internal Revenue Code of 1986, section 7701(e); Treas. reg. section 1.861-18; and *Garcia v. CIR*, 140 TC no. 6 (2013); 16 ITLR 61. Services that are supplied as part of a sale or lease of property to ensure that the property works properly are probably not services for the purposes of article V(9) but rather part of the sale or lease of the property.

What Does It Mean To "Provide" Services?

Under article V(9), the services must be "provided." In a CRA technical interpretation,[41] USco 1 entered into a contract to perform services for Canco, a customer resident in Canada. USco 1 engaged USco 2 to carry out the services on behalf of USco 1 that USco 1 was obligated to perform under the contract with Canco. The services were performed over a period of more than 183 consecutive days. USco 1 and USco 2 were residents of the United States and not of Canada for the purposes of the treaty. Many employees of USco 2 were involved in performing the consulting services. Canco, USco 1, and USco 2 were controlled by a common parent company. The CRA opined that USco 1 "provided" consulting services to Canco through the agency of USco 2 and therefore was deemed to have a services PE in Canada under article V(9)(b) of the treaty. This suggests that "provided" means nothing more than "performs" or "carries out," whether directly or through an agent or contractor.

Article 5(3)(b) of the UN model refers to services being "furnished." As discussed in more detail below, it has been suggested that this word permits services to be provided from outside the source state while still creating a services PE inside the source state. But the case law does not support that interpretation, and neither does the UN commentary to date.

Providing Services to Related Enterprises

Another introductory question is whether article V(9) can apply to services provided by an enterprise to a related or affiliated entity. Suppose USco and Canco were related or affiliated in some way. Would that mean that USco could not fall into article V(9), even if it otherwise met its conditions?

The OECD commentary on article 5 suggests that that would be the case. It states:

> The provision applies to services performed by an enterprise. Thus, services *must be provided by the enterprise to third parties*. Clearly, the provision could not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. For example, services might be provided by an individual to his employer without that employer performing any services (*e.g.* an employee who provides manufacturing services to an enterprise that sells manufactured products). Another example would be where the employees of one enterprise provide services in one country to *an associated enterprise under detailed instructions and close supervision of the latter enterprise*; in that case, assuming the services in question are not for the benefit of any third party, *the latter enterprise does not itself perform any services to which the provision could apply*.[42]

41 CRA document no. 2010-0391541E5, April 13, 2011.

42 Paragraph 42.30 of the commentary on article 5 of the OECD model treaty (emphasis added).

Similarly, the technical explanation of article V(9) states:

> Paragraph 9 applies only to the provision of services, and *only to services provided by an enterprise to third parties*. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise.[43]

The CRA does not believe that USco would be kept out of article V(9) merely because it provided services to a related party. In 2008, the CRA stated:

> Question 3 A2 Part I: Would CRA define what a "third party" is for purposes of this provision [article V(9)]?
>
> Question 3 A2 Part II: Are related parties considered third parties? . . .
>
> Answers to Question 3 A2:
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> Question 3 A2 Part I: It is our view that the term "third party" used in paragraph 9 of Article V of the Treaty should be interpreted to mean any person other than the person operating the enterprise in question.
>
> Question 3 A2 Part II: A related person in reference to a particular person is considered a "third party" for purposes of paragraph 9 of Article V of the Treaty.[44]

Various authors have noted that there is an apparent difference between the CRA's broad interpretation of article V(9) and that set out by the joint committee, which stated:

> According to the Technical Explanation, paragraph 9 applies only to services provided by the enterprise to third parties, *and not to services provided to that enterprise (i.e., inter-company services)*.[45]

It has been suggested that "[i]f the US adopts this interpretation of Article V(9), it would likely take the position with Canada that a US resident should not be deemed to have a permanent establishment in Canada under Article V(9) by providing services in Canada to its Canadian affiliate."[46]

However, the CRA itself does not see a discrepancy between its position and the joint committee's:

43 Technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V" (emphasis added).

44 CRA document no. 2008-0300941C6, December 9, 2008.

45 JCX-57-08, supra note 13, at 42 (emphasis added).

46 Douglas Cannon and Jeff Oldewening, "Article V(9) of the Canada-US Tax Convention, 1980: An Update on the 'Services PE' Deeming Rules" (2009) 8:2 *Toronto Centre CRA & Professionals Consultation Group Newsletter*.

> [Question]
>
> Is there a discrepancy between the CRA's position that subparagraph 9(b) of Article V of the Treaty could apply where services are rendered between related parties and the US Joint Committee on Taxation's statement in their report entitled "Explanation of the proposed Protocol to the Income Tax Treaty Between the United States and Canada" (JCX-57-08) dated July 8, 200[8]? In their explanation, the Joint Committee summarized a statement in the TE [the technical explanation of the fifth protocol] as follows: paragraph 9 only applies to services provided by the enterprise to third parties and not to services provided to that enterprise (i.e. inter-company services).
>
> CRA Response
>
> The CRA continues to be of the view that a related party may be a "third party" and therefore paragraph 9 of Article V can give rise to a permanent establishment where the services in question are rendered to a related party. The CRA agrees with the comment in the TE to the effect that paragraph 9 of Article V cannot give rise to a PE for an enterprise when services are rendered to that enterprise. It is not clear to the CRA that its views are contrary to the views of the U.S. Joint Committee.[47]

Looking at just the text of article V(9), there is nothing to suggest that a service provided by an associated or related enterprise would not fall within that provision.[48] It appears that the OECD commentary and the joint committee report may lead to confusion. Both state merely that a service provided "to" the foreign enterprise is not a service provided "by" that enterprise to its customers in the source state. Nothing in those publications suggests that a service provided to a legally separate but related entity would be outside article V(9). The purpose of the extract from the OECD commentary quoted above appears to be simply to note that if the employees of an enterprise travel to a source state and perform services for the enterprise in that state, a PE is not thereby created in the source state.[49] The phrase "inter-company services," in the context in which it used by the joint committee as quoted above, appears to be a reference to services provided *to* the foreign enterprise in the source state, not services provided *by* the enterprise in the source state.

This conclusion appears to be confirmed by the following statement in the OECD commentary on the suggested services PE provision, in the context of discussing whether the performance of services relating to a preliminary or auxiliary matter could create a PE:

> This alternative provision will not apply if the services performed are limited to those mentioned in paragraph 4 of the Article 5 which, if performed through a fixed place of

47 CRA document no. 2009-0319441C6, August 5, 2009.

48 As noted by Kuźniacki, supra note 17, at 20, the phrase "third parties" does not distinguish between related and unrelated parties.

49 See Arnold, supra note 17, at 284.

> business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. *Since the provision refers to the performance of services by the enterprise and this would not cover services provided to the enterprise itself*, most of the provisions of paragraph 4 would not appear to be relevant.[50]

My suggested reading of article V(9) is supported by *DIT v. Morgan Stanley*.[51] The taxpayer ("MS") was a US company that retained an Indian company ("MSAS") to do certain work. MS sent its employees to India to oversee MSAS's staff in performing the work ("stewardship activities") and also sent employees on secondment to MSAS. MS was assessed in India on the basis that both the stewardship and the secondment activities created a services PE under article 5(2)(l) of the India-US tax treaty.[52]

The stewardship activities involved briefing MSAS's staff to ensure that the output met MS's requirements. These activities included monitoring of the outsourcing operations at MSAS. The stewards were not involved in day-to-day management or in any specific services to be undertaken by MSAS. The India Supreme Court held that in respect of these activities, it could not be said that MS was rendering services to MSAS; it was merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS's services.

In *Re Golf in Dubai, LLC*,[53] the taxpayer was a UAE company that was in the business of organizing golf tournaments. It organized two tournaments in India and paid rental fees for the golf courses. It was held that the taxpayer had not provided services to anyone, and hence did not have a services PE.

In *Deputy Director of Income Tax v. Tekmark Global Solutions LLC*,[54] the taxpayer ("Tekmark") was a tax resident of the United States and had entered into an arrangement with Lucent Technologies Hindustan Pvt. Ltd. ("Lucent") for the deputation of personnel. Under the agreement, Tekmark was responsible for deputing personnel to Lucent under Lucent's supervision and control. The deputed personnel were to be under Lucent's direction, supervision, and control, but they would remain on Tekmark's payroll and Lucent would reimburse Tekmark for their deputation costs.

Since Tekmark considered that it had not rendered any services through its personnel, it treated the amount reimbursed by Lucent as business income that was not earned through a PE in India. The deputy director of income tax argued that Tekmark rendered services to Lucent through its personnel in India and thus created a services PE under article 5(2)(l) of the India-US tax treaty.

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50 Paragraph 42.48 of the commentary on article 5 of the OECD model treaty (emphasis added).

51 (2007), 9 ITLR 1124 (India SC).

52 The Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Together with a Related Protocol, signed at New Delhi on September 12, 1989.

53 (2008), 306 ITR 374 (AAR).

54 (2010), 38 SOT 7 (Mumbai ITAT).

The Income Tax Appellate Tribunal held that because Tekmark had provided personnel only to work under Lucent's control and supervision and did not render any technical services to Lucent through these personnel, the deputation of such personnel could not be considered to create a services PE.

These cases indicate that to have a services PE, the foreign enterprise must be providing the services to a person in the source state.

What About Seconded Employees?

An issue that arises when services are performed by one company across a border for another company is whether employees of the first company who actually travel to do the work remain employees of the first company, in which case they may create a services PE if they meet the days-of-presence test, or whether they become employees of the second company through a secondment, in which case a services PE will not be created.

In *Income Tax Technical News* no. 44 (ITTN no. 44),[55] the CRA stated that where a US enterprise was merely reimbursed for the amount of its compensation costs in respect of an employee that was seconded to a resident of Canada and the employee was under the supervision of the Canadian resident, the US enterprise would not be seen as providing services in Canada. The employee would be seen as performing his or her duties of employment in his or her capacity as an employee of the Canadian resident only. On the other hand, where a US resident seconded one of its employees to its Canadian subsidiary to provide services in Canada to a Canadian client, the employee remained on the US payroll, but the US company charged the Canadian subsidiary 85 percent of the employee's regular per diem rate for the use of the employee's services and the employee was under the supervision of the Canadian subsidiary's executive team, the US resident would have a services PE in Canada.

In ITTN no. 44, the CRA did not refer to *Morgan Stanley*. In that case, with respect to the seconded employees, the court held that an employee of MS, when "deputed" (seconded) to MSAS, did not become MSAS's employee. A "deputationist" (a seconded employee) had a "lien" on his employment with MS. As long as the lien remained with MS, MS retained control over the deputationist's terms and employment. The court held that on request/requisition from MSAS, MS deputed its staff. The request came from MSAS depending on its requirement. A deputationist under such circumstances was expected to be experienced in banking and finance. On completion of his tenure, he was repatriated to his parent job with MS in the United States. He retained his lien when he came to India. He lent his experience to MSAS in India as an employee of MS, and accordingly there was a services PE under article 5(2)(1).[56]

55 Canada Revenue Agency, *Income Tax Technical News* no. 44, April 14, 2011.

56 There was no need to discuss connected projects in this case because there was only one project.

Morgan Stanley was followed in *Centrica India Offshore Pvt. Ltd.*[57] The taxpayer ("CIOP") was an Indian, wholly owned subsidiary of Centrica plc, a UK company. British Gas Trading Ltd. and Direct Energy Marketing Limited, Canada ("the overseas entities") were also subsidiaries of Centrica plc. The overseas entities were in the business of supplying gas and electricity to consumers in the United Kingdom and Canada. The overseas entities outsourced their back-office support functions (for instance, debt collections/consumers' billings/monthly jobs) to third-party vendors in India. CIOP was established to ensure that the Indian vendors complied with the overseas entities' quality guidelines. CIOP was to act as a service provider to the overseas entities. CIOP entered into a service agreement with the overseas entities to provide local-based interface between them and their Indian vendors. CIOP's services included (1) providing management assistance for outsourced supplies in India and facilitating efficient interface back to Centrica plc; (2) ensuring that the vendors adhered to best practices and shared them on an optimal basis; (3) providing expert advice on widening the scope of potential services in India; and (4) such other services as might be requested by Centrica plc from time to time.

During its initial year of operation, CIOP required some employees on secondment from the overseas entities. It entered into an agreement with the overseas entities in which the latter seconded some employees for a fixed tenure. Under the secondment agreement, the employees were to work under CIOP's direct control and supervision. Conversely, the overseas entities were not responsible for any seconded employee's error or omission committed or omitted in the course of his work for CIOP. CIOP bore all risks and rewards associated with the work performed by the seconded employees. CIOP was required to enter into individual agreements with a predetermined format with each employee. The employees' families and financial affairs remained in their home countries, to which they intended ultimately to return after the completion of the CIOP assignment. The employees remained on the overseas entities' payrolls. CIOP reimbursed the overseas entities for their salaries.

The issue was whether the overseas entities were subject to withholding in India on "royalties," defined in the India-UK and India-Canada income tax treaties to include the provision of technical services. The Indian tax authority argued that CIOP was required to withhold on the reimbursement payments made to the overseas entities.

CIOP argued that the secondment agreement conclusively established that CIOP was the real and economic employer of the seconded employees and that they were acting for CIOP in the performance of their jobs and were not placed there to perform services for CIOP. CIOP relied on the concept of economic employment as opposed to legal employment and argued that the formal legal relationship of employer and employee as between the seconded employees and the overseas entities was irrelevant. It argued that it was the real employer because the content of the work or

57 *Centrica India Offshore Pvt. Ltd. v. CIT* [W.P.(C) no. 6807/2012], available at http://www.indiankanoon.org/doc/79087507/; on appeal from *Centrica India Offshore Pvt. Ltd. v. CIT* (2012), 348 ITR 45 (AAR).

employment, the entire direction and supervision over the seconded employees' work, and the pay and emoluments were borne by it. For convenience, the pay was disbursed by the overseas entities, but that amount was reimbursed to them.

The court agreed that it should look at the substance of the employment relationship and not the form. It agreed that the seconded employees were to be integrated into CIOP's operations for the agreed period and were subject to its supervision and control. CIOP's employment rules, regulations, policies, and other practices were applicable to the seconded employees. CIOP dictated the seconded employees' duties and functions. They had to perform the duties assigned with due diligence in accordance with CIOP's applicable laws and regulations, standards and practices, and control. The overseas entities were not responsible for any errors or omissions of such seconded employees or for their work. CIOP bore all risks in relation to the work of the seconded employees, and reaped the benefit from their output. CIOP also bore the cost of monthly remuneration and reimbursement of the cost of the seconded employees.

Despite all this, the court held that the employees remained employees of the overseas entities and were delivering services to CIOP, rather than performing services for the overseas entities as CIOP's employees. In the court's view, the crucial points were that the seconded employees retained their entitlement to participate in the overseas entities' retirement and social security plans and other benefits in terms of their applicable policies, and their salaries were payable by the overseas entities, which claimed the money from CIOP. There was no purported employment relationship between CIOP and the seconded employees. CIOP could not terminate the secondment arrangement. Furthermore, there was no entitlement or obligation, clearly spelt out, whereby CIOP had to bear the employees' salaries. That is, the employees could not sue CIOP for default in payment of their salary. All direct costs of the seconded employees' basic salaries and other compensation, cost of participation in the overseas entities' retirement and social security plans, and other benefits in accordance with the applicable policies and other costs were paid by the overseas entities. CIOP had the right to terminate the secondment (in its agreement with the overseas entities), but that would not alter or affect the services of the employees vis-à-vis the overseas entities. That employment relationship remained independent, and beyond CIOP's control.

In short, the court held that while CIOP may have had operational control over the seconded employees in terms of their daily work, and may have been responsible (in terms of the agreement) for their failures, these "limited and sparse factors" could not displace "the larger and established context of employment abroad."[58] As a result, the overseas entities were subject to withholding in India.

A similar conclusion, albeit in a different context, was reached in *IBM Canada Ltd. v. Ontario (Finance)*.[59] The issue was IBM's liability for Ontario employer health tax

58 Supra note 57 [W.P.(C) no. 6807/2012], at paragraph 35.

59 (2008) ONCA 216; leave to appeal denied [2008] SCCA no. 255.

in respect of employees who worked for IBM's affiliated companies abroad. An employee of IBM could take a fixed-term assignment to work for one of IBM's foreign affiliates, during which time the employee lived in the foreign country and worked exclusively for the foreign affiliate. IBM paid the expatriate employee's salary, bonuses, and allowances from Ontario, while the foreign affiliate reimbursed IBM for those payments. IBM continued to provide coverage for the expatriate's pension, medical, and dental plans while the expatriate worked abroad. The expatriate was guaranteed employment with IBM in Canada after completing the assignment. Ontario's minister of finance assessed IBM for employer health tax in respect of amounts paid to expatriates. IBM appealed, arguing that (1) the expatriates were not IBM's employees while working abroad; and (2) even if they were, IBM did not "remunerate" them since they worked exclusively for the foreign affiliate and the affiliate reimbursed IBM for all payments made to the expatriates.

The Ontario Court of Appeal held that the relationship between IBM and the expatriates remained one of employer-employee, stating that the reimbursements made by foreign affiliates "in no way diminish[ed] IBM Canada's direct obligation to the expatriate."[60]

On the issue of remuneration, the court held that while it could be argued that the foreign affiliate was the primary beneficiary of the expatriate's services, IBM's payments to expatriates were made "in the context of an ongoing employer/employee relationship"[61] and pursuant to a contractual obligation. The fact that the foreign affiliate reimbursed IBM was irrelevant, since that was merely a private arrangement between IBM and the affiliate, and was irrelevant to the employee's right to claim compensation from IBM for services performed. The Court of Appeal held that "the *Act* looks to the nature of the payment as between the employer and the employee and not to the source of the funds or to any arrangement which may exist between a third party and the employer for reimbursement."[62]

A very recent case dealing with the issue of whether a secondment can avoid a services PE is *DDIT v. JC Bamford Excavators Limited*.[63] The taxpayer was a UK company that owned, developed, and manufactured excavators. In 2004, the taxpayer entered into a technology transfer agreement ("the TTA") with its wholly owned subsidiary, JCB India Ltd. In 2005, the taxpayer entered into an international personnel assignment agreement ("the IPAA") with JCB India, which was effective from January 1, 2004. In total, the taxpayer seconded eight employees to JCB India. The taxpayer claimed to have received royalties/fees for technical services from JCB India

60 *IBM*, supra note 59 (ONCA), at paragraph 37.

61 Ibid., at paragraph 47.

62 Ibid., at paragraph 49.

63 ITA No. 540/Del/2011, March 14, 2014, ITAT (Delhi). On April 19, 2013, the Chinese State Administration of Taxation issued the "Announcement on Issues Concerning Enterprise Income Tax on Services Provided by Non-Resident Enterprises Through Seconding Personnel to China," which deals with secondments and PEs.

in consideration for the grant of exclusive rights to manufacture and market excavator loaders in India. JCB India withheld 15 percent tax in respect of royalties and fees for technical services under article 13(2) of the India-UK income tax treaty.

The assessing officer (AO) noted that the taxpayer was required to send its personnel to JCB India's plant for solving problems relating to the licensed products. He decided that the IPAA was entered into to formalize the broader terms set out in the TTA for the sending of the technical and other personnel.

The AO rejected the taxpayer's contention that the employees seconded to JCB India became the employees of JCB India on their assignment and hence ceased to have any relation with the taxpayer. Accordingly, in view of the secondment of these eight employees for a period of more than 90 days during the previous year relevant to the assessment year under consideration, the AO held that they constituted a services PE of the taxpayer under article 5(2)(k)(i) of the treaty. The AO relied on *Morgan Stanley*. He took the position that that the taxpayer carried on its business in India through the services PE and that the royalties/fees for technical services received from JCB India were effectively connected with that PE. Accordingly, under article 13(6) of the treaty, he assessed the taxpayer on the basis that the royalties/technical fees were subject to tax under article 7 rather than as royalties under article 13(2). Since the taxpayer either did not keep or did not furnish details of its expenses relating to its income, the AO allowed a deduction of 20 percent of the royalties/fees and assessed the taxpayer for tax on the remaining 80 percent of the royalties/fees.

On objection, the commissioner of income tax agreed with the taxpayer that the seconded employees became the employees of JCB India. Accordingly, the taxpayer was not providing any services to its subsidiary and therefore had no services PE in India. The AO appealed to the Income Tax Appellate Tribunal.

The tribunal held that, under the IPAA, the personnel to be provided by the taxpayer to JCB India were to act under the latter's direction. The subsidiary was to indemnify the taxpayer for any and all claims, liabilities, costs, and expenses resulting from or arising out of actions of the eight personnel while under its direction. JCB India was required to pay compensation to the taxpayer for providing these personnel. As a whole, contrary to the decision of the commissioner of income tax on objection, the tribunal held that the IPAA was not an independent agreement but simply formalized the terms for the supply of personnel by the taxpayer to JCB India under the TTA, and that the IPAA was nothing but an elaboration of the terms for the provision of such personnel by the taxpayer to JCB India; it was, essentially, an addendum to the TTA.

The tribunal held that, on the basis of the facts in their entirety, there remained "absolutely no doubt that these eight personnel deputed from JCB UK to JCB India on assignment basis remained employees of the assessee and never became the employees of JCB India."[64] The IPAA provided that JCB India desired to utilize the services of the employees on a "secondment basis." The tribunal held that the term "secondment"

64 *JC Bamford*, supra note 63, at paragraph 6.11.12.

means that the employee remains an employee of his existing employer, but by virtue of some agreement between the employer and a third person, the employee has to perform the duties for the benefit of such third person. At no time does the employee become an employee of the third person.

The tribunal supported its decision by looking at the JCB international assignment policy UK manual. It provided that "once an expatriate has completed three years under the terms of an expatriate posting package, ordinarily they will be transferred to local terms and conditions, repatriated to their home country" (JCB UK). It also stated that

> [d]uring the expatriate posting grievances and appeals relating to local conditions or local disciplinary matters should be referred in the first instance to International Home Resources Manager and/or the Group HR Director,

and that

> [u]pon completion of an expatriate posting, expatriates, their accompanying family, their personal effects and household goods will be repatriated. The home company will use its best endeavors to find a position in the home country to a level no less favorable to that which the expatriate left to take up the expatriate posting.

On the basis of this manual, the tribunal held that the employees continued to be the taxpayer's employees during the term of service for JCB India on secondment.

Perhaps most importantly, clause 4.5 of the TTA stated that the

> personnel of the Licensor [the taxpayer] and the Licensee [JCB India] during the time they are present on the premises of the other party shall be subject to all rules and regulations prevailing on such premises, but shall not be considered as employees of the other party. Subject to the provisions of this Agreement the Licensor and the Licensee shall each be responsible for the payment of all salary compensation and expenses of their respective personnel.

According to the tribunal, this clause made it clear that the eight persons who were sent on secondment to India continued to remain on the taxpayer's payroll and "maintained their lien" (that is, the lien of employment) on the taxpayer. The tribunal held that it was irrelevant that the taxpayer recovered its costs of such employees from JCB India. It also held that it was "quite natural" that when the employees were deputed to JCB India for a given consideration, they were bound to work under the direction of JCB India and could not have worked for the benefit of the taxpayer.[65] There was no material to indicate that the taxpayer ever terminated their services.

These cases make it clear that achieving a "true" secondment is difficult: in most cases, the employer's wish to avoid a services PE will conflict with and may become

65 Ibid., at paragraph 6.11.10.

subservient to the employee's wish to remain a true employee of his or her home company and not be an employee of the foreign affiliate. A detailed review of the employee's terms of service, any employment manuals, and all terms connected to the secondment must be carried out, to eliminate any reference to the worker's remaining an employee of the home company and to eliminate the employee's lien on the home company.

WILL ARTICLE V(9)(b) APPLY IN THE EXAMPLE?

Since no individual USco employee spends more than 183 days in Canada, USco will not have a PE in Canada under article V(9)(a). That leaves article V(9)(b) to be considered. Collectively, USco's employees spend more than 183 days in Canada in a 12-month period. The questions then are these:

1. What do the words "Subject to paragraph 3" mean?
2. Do the employees spend their time on "the same or [a] connected project"?

"Subject to Paragraph 3"

The meaning of the words "Subject to paragraph 3" is not perfectly clear. One author suggests that the phrase merely means that if services are performed on a building site or a construction or installation project that lasts for more than 12 months, then article V(3) will create a PE even if the 183-day test in article V(9)(b) is not met.[66] Others suggest that it means that if the services are performed in connection with a construction site, then one must ignore article V(9) altogether and focus only on article V(3).[67] The second explanation appears to be correct, on the basis of both the wording and the legislative history of article V(9).[68] While the technical explanation of article V(9)[69] does not address this issue, the joint committee explanation states:

> As stated above, paragraph 9 is subject to the provisions of paragraph 3 of Article V of the treaty. Paragraph 3 provides that a building site or construction or installation project constitutes a permanent establishment if, but only if, it lasts more than twelve months. *Thus, paragraph 9 does not apply to construction services that do not meet the requirements of paragraph 3 for a permanent establishment.* On the other hand, paragraph 9 is not subject to the provisions of paragraph 4 of Article V of the treaty. Paragraph 4 provides that the use of an installation or drilling rig or ship in a treaty [country] to explore for or exploit natural resources constitutes a permanent establishment if, but

66 Reid, supra note 34, at 863.

67 Di Maio and Hutchinson, supra note 21, at 3:3-4; and Lorna Sinclair, "The Services PE Provision of the Canada-US Income Tax Treaty," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 22:1-29, at 22:2.

68 See Tittle, supra note 21, at 19.

69 Technical explanation of the fifth protocol, supra note 12.

> only if, such use is for more than three months in any twelve-month period. Thus, drilling services that do not meet the requirements of paragraph 4 for a permanent establishment may still give rise to a deemed permanent establishment if the requirements of paragraph 9 are met.[70]

This interpretation of "Subject to paragraph 3"—that time spent by USco's employees on any Canco construction project does not count toward the 183-day test in article V(9)(b)[71]—is supported by the OECD commentary's suggested version of the services PE rule (reproduced above), the opening words of which are "Notwithstanding the provisions of [paragraph] . . . 3." Obviously, this is meant to convey the opposite—"Subject to [paragraph] . . . 3"; that is, even if time spent on a construction site does not meet the 12-month threshold required by paragraph 3, the time may still count toward the 183-day threshold in the services PE article.[72]

What Is a "Project"?

The treaty does not define a "project." In a different context, the CRA noted that

> [t]he word "project" is not defined in the Act. The Concise Oxford Dictionary, 8th Edition, defines "project" in part as:
>
> 1. a plan, a scheme; 2. a planned undertaking.
>
> The Oxford English Dictionary, 2nd Edition, defines the word "project" in part as:
>
> 1. a plan, draft, scheme, or table of something; a tabulated statement; a design or pattern according to which something is made . . . 5.(a) something projected or proposed for execution; a plan, scheme, purpose; a proposal.[73]

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70 JCX-57-08, supra note 13, at 45 (emphasis added). See also Brian J. Arnold, "The New Services PE Rule in the Canada-U.S. Treaty Protocol" (2008) 51:2 *Tax Notes International* 189-200, at 192-93, concluding that no day spent on a construction site counts toward the 183-day test in article V(9); and J. Scott Wilkie, "Services Permanent Establishments and the Canada-United States Income Tax Treaty" (2012) 19:3 *International Transfer Pricing Journal* 179-85, at 182.

71 See, however, paragraph 42.26 et seq. of the commentary on article 5 of the OECD model treaty, which takes the opposite approach (as noted by Lance B. Gordon, Alicia N. Peressada, and Lilo A. Hester, "Analysis of Construction PEs Under U.S. Income Tax Treaties" (2009) 20:9 *Journal of International Taxation* 32-41, at 40, note 31 and the accompanying text; and Arnold, supra note 17, at 285-86).

72 See paragraphs 42.26 to 42.28 of the commentary on article 5 of the OECD model treaty. Paragraph 42.28 provides that "[s]ome States, however, may consider that paragraph 3 should prevail over the alternative provision and may wish to amend the provision accordingly." Obviously, this is what Canada and the United States did in article V(9).

73 CRA document no. 2002-0119355, February 12, 2002, citing *Ainsworth Lumber Co. Ltd. v. The Queen*, 2001 DTC 496 (TCC). This definition was cited by Yves-André Grondin and Patrice Lareau, "Entreprises de services faisant affaire au Canada et à l'étranger," in Association de planification fiscale et financière, *Congrès 2009* (Montréal: APFF, 2010), paper 10, at section 2.3.7.3. Article III(2) of the treaty would allow Canada to adopt a domestic definition of "project" in the absence of a treaty definition. In CRA document no. 2013-0474851I7, April 11,

These definitions appear to convey the intended meaning of the word "project" in article V(9).[74] Accordingly, any plan or scheme or undertaking owned by Canco for which USco is retained to provide services will be considered to be a "project" for this purpose.

What Is "[a] Connected Project"?

Article V(9)(b) requires that services be supplied for more than 183 days "with respect to the same or [a] connected project." Clearly, this means that if the services are supplied for more than 183 days to a single project or to two or more projects that are "connected," then there is a PE. To understand the purpose and meaning of the adjective "connected" in this context, it is necessary to review material associated with the UN model treaty, the OECD commentary, the technical explanation of the treaty, the diplomatic notes to the treaty, the case law, and various textbooks and other publications.

Origins of the UN Provision

The concept of a services PE provision, though not the actual terms of such an article, appears to have originated in the discussions of the first report of the UN's Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries.[75]

The services PE provision, as it now exists in the UN model treaty, originated in the ad hoc group's second report.[76] Article 5(3)(b) of the UN model treaty states:

> 5(3) The term "permanent establishment" also encompasses: . . .
> (b) 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.

2014, the CRA looked at the construction PE provision in article 5(3) of the 1975 Canada-France income tax treaty and referred to an earlier (unnamed) technical interpretation that had given the word "project" as used in article 5(2)(g) of the 1978 Canada-UK income tax treaty a "broad meaning," without specifying exactly what that meaning is. See the discussion of this memorandum in the text below at note 128 and following.

74 See Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer, the Netherlands: Kluwer Law and Taxation, 1991), at 353.

75 Although no specific services PE provision was proposed in this first report, it is clear that developing countries wanted to broaden the concept of a PE as compared with the OECD definition. See United Nations, Ad Hoc Group of Experts on Tax Treaties, *Tax Treaties Between Developed and Developing Countries: First Report*, UN publication no. ST/ECA/110 (New York: United Nations, Department of Economic and Social Affairs, 1969), part 1, at paragraph 33 et seq., and part 2, at paragraph 145.

76 See United Nations, Ad Hoc Group of Experts on Tax Treaties, *Tax Treaties Between Developed and Developing Countries: Second Report*, UN publication no. ST/ECA/137 (New York: United Nations, Department of Economic and Social Affairs, 1970), part 1, at paragraph 70.

The reason for the new provision was explained as a requirement to broaden the definition of a PE, so as to allow developing countries to tax profits earned from services provided in their jurisdiction where there would otherwise be no PE:

> As a matter of legal analysis, it is customary to characterize income from industrial or commercial services as industrial or commercial profits. The same would seem to apply to professional and semi-professional services, at least in those countries which characterize all income of corporations and other commercial entities as business income. The example of corporations that are exclusively or predominantly engaged in rendering services demonstrates the problem of limiting the concept of business income to profits from manufacturing or activities of purchase and resale.
>
> On the other hand, the characterization of service income as industrial or commercial profits would preclude the taxation of that income by the developing countries unless the income is attributable to, or "effectively connected" with, a permanent establishment situated in their territory. As far as income from services performed in that area is concerned, it might be considered to broaden the concept of permanent establishment so as to include therein the performance of substantial services, similar to the rule of some treaties which give this effect to the maintenance of substantial equipment in the other treaty country. The substantiality of the services could be measured in terms of their duration, the compensation paid for them, or a combination of both factors.[77]

This proposal was further developed in the 1979 *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*.[78] It appears that there was a debate between developed and developing countries over the breadth of the term "royalties" as defined in the proposed UN model treaty. The developed countries felt that technical services should not be taxed as royalties, while developing countries thought they should. As a compromise, it was agreed that such services would be taken out of the definition of royalties but that a new services PE provision would be inserted to capture such services if they lasted for more than 12 months:

> In order to solve the problem of the definition of royalties the Group agreed to consider income from such activities as business profits and to include in guideline 5, paragraph 3, a new subparagraph (b) which provides that the term permanent establishment should likewise encompass "the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve-month period."[79]

77 Ibid., part 2, at 39.

78 United Nations, Department of International Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/94 (New York: United Nations, 1979).

79 Ibid., at 77. See Edwin van der Bruggen, "Source Taxation of Consideration for Technical Services and Know-How" (2001) 7:3 *Asia-Pacific Tax Bulletin* 42-60, at 52, note 103 and the accompanying text.

The "Connected" Requirement Is a Limitation

Although developing countries wanted to be able to tax profits from services provided in their jurisdiction through the new services PE rule, it was recognized that international tax policy required the foreign enterprise to have a substantial connection to the source state before that state would have the "right" to tax its profits. If the services PE rule provided that any provision of services for more than 183 days would create a PE, then that would merely create situations where a foreign enterprise might be saddled with a PE despite having relatively little connection to the source state in respect of any one project. To avoid this possibility, the UN drafted the provision to require that the 183 days be spent on a single project or on two or more connected projects.

In other words, the connected project rule was inserted as a *limitation*, to ensure that the services PE provision did *not* capture service income from unrelated projects.[80] The ad hoc group's second report explained:

> Some members from developed countries thought that the time-limit approach was an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue," since they thought it undesirable to add together unrelated projects in view of the uncertainty that step involved and the undesirable distinction it created between an enterprise with, say, one project of three months' duration and another with two projects, each of three months' duration, one after the other. In this regard, other countries found the injection of a "project" limitation as either too easy to manipulate or too narrow in that it might exclude a continuous number of separate projects, each of four or five months duration.[81]

80 One author has noted that, from the point of view of a developed country negotiating a services PE provision with a developing country, under the domestic law of many developing countries gross service income is taxed at source, with no threshold. Therefore, while developed countries would prefer not to have a services PE provision at all, such an article at least has the benefit of ensuring that service income is taxed as business income on a net basis. See M.S. Feinburg, "United States Views on Selected Aspects of Developing Country Tax Treaty Issues," in International Fiscal Association, *Double Taxation Treaties Between Industrialised and Developing Countries; OECD and UN Models, a Comparison: Proceedings of a Seminar Held in Stockholm in 1990 During the 44th Congress of the International Fiscal Association* (Deventer, the Netherlands: Kluwer Law and Taxation, 1992), 39-46, at 43 and 45. Although Feinburg did not cite this source, H. David Rosenbloom made the same comment in "Trends in Tax Treaties Between the United States and Developing Countries," in International Fiscal Association, *UN Draft Model Taxation Convention: Trends in Income Tax Treaties Involving Developing Countries, with Special Reference to the UN Group of Experts on Tax Treaties Between Developed and Developing Countries: Proceedings of a Seminar Held in Copenhagen During the 33rd Congress of the International Fiscal Association* (Deventer, the Netherlands: Kluwer Law and Taxation, 1980), 18-21, at 20. See, for example, *WorleyParsons Services Pty. Ltd. v. CIT* (2008), 301 ITR 54 (AAR), where the taxpayer argued, and the Authority for Advance Rulings agreed, that the taxpayer had a services PE in India and therefore was taxable only on its net business income rather than on a gross royalty basis under article 12 of the relevant treaty.

81 ST/ECA/137, supra note 76, part 1, at paragraph 71.

It has been argued that the connected project limitation on the services PE rule is not justified in policy. Arnold argues that 183 days of physical presence in the source state creates enough of an economic connection to that state to justify its taxation of the profits from those services, even if the days are spent on 183 separate projects for one day per project.[82] With respect, I disagree. It is clear from the other kinds of PEs defined by article 5 that mere presence in a state, no matter how long, has never been sufficient to create the kind of economic connection required to justify taxation in that state. That is why there must be a fixed base. And if there is to be a PE based on time alone, then that time must be spent on a single project, such as a construction site. Admittedly, the agent PE rule is an exception, in that the mere presence of the agent is sufficient to create a PE, even while the presence of the agent's principal, performing the same functions as the agent, would not be. But in my view that is the proverbial exception that proves the rule; the anomaly presented by the agent PE rule should not be expanded to services generally by eliminating the connected project requirement. Nevertheless, many countries are of the same view as Arnold, and their treaties do not contain the limitation found in the UN model.

The concept that the connected project rule is a limitation on the scope of article V(9) is supported by a number of cases that have held that even without such a phrase, interrelated projects could meet the time threshold for a construction site PE. If that is correct, then the "connected project" term in article 5(3)(b) of the UN model treaty must be there for a different purpose: to limit the ability to create a services PE merely by time alone.

A case that suggests the opposite is *C.J.M. v. Belgische Staat*,[83] where the Belgium Court of Appeal was presented with a situation involving the construction site PE provision of the Belgium-Netherlands income tax treaty (1970). The taxpayer, resident in the Netherlands, carried out several contracts throughout Belgium for the same principal in Belgium. No single contract took more than nine months to complete, but it took more than nine months to carry out the work from the start of the first contract to the end of the last. The tax authorities of the two countries had agreed on certain interpretive rules for the construction site PE provision. The Court of Appeal rejected these rules and held that they were inconsistent with the terms of the construction site PE provision. Because the contracts covered several different locations and the relevant treaty provision referred only to a "place" and not to "places," there was no single construction site and hence no PE.

The *C.J.M.* case was referred to in *BV A.A. v. Belastingadministraitie*,[84] which involved the same treaty and the same provision. The taxpayer was a company performing several contracts in Belgium, directly and through a subsidiary, and in several locations.

82 See the expanded online version of Brian J. Arnold, "The Taxation of Income from Services Under Tax Treaties: Cleaning Up the Mess" (2011) 65:2 *Bulletin for International Taxation* 59-68.

83 A decision of the Lower Court of Antwerp, June 29, 1982, published in (1983) 2:20 *Fiscale Jurisprudentie/Jurisprudence Fiscale* 34.

84 A decision of the Antwerp Court of Appeal, April 12, 1984, published in (1984) 12 *Algemeen Fiscaal Tijdschrift* 223.

Although no single contract took more than nine months to complete, as a whole the contracted work took more than nine months. The court held that the contracts were not interrelated, and therefore there was no construction site PE. In contrast to the *C.J.M.* decision, the court held that if two or more of the contracts had been interrelated, then there could have been a PE, even if the contracts were performed at different locations.

Two German cases appear to have reached opposite conclusions on somewhat similar facts. In a decision dated April 21, 1999,[85] the Federal Tax Court in Munich held that several construction projects were one connected project and thus formed a construction site PE under the 1971 Germany-Switzerland tax treaty, because they formed a coherent whole, commercially and geographically. In particular, the projects formed a commercial whole because they had similar functions and were carried out close in time to each other.

On the other hand, in a decision of the same court on May 16, 2001 under the 1977 Germany-Hungary tax treaty,[86] the court held that various construction projects did not form a coherent whole because the projects were not related to each other and were carried out at different sites, even though they were all carried out at the same time and were of the same nature.

These cases indicate that the word "project," if used by itself in article V(9)(b), would include a series of related projects, suggesting that the deliberate use of the term "[a] connected project" is to limit that rule and ensure that a services PE exists only where two or more projects meet the conditions for being "connected" as discussed below.

The ad hoc group did not discuss the services PE provision in its subsequent (third to eighth) reports, but the provision appeared originally as article 5(2)(h) in the 1974 guidelines[87] and then finally as article 5(3)(b) of the 1980 UN model treaty. A services PE rule also appears as article 5(3)(b) in the 2001[88] and 2011[89] versions of the UN model treaty. The 1974 guidelines, in words repeated in the 1979 UN manual[90] and the 2003 UN manual,[91] explain the purpose of the provision as follows:

85 Case I R 99/97, published in [1999] *Bundessteuerblatt Part II* 694.

86 Case I R 47/00, published in [2002] *Bundessteuerblatt Part II* 335.

87 United Nations, *Guidelines for Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/14 (New York: United Nations, Department of Economic and Social Affairs, 1974).

88 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no. ST/ESA/PAD/SER.E/21 (New York: United Nations, 2001).

89 United Nations, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 2011) (www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).

90 ST/ESA/94, supra note 78.

91 United Nations, Department of Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/PAD/SER.E/37 (New York: United Nations, 2003).

> Management and consultancy services were not covered specifically in the OECD Draft Convention, because they were not as important now as at the time when the Convention was finalized. However, at the current time, the furnishing of consultancy and similar services in developing countries by corporations of industrialized countries often involves very large sums of money. The Group felt that profits from such services should be taxed by the developing countries in certain circumstances.[92]

In terms of discussion, the commentary on article 5 of the 1980 UN model treaty repeats paragraph 71 from the second report of the ad hoc group, quoted above.[93]

In 1980, the ad hoc group was renamed the Ad Hoc Group of Experts on International Cooperation in Tax Matters. In its eighth report, the ad hoc group adopted the final version of the 1980 model treaty and the commentary thereon. With respect to the services PE provision in article 5(3)(b) of the model, the commentary confirmed that the overall purpose of the provision was to tax profits that were otherwise not earned through fixed-base PEs or other types of PEs, but that the "connected project" condition was inserted to limit the ability to tax such profits arising from unrelated projects. The ad hoc group summarized its discussions on this point as follows:

> Article 5, paragraph 3, of the United Nations Model Convention contains a new subparagraph (b) dealing with the furnishing of services, including consultancy services which are not covered specifically in the OECD Model Convention in connexion with the concept of permanent establishment. The Group felt that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involved very large sums of money. The Group was of the opinion that profits from such services should be taxed by developing countries in certain circumstances. However, some members from developing countries proposed the inclusion in that paragraph of another criterion based on the amount of remuneration for the furnishing of services. Such criterion would constitute the subject of an additional subparagraph, namely subparagraph 3(c), which would be worded as follows:
>
> > "(c) The furnishing of services including consultancy services by an enterprise, but only where the remuneration for activities of that nature (for the same or a connected project) derived from a resident of a Contracting State or a permanent establishment or a fixed base situated therein exceeds in the fiscal year an amount of . . . (an amount to be established through bilateral negotiations)."
>
> . . .
>
> Some members from developed countries thought that the time-limit approach would be an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue," since they thought it desirable to add together unrelated projects in view of the uncertainty which that step involved and the

92 ST/ESA/94, supra note 78, at 18.

93 See the text accompanying note 81, supra.

> undesirable distinction it created between an enterprise with, for example, one project of three months' duration and another with two projects, each of three months' duration, one following the other. In that respect, other members found that the injection of a "project" limitation would be either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration.[94]

It is also clear from the commentary on article 12 (royalties) that article 5(3)(b) was inserted to ensure that foreign service providers would be entitled to report "net" services income (that is, income net of expenses incurred to earn that income) as business profits under articles 7 and 5 rather than be subject to withholding tax under article 12. The ad hoc group

> recognized the difficulty involved in the definition of royalties but agreed to consider income from such activities as business profits and to include in article 5, paragraph 3, a new subparagraph (B) [sic "(b)"] which provided that the term permanent establishment should likewise encompass "the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period."[95]

Starting with the 2001 revision to the UN model treaty and the commentary thereon, the passages from the commentary quoted by the ad hoc group above were replaced with paragraph 12 of the commentary on article 5, which again confirmed that the connected project rule was inserted as a limitation on the source state's right to tax profits from unrelated projects:

> 12. Subparagraph (b) encompasses service activities only if they "continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any 12-month period." The words "for the same or a connected project" are included because it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of three months' duration and another with two unrelated projects, each of three months' duration, one following the other. However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of 120 or 150 days' duration.[96]

94 United Nations, Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Tax Treaties Between Developed and Developing Countries: Eighth Report*, UN publication no. ST/ESA/101 (New York: United Nations, Department of Economic and Social Affairs, 1980).

95 Ibid.

96 Commentary on article 5 of the UN model treaty.

"Connected" as an Anti-Abuse Rule

At the time the ad hoc group's eighth report was written, some countries were concerned that an enterprise might split up a single project artificially into two or more projects so as to escape the 183-day threshold. As noted above, the commentary on article 5 later incorporated the following statement:

> However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of 120 or 150 days' duration.[97]

This concept of using "connected project" as an anti-abuse rule was not, in 1980, and still is not, referred to in the commentary on article 5(3)(b) of the UN model treaty. Nevertheless, the concern expressed above by some countries did not disappear. In 2004, the ad hoc group was again renamed, as the Committee of Experts on International Cooperation in Tax Matters. The committee discussed the services PE article in a number of reports. Specifically, at its second and third meetings, the committee discussed the services PE article in the context of abuse of treaties and took a very different approach than the UN had taken originally. The committee suggested that the connected project concept was really an anti-abuse rule, designed to prevent "contract splitting," which would allow non-residents to perform services in the source state while avoiding the 183-day rule.[98] In the committee's report on its sixth session, issued in 2010, the committee agreed to continue to adopt paragraph 12 of the commentary on article 5, with the revisions noted above, and that

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97 Ibid. At the Third Session of the Committee of Experts on International Cooperation in Tax Matters, Geneva, October 29-November 2, 2007, a paper was prepared by the Subcommittee on Definition of Permanent Establishment (coordinator, Mr. Sollund) entitled *Proposal for Amendments to Article 5 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no. E/C.18/2007/CRP.3 (New York: United Nations, 2007). In that paper, this sentence was changed slightly, and the revised sentence now appears in the commentary on article 5 of the 2011 UN model treaty. The revised sentence states, "However, some countries find the 'project' limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration." It does not appear that these changes embody any substantive difference from the former version.

98 See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Proposal for Amendments to Article 5 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no. E/C.18/2006/4 (New York: United Nations, 2006), at paragraph 20. See also United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Treaty Abuse and Treaty Shopping*, UN publication no. E/C/18/2006/2 (New York: United Nations, 2006), at paragraph 70 et seq.; United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Supplementary Note to Treaty Abuse and Treaty Shopping*, UN publication no. E/C/18/2006/2/Add.1 (New York: United Nations, 2006); and United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Improper Use of Treaties*, UN publication no. E/C.18/2007/CRP.2 (New York: United Nations, 2007), at paragraph 95 et seq.

commentary appears as paragraph 12 of the commentary on article 5 of the 2011 UN model treaty.[99]

There the matter stayed, until recently. At the committee's seventh session,[100] in 2011, the consensus was to move forward with studying services, but the meaning of connected project was not discussed. However, a paper was requested on the topic, as follows:

> It was necessary to clarify in paragraph 12, the meaning of the word "connected" to describe projects that were sufficiently related to be added together, and it was decided to include that question in the catalogue of issues.[101]

So far as I can determine, no UN tax committee has explored any further the issue of whether the connected project rule is a limitation or an anti-abuse rule. The OECD's perspective is discussed below.

The possibility of viewing the connected project rule as an anti-abuse rule is supported by *Assistant Director of Income Tax, International Taxation, Circle 2(2), Mumbai v. Valentine Maritime (Mauritius) Ltd.*[102] Valentine was a company established and resident in Mauritius. It was in the business of marine and general engineering and construction. It carried on several projects in India, in connection with which it provided construction services in India for various customers.

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99 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Proposed New Commentary on Article 5: Paragraphs 1 to 15.3*, UN publication no. E/C.18/2010/5 (New York: United Nations, 2010), annex, at paragraph 12.

100 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Provisional Agenda*, UN publication no. E/C.18/2011/1 (New York: United Nations, 2011), at item 5(f).

101 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Report on the Seventh Session*, UN publication no. E/2011/45-E/C.18/2011/6 (New York: United Nations, 2012), at paragraph 31. In 2012, the committee's Subcommittee on Services commissioned Brian Arnold, a noted Canadian tax expert, to write two reports on the treatment of services. See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Note on the Taxation of Fees for Technical and Other Services Under the United Nations Model Convention*, prepared by Brian J. Arnold, UN publication no. E/C.18/2012/4 (New York: United Nations, 2012) and his *Follow-Up Note on the Taxation of Fees for Technical and Other Services and Comments on That Note*, UN publication no. E/C.18/2012/CRP.4 (New York: United Nations, 2012). However, Arnold's reports did not discuss the meaning of "connected project."

102 (2010), 38 DTR 117 (Mumbai ITAT). Some services PE and construction site PE cases are reviewed in Jean Schaffner, *How Fixed Is a Permanent Establishment?* Series on International Taxation vol. 42 (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2013), at 105 et seq. Others are discussed in Radhakishan Rawal, *The Taxation of Permanent Establishments: An International Perspective* (London: Spiramus, 2006), chapter 20, and in Ekkehart Reimer, Nathalie Urban, and Stefan Schmid, eds., *Permanent Establishments: A Domestic Taxation, Bilateral Treaty and OECD Perspective*, 3d ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012). There are summaries of other cases dealing with construction site PEs in article 5 of Michael Edwards-Ker, ed., *The International Tax Treaties Service*, vol. 1 (Dublin:

Under article 5(2)(i) of the India-Mauritius tax treaty,[103] a PE included "a building site or construction or assembly project or supervisory activities in connection therewith, where such site, project or supervisory activity continues for a period of more than nine months." None of the taxpayer's Indian projects individually exceeded nine months, but collectively they did.

The Income Tax Appellate Tribunal held that in the absence of abuse, each project had to be tested separately. According to the tribunal, abuse would exist where various business activities of the enterprise in different locations were so inextricably interconnected that they were required to be viewed as a coherent whole. With respect to the OECD commentary that requires the projects to be a "coherent whole commercially and geographically,"[104] the tribunal held that "geographically" means a situation in which the very nature of a construction or installation project may be such that the contractor's activity is to be relocated continuously or at least from time to time (as is the case, for example, in the construction of roads and canals, the dredging of waterways, or the laying of pipelines), where the activities performed at each particular location in a single project must be regarded as a single unit and hence a single "place" of business. In short, so far as geographical coherence is concerned, the tribunal held that what is really to be seen is whether different locations where activities are carried out by an enterprise in the other contracting state are one place of business or different places of business. If it is concluded that they are different places of business, the matter ends there. However, if these different locations are seen as one place of business, the next thing to be ascertained—commercial coherence—is whether the work done at these sites constitutes one business venture, consisting of one or more contracts, or different business ventures altogether. The true test is whether the activities performed by the enterprise in various projects or at various sites are interconnected and must be considered a coherent whole,

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In-Depth) (looseleaf) (discontinued 1997), especially the cases from Belgium/Netherlands June 29, 1982; Belgium/Netherlands April 12, 1984; Belgium/Germany March 24, 1987, and Netherlands/Germany February 4, 1970. There are various references in some publications to an early Indian case on the subject, but searches have not revealed what it is. Hans Pijl, "Interruptions in Building Site Permanent Establishments To Be Interpreted Under the Limited Inclusion Theory" (2013) 67:7 *Bulletin for International Taxation* 331-43, at note 2 and the accompanying text, suggests that there are 30 cases on construction site PEs dealing with the connected project concept. For a discussion of the connected project concept in the context of construction site PEs from the German point of view, see Georg Seitz, "The Construction Clause in Article 5(3) of the OECD Model" (2013) 67:9 *Bulletin for International Taxation* 450-59, at 457 et seq. For a discussion of the concept in the context of a particular industry, see Jan de Goede and Ruxandra Vlasceanu, "Permanent Establishment Implications for Coordination Centres in the Oil and Gas Industry" (2013) 67:9 *Bulletin for International Taxation* 466-73, at 469 et seq.

103 The Convention Between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Port Louis on August 24, 1982.

104 Commentary on article 5 of the OECD model treaty, at paragraph 18.

regardless whether the activities so carried out by the enterprise are for the same principal or different principals.

The ratio set out in the *Valentine* decision is as follows:

> It is thus clear that the justification for aggregation of time spent by the assessee on different project sites, for applying [the] threshold of duration test, is not sustainable. Neither the work having been carried out for the same principal is sufficient to justify the aggregation of time spent on all the projects, nor the fact that this work was carried out in the same area, which is a huge geographical area anyway, is sufficient to invoke that exercise. Even if these projects are commercially coherent in the sense that these projects are for the same organization directly or through a sub contractor, and geographically coherent in the sense that these are on nearby locations, these two factors would not necessarily mean that these projects are to be necessarily seen as a coherent whole—geographically and commercially. The true test, as we have noted above, is in interconnection and independence—in addition to geographical proximity and commercial nexus.[105]

On the facts, the tribunal held that this test was not met:

> There is no finding, nor even a suggestion, by any of the authorities below to the effect that the three contracts are inextricably interconnected, interdependent or can only be seen only as a coherent whole in conjunction with each other. As a matter of [sic] all the three contracts are for three different purposes—for charter of accommodation barge, for use of barge in domestic are [sic] and for replacement of decks. None of these contracts are such that these can be viewed as interconnected or interdependent.[106]

105 *Valentine*, supra note 102, at paragraph 17.

106 Ibid. The US Treasury department's technical explanation of article 5(3) (construction sites) of the United States Model Income Tax Convention of November 15, 2006 states that two projects will be viewed together for the purposes of determining whether the time limit in that article is met when those projects are "interdependent both commercially and geographically." The use of "interdependent" rather than "coherent whole" is supported by the decisions in *Valentine*, supra note 102, and a similar case involving a sister company discussed below (see infra note 113 and the accompanying text). The phrase "interdependent both commercially and geographically" appears to have been used first in the US technical explanation to the US-Romania income tax treaty, in force February 26, 1976, 1976-2 CB 492. In the technical explanation of the 1982 US-Philippines income tax treaty, 1984-2 CB 384, the Treasury department stated that the use of that phrase applied to construction site PEs and "[i]n that respect, it is similar to the furnishing services rule." This confirms my view, expressed elsewhere in this article, that geographical as well as commercial coherence is required for two projects to be connected. In the technical explanation to the 1987 US-China income tax treaty, 1988-10 IRB 8, the Treasury Department suggested that an example of two projects forming a single construction site PE would be a "turnkey" project in which a facility is constructed and equipment installed. In the technical explanation to the 1994 US-Mexico income tax treaty 1994-34 IRB 4, another example given was the construction of a housing development even though each house may be constructed for a different purchaser. It will be noted that, as discussed elsewhere, this example indicates that the interdependence of two projects should be determined from the service provider's point of view, since clearly each separate purchaser would not view his or her house as being connected to any other purchaser's house.

Although *Valentine* did not cite *J. Ray McDermott Eastern Hemisphere Ltd. v. Joint Commissioner of Income-Tax-Special Range 21*, *Mumbai*,[107] it appears that the reasoning in the former case was taken directly from the latter.[108] The tribunal in *Valentine* did cite *Sumitomo Corpn. v. DCIT*[109] and *Joint Director of Income Tax (International Taxation) v. Krupp UHDE Gmbh*.[110] In *Sumitomo*, the taxpayer was a Japanese-resident company. It had a liaison office in India and had liaison suboffices at Mumbai, Chennai, Bangalore, and Calcutta. Sumitomo started expanding its activities in India. It established project offices for two projects with the Karnataka Power Corporation: the Basin Bridge project and the paint and assembly shop for Maruti Udyog Ltd.

The issue was whether Sumitomo had a construction site PE in India, which under the India-Japan treaty was defined as follows:

> 5(4) An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it carries on supervisory activities in that Contracting State for more than six months in connection with a building site or construction, installation or assembly project which is being undertaken in that Contracting State.[111]

The Income Tax Appellate Tribunal held that each project performed by Sumitomo was independent and the projects did not complement each other. Sumitomo was not the only person rendering supervisory services. The sites were located at different places (assembly floor, paint shop, or weld shop). It could not be said that all contracts put together formed a coherent whole, commercially or geographically.[112]

107 (2010), 39 SOT 240 (Mumbai ITAT).

108 In *J. Ray*, the Income Tax Appellate Tribunal held that none of the taxpayer's construction projects met the test of commercial and geographical coherence, so they could not be added together to meet the nine-month construction test. The tribunal remitted the matter to the appeals officer to determine whether any one project was more than nine months long. The appeals officer said no, and the tribunal dismissed the Revenue's appeal from that decision: ITA no. 2089/Mum/2011, October 12, 2012.

109 (2007), 17 SOT 197 (Delhi ITAT).

110 (2009), 26 DTR 289 (Mumbai ITAT) (discussed below in the text at note 124 and following).

111 The Convention Between the Government of Japan and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at New Delhi on March 7, 1989.

112 The Income Tax Appellate Tribunal released additional reasons in *Sumitomo* on February 27, 2014, available at http://indiankanoon.in/doc/168545514/. From these reasons, it appears that the taxpayer had appealed the initial decision of the tribunal to the High Court. On April 6, 2009, that court remanded the case to the tribunal for a determination of whether the income earned by the taxpayer could be taxed in India as royalties under article 12 of the relevant treaty. Specifically, the question as remanded by the High Court was as follows: "Whether in the facts and circumstances of the case 'fee for technical services' received by the assessee from M/s Maruti Udyog Ltd was taxable under Article 12(2) or Article 12(5) read with Article 7(3) of DTAA?" By its decision in 2014, the tribunal held that the taxpayer had no PE in India and therefore article 12(2) applied.

On the same day that *Valentine* was decided, the same tribunal decided a case involving roughly the same facts and the same issue for a sister company, *Valentine Maritime (Gulf) LLC v. Assistant Director of Income Tax*.[113] Although the word "abuse" is not used in the reasons for judgment, one may speculate that the tribunal had that concept in mind when it said:

> In our considered view, the only other situation in which aggregation of time spent of [sic] various activities is to be done is when the activities are so inextricably interconnected or interdependent that these are essentially required to be viewed as a coherent whole.[114]

The tribunal suggested that the test set out in the commentary on the US (UN?) model treaty, that projects will be connected only when they are "interdependent both commercially and geographically," was to be preferred to the OECD commentary's test of commercial and geographical coherence.

"Connected" from Whose Perspective?

In discussing whether two projects are "connected," one must ask, "From whose perspective—the foreign enterprise, or the person in the source state for whom the services are provided?"

There was an extensive discussion of connected projects at the UN committee of experts' eighth session in October 2012. In a note prepared for the Subcommittee on Services and tabled at that session,[115] it was recommended that paragraphs 42.39 through 42.41 of the OECD commentary on article 5 (which relate to the alternative provision on the taxation of services) be adopted as the UN commentary on the services PE provision. Under paragraph 42.40 of the OECD commentary, the determination of whether an enterprise is performing services for "the same project" is to be interpreted from the perspective of the enterprise that provides the services. The paragraph gives as an example an enterprise that is to provide both tax advice and training in an area unrelated to tax to a single customer. The paragraph concludes that while these may be related to a single project of the customer, one should not consider that the services are performed for the same project. Notably, the UN commentary does not say from whose perspective the connected concept should be determined.

The note indicates that some members of the subcommittee expressed the view that the "perspective of the service provider" rule should apply only to the "same

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113 ITA no. 2879/Mum/05 (Mumbai ITAT).

114 Ibid., at paragraph 14.

115 See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Note on United Nations Model Tax Convention Article 5: The Meaning of "Connected Projects,"* prepared by Claudine Devillet, UN publication no. E/C.18/2012/CRP.5 (Geneva: United Nations, September 2012).

project" aspect of article 5(3)(b) and not to the "connected project" aspect. The note suggested that the entire committee would have to debate this.[116] In the committee's report, this issue was further debated, and the author of the note (Claudine Devillet) was instructed to prepare a revised note.[117]

In August 2013, the secretariat of the committee of experts published a note on issues for consideration[118] in preparation for the committee's ninth session to be held on October 21-25, 2013. The note indicates that the topic of connected projects would be discussed at the ninth session and that Devillet would deliver an update of her 2012 paper. The note provides some background to the upcoming revised paper. The background indicates that at the eighth session there were two main areas of debate, the second of which was whether the determination of whether two or more projects were connected should be regarded from the point of view of the enterprise furnishing the service or from the perspective of the consumer, or both.[119]

On this issue, the committee was divided. A majority of the members appear to have thought that the determination should be made from the service provider's point of view. They suggested that if an enterprise provides services to a consumer for two different projects through two different departments using different personnel, then the two projects are not related and the same or connected project provision cannot be applicable. Looking at the matter from the service provider's point of view would ensure that result. A minority of the committee members thought that the purpose of the same or connected project provision was to avoid a situation where an enterprise that did not want to have a PE in a country where it

116 Ibid., at 3.

117 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Report on the Eighth Session*, UN publication no. E/2012/45-E/C.18/2012/6 (New York: United Nations, 2013), at paragraph 75.

118 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Model Tax Convention: Issues for Consideration by the Committee*, UN publication no. E/C.18/2013/3 (New York: United Nations, August 2013).

119 The issue was whether the enterprise providing the services in the other state must have a physical presence through its personnel there, or whether a services PE could exist under the wording of article 5(3)(b) of the UN model treaty without such presence. The majority of the committee thought that a physical presence was required. For a discussion, see Arnold, supra note 17, at 284. Article V(9)(b) of the Canada-US treaty requires the services to be provided "in" the other state. If the wording were "provide services to" someone in Canada, no physical presence would be required, but it is difficult to understand how USco could provide services "in" Canada without having a physical presence there. It has been suggested that "furnishing of services" in UN article 5(3)(b) is wider than "provides": see Kuźniacki, supra note 17, at 20-21, and "Canada Revenue Agency and Revenu Québec Round Table," in the 2011 Conference Report, supra note 21, 4:1-24, question 1, at 4:1-2. But see *Linklaters LLP v. ITO* (2010), 132 TTJ 20 (Mumbai ITAT), which held that "provides" services and "furnishes" services are equivalent expressions (the force-of-attraction aspect of the case was not followed in *Clifford Chance v. Asst. DIT (IT)*, May 13, 2013 (Mumbai ITAT)). The French version of article V(9) is "les services sont *fournis* dans cet autre État [emphasis added]," so even the language equates providing and furnishing services.

provided services would just split up projects into different parts and seek to avoid the threshold of 183 days in any 12-month period. With this in mind, it seems logical to look at the provision from the point of view of the consumer, rather than that of an enterprise that is trying to avoid the provision.

Yet another minority of the committee members argued that the difficulties and restrictions implied by using the wording "the same or a connected project" could be avoided by simply not including such wording in article 5(3).

In my view, the majority is correct. An analogy may be drawn to the issue of whether a worker is an employee of or an independent contractor for a particular principal. At least in Canada, one of the factors that is looked at in making that determination is whether the worker is "integrated" into the principal's business. The rule is clear that that factor is to be considered from the worker's point of view, not the principal's, because from the principal's point of view, everyone he hires to work for his business is an integral part of that business.[120] The real question is whether the worker is carrying on his own business, and that can be determined only from his perspective. Similarly, if the test is whether two or more projects are connected, then, in our example, from Canco's point of view, all of its projects are connected: it is a single company carrying on a single business and paying all of USco's fees from a single fund. The real test is whether it is "fair" in tax policy terms for Canada to tax USco on its Canadian-source income on the basis that USco is providing services in Canada in respect of two or more interdependent projects for more than 183 days—and that can be determined only by examining interdependence from USco's point of view.

Is Geographical Coherence Required?

The updated paper to be delivered at the ninth session of the UN committee of experts was issued on October 14, 2013.[121] The paper contains proposed revisions to the commentary on the services PE provision in the UN model treaty. Under the proposed revisions, three points are made:

1. It is not clear from the wording of article 5(3)(b) of the UN model treaty whether the workers must be present physically in the source state for a services PE to be created, and either the text or the UN commentary should make that clear.
2. There is no consensus on the manner of determining whether two projects are connected—that is, whether the determination should be made from the point of view of both the service provider and the customer, or merely from one or the other's point of view. The majority of the subcommittee appears to believe that it should be only from the provider's view, while the committee

120 See *Precision Gutters Ltd. v. Canada (Minister of National Revenue)*, 2002 FCA 207, at paragraph 31.

121 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Article 5: The Meaning of "The Same or a Connected Project,"* UN publication no. E/C.18/2013/CRP.2 (New York: United Nations, 2013).

as a whole is prepared to say that both views should be taken into account, and that a real difference in those viewpoints would arise only where a provider performed different services on different projects, all for the same customer. In that case, the customer might well view all of the projects as being connected, but the provider would not.

3. In determining whether two projects are connected, only commercial coherence is required, and not geographical coherence.

It has been suggested to me by a member of the committee that this last point is based on the view that article 5(3)(b) constitutes a limited extension of the fixed-base PE definition in article 5(1) of the UN model treaty. It is an extension because geographical coherence is not required. It is only a limited extension because it requires, through the same or connected project condition, that commercial coherence exist among the activities taken into consideration. Accordingly, taking into account the purpose of the services PE rule as well as the examples provided in paragraphs 42.25 through 42.28 (especially 42.28) of the commentary on article 5 of the OECD model, the OECD services PE provision does not require geographical coherence in order to determine that projects are connected; only commercial coherence is required. If this were not the case, the services PE rule would be particularly narrow and would cover primarily cases already covered under the fixed-base PE rule in article 5(1). Where an enterprise performs services in the source state through a particular location constituting a coherent whole commercially and geographically, at which its personnel are present for more than 183 days, such location will in most cases constitute a fixed place of business.

On the basis of my review of the origins and purpose of the services PE provision and the original OECD commentary on construction site PEs as set out below, and with due respect, I disagree entirely with this suggestion. Simply, it is wrong to say that the services PE rule is somehow an "extension" of the fixed-based PE rule with geographical coherence removed.[122] The services PE provision was intended to be a completely new and separate rule that would create a PE where none otherwise existed.[123] More importantly, the concept of a connected project was intended to be a limiting factor that would narrow the circumstances under which a services PE would be created: it is only where projects are so closely intertwined that it would be "fair" in tax policy terms to view them as establishing a close enough connection for the source state to tax the related profits that a PE should exist.

122 See Liselott Kana and Ron van der Merwe, "The Commentary on Article 5—The Changes and Their Significance" (2012) 66:11 *Bulletin for International Taxation* 603-7, at 605: "There was no disagreement with the 'self-standing' nature of article 5(3)(b) [of the UN model] with respect to the services PEs."

123 See Jürgen Lüdicke, "Recent Commentary Changes Concerning the Definition of Permanent Establishment" (2004) 58:5 *Bulletin for International Fiscal Documentation* 190-94, at 192: "Thus, a 'services permanent establishment' under the UN Model is independent of any 'fixed place of business.' "

My view that geographical coherence should be required before two projects may be said to form a coherent whole is supported by the decision in *Krupp UHDE Gmbh*.[124] The issue in that case was whether the taxpayer, a German resident, had a construction site PE in India under the treaty between those two countries. The taxpayer was in the engineering business and provided technical knowhow, engineering services, and supervisory activities in connection with the construction or installation of machinery. The Income Tax Appellate Tribunal held, applying *Sumitomo*,[125] that the taxpayer's different construction projects had no "effective interconnection" with each other: they were different contracts with different parties in respect of different independent projects located at different places. Hence, they did not form a coherent whole in any respect, and there was no construction site PE.

IRS Interpretation

There appears to be only one US technical publication on point.[126] In this memorandum, it was held that where a contract driller's work activity is controlled under a two-year contract by one customer ("B"), even though the driller's work location within a relatively large geographic area (approximately 200 miles wide) changes frequently, the principle of a commercially and geographically coherent whole in the OECD commentary should be applied to the driller's work activity. It was held that the drilling activity under the contract for 26 months in an outer continental shelf area along the coasts of two contiguous states constituted a single commercially and geographically integrated project.[127]

The CRA has recently released a detailed analysis of commercial and geographical coherence in the context of a construction site PE. In a CRA district office memorandum,[128] the Rulings Branch was asked by a CRA auditor to consider the construction

124 Supra note 110.

125 *Sumitomo*, supra note 109.

126 Internal Revenue Service, General Counsel Memorandum 39373, March 1, 1985, which formed the basis for Technical Advice Memorandum 8526005, March 8, 1985.

127 One author has suggested that the "more flexible" approach of the IRS toward geographical integration as shown in this memorandum is questionable in light of the inconsistency with certain other authorities. See Richard E. Andersen, *Analysis of United States Income Tax Treaties* (online, current through 2013, Thomson Reuters Tax and Accounting), at note 80. Another author, in discussing GCM 39373, suggests that the following factors may be relevant to determining whether two construction projects (and, presumably, two service projects) may form a coherent whole: "identity of contract, separate bidding and negotiation of contracts, separate invoicing, identity of clients, interruptions between projects, lack of technical connection between projects, independent pricing, separate delivery or acceptance and whether a reasonable business person would not have entered into one of the agreements for the terms agreed on without also entering into the other agreements." See Gordon et al., supra note 71, at note 23 and the related text.

128 CRA document no. 2013-0474851I7, supra note 73. The memorandum was issued in French; the (unofficial) translation here is my own.

site PE provision in article 5(3) of the 1975 Canada-France income tax treaty.[129] Canco, a Canadian corporation, entered into a series of contracts with Franceco, a French corporation with which Canco was dealing at arm's length. There was no single, comprehensive agreement or contract between the parties; Canco's decision to retain Franceco for any particular contract was made on a case-by-case basis under a formal tender process. The series of contracts provided for Franceco to integrate new equipment at Canco's plant in Canada. Franceco provided various services under the contracts, including the receipt, delivery, assembly, and installation of specialized equipment, the supervision of employees, and the training needed to use the equipment. The contractual arrangements between the parties were recurrent. Under the contracts, many of Franceco's employees and subcontractors visited Canco's premises to attend to the delivery and assembly of the equipment, to oversee its installation, and to provide training to Canadian operators.

The contracts were let under tender at various times. The presence of Franceco's employees in Canada was essential to the projects because no local company had the technical knowledge related to the installation of equipment, optimization of the equipment, and training of Canadian operators.

The CRA auditor had determined that Franceco was carrying on business in Canada and had no other PE in Canada. The auditor considered that although no one contract lasted for more than 12 months, the series of contracts together formed a coherent whole, commercially and geographically, that lasted for more than 12 months.

With respect to the duration of the construction project, the CRA noted that it was the actual duration of the project that counted, regardless of what the contract said, and that all facts and circumstances should be taken into account in determining the duration of the project:

> The duration of the project, and not the contract is crucial in analysis of a situation for the purposes of paragraph 3 of Article 5 of the Convention. All facts and circumstances must be considered in order to determine whether the duration of the project exceeded twelve months, as required by the Convention.[130]

In my view, these comments apply equally to article V(9) of the Canada-US treaty.

With respect to whether several different projects could be connected to each other, the CRA noted that the first task was to identify each "project." That term was not defined in the Canada-France treaty, and the CRA suggested that the term should have a wide meaning, based on an unnamed earlier publication concerning the Canada-UK income tax treaty:

129 Convention Between Canada and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Paris on May 2, 1975, as amended by the protocols signed on January 16, 1987, November 30, 1995, and February 2, 2010.

130 CRA document no. 2013-0474851I7, supra note 73.

> The term "site" is not defined in the Convention, the Income Tax Act Interpretation Act, the OECD Model Convention or the OECD commentary. But [as] we established [in (redacted)] the term "project" used in the English version of the tax treaty between Canada and the United Kingdom should be interpreted broadly, according to its usual meaning.[131]

With respect to geographical coherence, the CRA suggested that

> since all equipment covered by the contracts (including that of the Project) have been installed in the factory located at Canco's plant located at [redacted], it seems that geographical coherence could be established between different projects, as appropriate.[132]

However, with respect to commercial coherence, the CRA suggested that it was lacking sufficient details to make a determination. It suggested a non-exhaustive list of factors that should be taken into account in making this determination:

> However, information available in respect of agreements contracted between the parties does not allow us to provide a determination on the mounting of various projects that occurred during the period under audit, or on the commercial coherence between these different sites, as appropriate.
>
> Based on the OECD commentary and other works on the subject, we believe that the following criteria can be taken into consideration in establishing a commercial coherence between different installation projects:
>
> - Existence of a single contract covering the different assembly projects;
> - Signature of different assembly contracts at the same time;
> - A predictable conclusion of additional contracts;
> - Uninterrupted periods between contracts;
> - Works, objectives and activities of the same nature [for each project];
> - Services provided by the same company or related companies;
> - Services provided by the same individuals;
> - Single billing [for all projects].
>
> Please note that this list of criteria is not exhaustive, nor cumulative. In addition, the analysis for the determination of whether separate projects have commercial and

131 Ibid. The word "project" appears in article 5(2)(g) of the 1978 Canada-UK income tax treaty, which includes, as one possible type of PE, "a building site or construction or assembly project which exists for more than 12 months." (Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980 and October 16, 1985.) I understand from my discussions with the CRA that the redacted reference was to a technical interpretation (in English) given by CRA Rulings to a CRA taxation services office that looked at the meaning of "project" in the *Oxford Dictionary* and the *Webster Third New International Dictionary*, and determined on the basis of those dictionaries that the word should be given a broad meaning.

132 CRA document no. 2013-0474851I7, supra note 73.

> geographical coherence must be made case by case, depending on the facts and circumstances of the situation under study.[133]

Again, in my view, these comments could apply to article V(9)(b) of the Canada-US treaty.[134]

It is clear from the case law and administrative material that both commercial and geographical coherence are required for two or more construction projects to form a coherently whole project for the purposes of the 12-month test in article 5(3) of the OECD model treaty. It is difficult to see why geographical coherence is not also required when determining whether two or more projects are connected for the purposes of the 183-day test in the services PE rule.

As for a definition of geographical connection, there is none. In fact, on the basis of a German case involving the 1958 Germany-Luxembourg tax treaty,[135] it appears clear that there is no rule of thumb that may be applied to determine whether projects are geographically connected. The taxpayer was a German-resident individual. He was retained as a contractor in Luxembourg by a telephone company there to connect telephone cables laid by other contractors. Each assignment was a separate assignment awarded after a separate tender. The projects covered all of Luxembourg. All the projects were completed at roughly the same time.

The court held that all relevant facts and circumstances must be taken into account in deciding whether two or more projects form a coherent whole. In this case, the court held that since the projects were carried out throughout the whole country, there was no geographical coherence. In particular, the court rejected the tax authority's rule of thumb that geographical coherence existed automatically if two projects were less than 50 kilometres apart as the crow flies.

The CRA and the UN Model

Although it is clear that the services PE rule originated with the UN model and not with the OECD model, the CRA does not appear to place much, if any, importance on the UN material. At a Tax Executives Institute conference, the following question was put to the CRA:

> Paragraph 2 of Annex B to the Protocol . . . states that projects are considered "connected" if they constitute a coherent whole, commercially and geographically. Will

133 Ibid.

134 As an aside, it is interesting to observe that CRA Rulings relied on the OECD commentary on article 5(3) as it read in 1975 at the time the Canada-France treaty was signed, rather than on later commentary, contrary to the CRA's usual approach. The memo noted (supra note 73), "Although some changes have been made in paragraph 17 of the OECD Commentary on Article 5 of the Model since the adoption of the Convention, we believe that the comments above mentioned are applicable in this case."

135 No parties named, Case I R 3/02, a decision of the Hof Van Beroep/Cour d'Appel, Antwerpen/Anvers, November 19, 2003.

CRA provide specific examples of what it considers to be the "same or connected project"?[136]

In response, the CRA referred to the technical explanation and the OECD commentary on article 5 of the OECD model, and suggested that the examples in the technical explanation and the OECD commentary would be instructive. The CRA did not refer to the UN commentary, although it is difficult to know how much to read into that. Perhaps the absence of any such reference simply reflects the fact that the CRA is a member of the OECD and is not represented on the UN committee, and consequently looks mostly or solely at OECD material, rather than being some definitive indication that the CRA does not agree with the UN commentary.

In summary, the UN model and commentary do not define a connected project but appear to view this requirement as a limitation on the ability to create a PE, while noting that some countries view it as an anti-abuse rule designed to prevent the foreign enterprise from splitting up a project into artificial segments in order to avoid the 183-day test.

The OECD

The work of the OECD on a services PE provision is much more recent than the UN's work, and can be traced back to as late as 2004. In that year, the OECD's Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits issued a final report that discussed whether the current treaty rules for taxing business profits were appropriate for e-commerce.[137] Section 4(A)(g) of the report considered whether the OECD model treaty should include a services PE provision similar to the UN provision discussed above, and concluded that it should not.

Following that report, in December 2006, Working Party No. 1 on Tax Conventions and Related Questions of the OECD Committee on Fiscal Affairs issued a public discussion draft on the tax treaty treatment of services.[138] The draft set out proposed changes to the OECD commentary on article 5 of the OECD model treaty, including the possibility of adding a services PE provision to any particular treaty. It included commentary that suggested wording for a services PE provision that states could include in their tax treaties.[139]

136 CRA document no. 2008-0300941C6, December 9, 2008.

137 Organisation for Economic Co-operation and Development, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report* (Paris: OECD) (www.oecd.org/tax/treaties/35869032.pdf). The report is undated but was presented to the OECD in June 2004.

138 Organisation for Economic Co-operation and Development, *The Tax Treaty Treatment of Services: Proposed Commentary Changes: Public Discussion Draft* (Paris: OECD, December 8, 2006) (www.oecd.org/tax/treaties/37811491.pdf).

139 For a comparison of the UN and the OECD versions of the services PE provision, see Sriram P. Govind, "The International Tax Treatment of Cross-Border Services," published in the online version of (2012) 66:1 *Bulletin for International Taxation*.

With respect to the concept of projects or connected projects, the 2006 commentary stated:

> 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 involve the provision of services of the same or of a similar nature and within the framework of contracts concluded with the same enterprise or with associated enterprises. [The Working Group invites comments in particular on the meaning of "connected projects."][140]

A Coherent Whole, but Only Commercially?

In response to that invitation, a number of people suggested that the concept of a connected project in the services PE context should be based on the "coherent whole" concept used in the construction site PE context to determine whether two or more construction contracts should be viewed together in determining whether the 12-month time limit had been exceeded.[141]

The OECD adopted that suggestion (somewhat). The 2006 update was finalized on July 18, 2008.[142] Paragraph 42.11 and following of the 2008 commentary includes the discussion of a services PE provision, as well as a number of examples of how that provision would be applied to different situations.

Paragraph 42.11 of the OECD commentary on article 5 reiterated Carroll's rule from 1933 that a foreign enterprise carrying on business in the source state should

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140 *Tax Treaty Treatment of Services*, supra note 138, at paragraph 42.40 of the proposed commentary.

141 See Hans Pijl, "The OECD Services Permanent Establishment Alternative" (2008) 49:9 *European Taxation* 472-76, at 476, note 34 and the accompanying text, and the comments from David Ward, Radhakishan Rawal, and Hans Pijl (available at www.oecd.org/tax/treaties/publiccommentsonthediscussiondraftonthetaxtreatytreatmentofservices.htm).

142 Organisation for Economic Co-operation and Development, *The 2008 Update to the OECD Model Tax Convention* (Paris: OECD, July 18, 2008) (www.oecd.org/tax/treaties/41032078.pdf). In addition to the *2008 Update*, the OECD published a detailed response to the comments submitted on earlier OECD reports that made up the final *2008 Update*. See *Response of the Committee on Fiscal Affairs to the Comments Received on the April Discussion Draft on the 2008 Update to the Model Tax Convention* (Paris: OECD, July 18, 2008) (www.oecd.org/ctp/treaties/41032122.pdf). The *Response* states, ibid., at 3: "The Committee, however, has noted that some States (including some OECD countries) do not share that view. These States use various treaty approaches to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. The Committee has considered that it was important to circumscribe the circumstances in which States could do so and has therefore decided to include in the Commentary an alternative provision that these States could use for that purpose and that would ensure that the additional taxation rights that would be granted to a State using the provision would not extend to services performed outside the territory of that State, would apply only to the profits from these services (as opposed to gross payments for them) and would not apply unless a certain threshold of physical presence in that State had been met." The phrase "would not extend to services performed outside the territory of that State" suggests that even the OECD does not interpret "furnishing of services" to permit the performance of the services from outside the source state. See the discussion of this point at note 119 above.

be taxable by that state on business profits earned in that state only when those profits are earned through a PE in that state, because it is only then that the enterprise can "be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State."[143] Paragraph 42.11 emphasizes that this basic rule applies to profits earned from supplying services, as well as any other kind of business profits.

Paragraphs 42.14 through 42.22 of the OECD commentary on article 5 note that, notwithstanding the administrative difficulties that the taxation of service profits entails, as discussed in paragraphs 42.12 and 42.13, some countries believe that service profits earned in their state should be taxable in their state, even without a PE, because the source of the profit is obviously in their state. To balance this need against the general PE rule expressed in paragraph 42.11, the commentary at paragraph 42.23 suggests wording to create a services PE provision (which, for convenience, is reproduced here):

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
>
> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State
>
> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

It is clear from paragraph 43.22 that one of the key policies behind the wording of the suggested rule is that taxation by the source state is permissible only when there is a "minimum level of presence" in the source state.

The 2008 Commentary defined a connected project as follows:

> 42.41 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* (see paragraphs 5.3 and 5.4 above). The

143 Ibid., commentary on article 5, at paragraph 42.11.

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 [emphasis added].

In terms of examples of connected projects, the 2008 commentary states:

42.44 The following examples illustrate the application of subparagraph b) (assuming that the alternative provision has been included in a treaty between States R and S): . . .

— Example 3: ZCO, a resident of State R, has outsourced to company OCO, which is a resident of State S, the technical support that it provides by telephone to its clients. OCO operates a call centre for a number of companies similar to ZCO. During the period of 1 January 00 to 31 December 00, the employees of OCO provide technical support to various clients of ZCO. Since the employees of OCO are not under the supervision, direction or control of ZCO, it cannot be considered, for the purposes of subparagraph b), that ZCO is performing services in State S through these employees. *Additionally, whilst the services provided by OCO's employees to the various clients of ZCO are similar, these are provided under different contracts concluded by ZCO with unrelated clients: these services cannot, therefore, be considered to be rendered for the same or connected projects* [emphasis added].

It is notable that the OECD commentary does not require that two projects have any geographical coherence before being considered connected projects, but merely that they have commercial coherence. As discussed above, under the 2013 UN proposed revised commentary, the most recent UN discussion has suggested that that view is correct. Yet, as noted below, that singular approach has not been followed in the diplomatic notes to the fifth protocol of the Canada-US treaty. One might assume that the diplomatic notes hark back to the initial purpose of the connected project rule, which is to limit the circumstances under which a services PE would exist. I suggest that the absence of the requirement for geographical coherence in the OECD commentary is a mistake: the earliest references to coherence in the context of a connected project rule clearly state that both commercial and geographical coherence are required.[144]

144 The earliest mention appears to be in Organisation for Economic Co-operation and Development, *Permanent Establishment: Second Report by Working Group No. 1 on Potential Amendments to Article 5 and to the Commentary Thereon*, document no. DAF/CFA/2697 (Paris:

The OECD Adopts an Anti-Abuse Perspective of the Connected Project Rule—Or Does It?

With regard to the policy behind the connected project rule, one may start by noting that paragraph 18 of the OECD commentary on article 5, dealing with construction site PEs, considers that the 12-month rule applicable to such PEs may be open to abuse by the splitting of projects:

OECD, May 18, 1973) (www.taxtreatieshistory.org), at paragraph 8(d), which stated, "The criterion of the 12-month-time limit applies to each individual site or project. The duration of several sites or projects operated by the same enterprise in the same State should not be calculated cumulatively if—and this is the decisive condition—the projects are at different locations and in no factual connection. This principle may be contested by claiming that the above approach would allow an enterprise to do business in another State for more than 12 months by operating a building site or construction project without being liable to tax in that State, provided that the projects are independent of each other. This is true, of course, but if building sites and construction/assembly projects of shorter duration were to be calculated cumulatively, this would lead to an element of uncertainty for the enterprise as far as the tax treatment of its activities is concerned; this uncertainty would clearly be incompatible with the spirit of close international co-operation in the economic field. If, for instance, an enterprise initially operates a building site which exists for 4 months, its calculations (for tax purposes) being based on the assumption that such site is not a PE, and if the same enterprise subsequently operates a site which exists for, say, 9 months, the cumulation of such periods of time would lead to retroactive changes in the taxation of the enterprise. A building site will have to be regarded as a single unit, even if it is based on several contracts, provided that it forms *a coherent whole from the point of view of location and subject matter*. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for terraced houses) [emphasis added]." The terminology was changed to "coherent whole commercially and geographically" in Organisation for Economic Co-operation and Development, Working Party No. 1 of the Committee on Fiscal Affairs on Double Taxation, *Revised Report on Article 5 (Permanent Establishment)*, document no. CFA/WP1(74)(6) (Paris: OECD, August 30, 1974) (www.taxtreatieshistory.org), at paragraph 8(c): "The 12 months-test applies to each individual site, project or installation. 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 if they 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*. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses) [emphasis added]." In Working Group No. 1's *Third Report on Article 5 (Permanent Establishment)*, October 13, 1975, CFA/WP1(75)6, at 13, this commentary was inserted as paragraph 17: "The 12 months-test 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 if they 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. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses)." The same paragraph 17 appeared on page 12 of Working Group No. 1's *Fourth Report on Article 5*, April 7, 1976, CFA/WP1(76)6. The omission of any explanation in the current OECD commentary for not requiring geographical coherence to connect two projects for the purposes of the services PE provision appears to be an error in light of these previous commentaries. For a discussion of these various reports, see Pijl, supra, note 102.

> The twelve month test 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. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (*e.g.* for a row of houses). *The twelve 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 twelve 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 [emphasis added].

Paragraph 42.45 of the OECD commentary on article 5 then adopts paragraph 18 in the context of the services PE rule:

> The 183-day thresholds provided for in the alternative provision may give rise to the same type of abuse as is described in paragraph 18 above.

It may appear from this that the connected project rule is designed to prevent such abuse. But paragraph 42.45 goes on to say, "[A]s indicated in that paragraph [18], legislative or judicial anti-avoidance rules may apply to prevent such abuses." It appears, therefore, that the OECD was not of the view that the connected project rule is itself an anti-abuse rule; if it were, then there would be no need to suggest separate legislative or judicial anti-abuse rules. Accordingly, it appears that for the OECD, the connected project rule is based on a policy simply of ensuring that interrelated projects are counted together toward the 183-day test, without assuming that separate but related projects were established as an abusive attempt to avoid that test.

The OECD has issued subsequent updates to its commentary on article 5, but none address the services PE provision.[145]

The Treaty's "Definition" of a Connected Project—A Coherent Whole, Commercially and Geographically

While the Canada-US treaty does not contain a definition of "connected project," the diplomatic notes to the fifth protocol state:

145 Organisation for Economic Co-operation and Development, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)* (Paris: OECD, October 19, 2012).

2. *Meaning of connected projects*

> For the purposes of applying subparagraph (b) of paragraph 9 of Article V (Permanent Establishment) of the Convention, it is understood that projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically.[146]

While there is no direct evidence on this point, it seems obvious[147] that this definition is taken from the OECD commentary on article 5(1) on fixed-base PEs and on article 5(3) on construction site PEs, which states:

> 5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified *as constituting a coherent whole commercially and geographically* with respect to that business. . . .
>
> 18. The twelve month test 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*. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (*e.g.* for a row of houses). The twelve 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 twelve 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. . . .
>
> 20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations

146 Diplomatic notes, supra note 30, at paragraph 2.

147 See J. Ross MacDonald, "'Songs of Innocence and Experience': Changes to the Scope and Interpretation of the Permanent Establishment Article in U.S. Income Tax Treaties, 1950-2010" (2010) 63:2 *Tax Lawyer* 285-414, at 379, note 322 and the accompanying text. Paragraph 42.40 of the 2006 draft OECD commentary on services PEs did not refer to "commercial coherence"; this reference was added to the final 2008 OECD commentary only after several commentators suggested doing so in response to the OECD's request for comments on the 2006 draft.

within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. *The activities performed at each particular spot are part of a single project*, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months [emphasis added].[148]

Taking the diplomatic note definition into account, the report of the US Senate's foreign relations committee and the technical explanation of the fifth protocol both contain the following discussion of "connected projects":

For purposes of determining whether the time threshold has been met, subparagraph 9(b) permits the aggregation of services that are provided with respect to connected projects. Paragraph 2 of the General Note provides that for purposes of subparagraph 9(b), projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. The determination of whether projects are connected should be determined from the point of view of the enterprise (not that of the customer),[149] and will depend on the facts and circumstances of each case. In determining the existence of commercial coherence, factors that would be relevant include: 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but not determinative, in finding that projects are commercially coherent.

The aggregation rule addresses, for example, potentially abusive situations[150] in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. Assume for example, that a technology consultant has been hired to install a new computer system for a company in the other country. The work will take ten months to complete. However, the consultant purports to divide the work into two five-month projects with the intention of circumventing the rule in subparagraph 9(b). In such case, even if the two projects were considered separate, they will be considered to be commercially coherent. Accordingly, subject to the additional requirement of geographic coherence, the two projects could be considered to be connected, and could therefore be aggregated for purposes of subparagraph 9(b).

148 The concept of a "coherent whole" can be traced back to, at least, the OECD's *Permanent Establishment: Second Report by Working Group No. 1*, supra note 144.

149 It will be noted that this is different from the OECD commentary.

150 In an early draft of this article, I was tempted to say that this is simply wrong because, as discussed above, the connected project rule was inserted into the UN model treaty as a limitation, to ensure that a PE was not created merely by services being performed anywhere in the source state for more than 183 days. However, on reflection, I do not think that is completely correct. Applying "connected" as an anti-abuse concept arguably is brought in through paragraph 11 of the commentary on article 5(3)(b) and paragraph 96 of the commentary on article 1 of the UN model.

> In contrast, assume that the technology consultant is contracted to install a particular computer system for a company, and is also hired by that same company, pursuant to a separate contract, to train its employees on the use of another computer software that is unrelated to the first system. In this second case, even though the contracts are both concluded between the same two parties, there is no commercial coherence to the two projects, and the time spent fulfilling the two contracts may not be aggregated for purposes of subparagraph 9(b). Another example of projects that do not have commercial coherence would be the case of a law firm which, as one project[,] provides tax advice to a customer from one portion of its staff, and as another project provides trade advice from another portion of its staff, both to the same customer.
>
> Additionally, projects, in order to be considered connected, must also constitute a geographic whole. An example of projects that lack geographic coherence would be a case in which a consultant is hired to execute separate auditing projects at different branches of a bank located in different cities pursuant to a single contract. In such an example, while the consultant's projects are commercially coherent, they are not geographically coherent and accordingly the services provided in the various branches shall not be aggregated for purposes of applying subparagraph 9(b). The services provided in each branch should be considered separately for purposes of subparagraph 9(b).[151]

It may be noted that whereas the 2008 OECD commentary refers only to commercial coherence, the diplomatic notes and the technical explanation refer to both commercial and geographical coherence.

In summary, the diplomatic notes set the criteria under which two projects may be connected, but do not define those criteria.

SUMMARY AND CONCLUSIONS ON CONNECTED PROJECTS

Under article 5(1) of both the UN and the OECD model treaties, a PE requires a fixed place of business. In the late 1960s, developing countries voiced their concern that developed countries would often send employees to perform services and earn large profits over a long period of time, but without creating a fixed-base PE, and so would not be taxable in the source state on the profits. To fix that problem, the services PE rule was created. It deems a PE to exist solely on the basis of the length of time during which services are performed in the source state.

Originally, some countries suggested that a services PE should exist whenever the employees from the resident state spent more than 183 days in the source state on any project or projects. But others felt that this would be unfair and would create a PE even when a project lasted only a short time and did not create a real connection to the source state. Accordingly, the services PE rule was developed so that the 183 days had to be spent on a single project or on two or more projects that were "connected." The majority of countries appear to view the connected project condition

151 See S exec. rep. no. 110-15, supra note 24, at 25-26; technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V."

as a limitation on the source state's right to tax the business profits earned by the enterprise in the source state from performing services in that state; a minority of countries appear to view the connected project requirement as an anti-abuse rule, to prevent enterprises from artificially splitting a single project into several projects.

Although the word "connected" is not defined in the model treaties or related materials, it is clear that it was intended to mean two projects that were so interdependent and closely intertwined that it would be fair in tax policy terms to treat them as one single project and to create a PE on the basis of those two intertwined projects.

It has been suggested to me that the OECD commentary on services PEs requires no geographical coherence to determine whether projects are connected because if it were required, the services PE rule would be unduly narrow and would cover primarily situations already covered under the fixed-base PE rule. I disagree. It is true that in some cases, if employees are present in the source state for more than 183 days, there may be a fixed-base PE. But as shown in the *Dudney* case, that will not always be true. So the services PE rule is *not* an extension of the fixed-base PE rule; it is, and has always been intended to be, a completely new and different rule.[152]

As noted above in the context of a construction site PE, which is also an alternative to (and not an extension of) the fixed-base PE rule, the original OECD commentary[153] provided that the 12-month threshold in that rule would apply to connected projects—that is, projects that formed a coherent whole, both commercially and geographically. The commentary shows that the OECD understood "coherent whole" to mean both commercially and geographically connected. The current OECD commentary on services PEs is simply wrong in focusing only on commercial connections and leaving out geographical connections. That mistake arises from ignoring both the purpose of the services PE rule and the historical commentary from the OECD.

The case law from around the world on services PEs and construction site PEs shows that both commercial and geographical connections are required before it will be considered fair in tax policy terms to treat two projects as one large project for PE purposes.

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152 Paragraph 42.24 of the OECD commentary on article 5 states that the suggested services PE provision is an "extension" of the "permanent establishment definition that allows taxation of income from services provided by enterprises carried on by non-residents." However, it is clear from the preceding paragraphs in the commentary that, in this context, "extension" means a new rule. In particular, paragraph 42.11 states clearly that service profits are not taxable in the source state unless earned through a "permanent establishment" in that state as defined in article 5 of the OECD model. Indeed, paragraph 42.25 states, "The [services PE] provision has the effect of deeming a permanent establishment to exist where one would not otherwise exist under the definition provided in paragraph 1 and the examples of paragraph 2. . . . Since the provision simply creates a permanent establishment when none would otherwise exist, it does not provide an alternative definition of the concept of permanent establishment."

153 See supra note 144.

Limitation Versus Anti-Abuse Rule

There appears to be a debate as to whether the connected project requirement is a limitation created to protect the enterprise from an overeager source state, or to protect a source state from a conniving foreign enterprise. The determination to be made is whether the projects are sufficiently related or intertwined such that, in tax policy terms, it is fair to combine the time worked on them in determining whether the 183-day test is met. Another aspect to be looked at is whether two projects have been split artificially so as to avoid the 183-day rule; however, in my view, this is not a separate test, but merely a corollary of the first test. In other words, my view is that any such debate is sterile.

The original intention of the PE concept as a whole was to ensure that a foreign enterprise should be taxed in the source state whenever it has a "close enough" connection to that state to justify taxation by that state of the enterprise's profits earned in that state. Accordingly, as a limitation rule, the connected project concept ensures that enterprises having only a slight attachment to the source state will not be taxed.[154] As an anti-abuse rule, the concept ensures that enterprises that try to disguise their real connection to the source state will be taxed.

So regardless how one views the purpose of the connected project rule, the criteria that one should use to determine whether that rule is met are the same. Perhaps only in a case where the facts are exactly balanced between two projects being connected or not would the purpose of the rule be a factor in the decision, but such cases are likely to be so rare as not to be worth discussing. Perhaps the important point is that a revenue authority or a court should not have a presumption one way or the other as to whether two projects are connected: one should neither assume that all projects are connected unless proved otherwise (the anti-avoidance perspective), nor assume that no two projects are connected unless proved otherwise (the limitation perspective). One should start with the fact that there are, at least ostensibly, two projects and then ask whether they exhibit the necessary conditions to be regarded as connected.

In making that determination, the following rules apply:

1. The test of whether the two projects are related sufficiently to create a PE is based on whether they form a coherent whole, both economically and geographically—that is, whether they are intertwined and interdependent both commercially and geographically. Another way of saying the same thing is to ask if the separate projects form a comprehensive overall project, or to ask if the foreign enterprise's various business activities on apparently different projects are so inextricably interconnected that they are required to be viewed as a coherent whole.

154 Tittle, supra note 21, at 208, notes 697 and 698 and the accompanying text.

2. Whether the test is met is to be determined from the point of view of the foreign enterprise, not from the point of view of the person to whom the services are provided.
3. To borrow a phrase from another context, the issue of whether two projects are connected is a "practical, hard matter of fact."[155] All relevant facts must be considered in making the "connected or not" determination. Other cases, or OECD or technical explanation examples, may give guidance but do not create legal precedents. There are no rules of thumb that determine whether two projects are interconnected either geographically or commercially.
4. Even if two projects are commercially coherent in the sense that the work is done for one customer, and geographically coherent in the sense that the projects are carried out at the same or nearby locations, these two factors alone do not mean that the projects are necessarily to be seen as a coherent whole. The true test is whether the projects have sufficient interconnection to be viewed as a single project. Put another way, a commercial connection does not exist just because the enterprise carries out two projects for two different departments of a multifaceted customer, or because two different departments of the same enterprise perform work for the same facet of a single client.
5. There is no fixed list of factors that must be looked at to determine whether two projects are connected, but some factors that one would normally consider include the following (in no particular order, with no particular weight assigned to any factor, and with no absolute requirement that all factors or any one factor be considered in any particular case):
   a. whether the services are provided at the same or different locations;
   b. whether the services are provided under a single master contract or different contracts;

155 *Nathan v. Federal Commissioner of Taxation* (1918), 25 CLR 183, at 189 (HC), deciding what was the geographical source of income in a specific fact situation. It is perhaps worth noting both the full quotation: "The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact." In the concurring reasons for judgment of Burchett J in *Thorpe Nominees Pty Ltd. v. Federal Commissioner of Taxation* (1988), 19 ATR 1834 (FCFCA), at 1846, he said, "Practical reality is not a test so much as an attitude of mind in which the court should approach the task of judgment. Reality, like beauty, is often in the eye of the beholder. . . . What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law. For the word 'source,' in this context, has no precise or technical reference. It expresses only a general conception of origin, leading the mind broadly, by analogy. The true meaning of the word evokes springs in grottos at Delphi, sooner than the incidence of taxes. So the exactness which the lawyer is prone to seek must be consciously set aside; indeed, with respect to a choice between various contributing factors, it cannot be attained. The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income—where it came from—as a businessman would perceive it." Much the same may be said about whether two projects are connected for the purposes of article V(9)(b) of the Canada-US treaty.

c. whether the services are provided for the same or different customers;
d. whether the nature of the services provided is the same or different;
e. whether the services are provided continuously or at different times;
f. whether the client's request for services in respect of the second project would reasonably have been expected when concluding the contract for the first project;
g. whether the same individuals are performing the services under the different projects;
h. whether the projects would, in the absence of tax-planning considerations, have been concluded pursuant to a single contract;
i. whether the projects are billed separately or together in the same invoice;
j. whether the services are performed by the same or different personnel;
k. whether there was separate bidding and negotiation on the projects or whether the projects all resulted from the same discussion;
l. whether the results of the projects (the so-called deliverables) are independent of each other or whether one deliverable is somehow connected to or dependent on another deliverable;
m. whether the deliverables under each project are capable of separate delivery or acceptance;
n. whether there are uninterrupted periods between contracts; and
o. whether a reasonable business person would have entered into the contract for one project by itself or whether the business person would have done so only because the other contracts for the other projects were also to be granted.

WHERE DO WE GO FROM HERE?

Although cross-border services among treaty residents from different nations constitute a trillion-dollar industry, it seems unlikely that we will ever see a services PE article in the actual text of the OECD model treaty. This is for two reasons. First, the OECD's recent BEPS (base erosion and profit shifting) project appears to have diverted all attention away from changes to the OECD model and its commentary, and diverted attention to the integration of treaty concepts into a potential BEPS multinational treaty. Second, it seems that the appearance of the suggested services PE provision in the OECD commentary on article 5 was a compromise: many countries (and commentators) did not want it at all; some wanted it in the model itself. In the OECD's 2008 detailed response to its 2006 draft services PE rule, the OECD said:

> As indicated in the changes, the Committee considers that the provision of services should, as a general rule subject to a few exceptions for some types of service (*e.g.* those covered by Articles 8 and 17), be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services. This conclusion is supported by various policy and administrative considerations described in the new paragraphs of the Commentary.

> The Committee, however, has noted that some States (including some OECD countries) do not share that view. These States use various treaty approaches to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. The Committee has considered that it was important to circumscribe the circumstances in which States could do so and has therefore decided to include in the Commentary an alternative provision that these States could use for that purpose and that would ensure that the additional taxation rights that would be granted to a State using the provision would not extend to services performed outside the territory of that State, would apply only to the profits from these services (as opposed to gross payments for them) and would not apply unless a certain threshold of physical presence in that State had been met.
>
> The decision to include such a possible alternative in the Commentary was a difficult one for the Committee. The Committee as a whole does not support the use of such a provision and many member countries have clearly indicated that they would resist its inclusion in their bilateral treaties. The Committee, however, concluded for various reasons that it was better to acknowledge the existence of a minority treaty practice in this area.[156]

Nevertheless, Canada now has a services PE provision in 35 or so different income tax treaties, with each one referring to a connected project (or connected projects). So the concept is here to stay. One assumes that sooner rather than later the Tax Court of Canada will have to grapple with some or all of the issues raised in this article.

POSTSCRIPT

After this article was prepared but before it went to press, the CRA released further comments on the services PE question.[157] In the memo, the Rulings Branch of the CRA opined on a series of questions posed by a local CRA auditor relating to a US corporation, USco. USco was part of a worldwide group of corporations and provided services related to the planning and executing of construction projects to other members of that group. USco's services were of the "intellectual, planning and supervisory" type, performed by engineers, advisers, and coordinators; USco did not perform physical construction activities. For example, USco provided the following services with respect to the projects: technological assistance, general advice on strategy development, advice on business controls, development planning, engineering, design, and project execution.

Certain of USco's Canadian affiliates were in the process of working on several multi-year projects in Canada. The major projects were subdivided into separate phases, with each phase lasting more than 12 months.

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156 *Response of the Committee on Fiscal Affairs*, supra note 142, at 3.

157 CRA document no. 2013-0475161I7, "Whether USco Has a PE in Canada," February 25, 2014. (Originally, the memo was posted on CCH Protos on May 28, 2014. A slightly revised version was posted at the CRA's request on June 2, 2014.)

USco provided its services to the Canadian affiliates pursuant to a master services agreement. That agreement governed both USco's services provided to the affiliates in respect of the projects discussed in the memo and those provided to other Canadian affiliates not discussed in the memo, even though the agreement was not signed by those other Canadian affiliates that carried on those other projects.

To provide its services, USco sent employees to Canada. Most of the services were provided at the Canadian affiliates' offices, at various third-party contractors' offices, at other project participants' offices, or in hotels. The employees' presence in Canada totalled 183 days or more in a 12-month period.

It appears that some of USco's employees may have been seconded to the Canadian affiliates, although whether they were is not explored in detail in the memo. USco also retained subcontractors in Canada to provide some of its services. The memo noted that in prior rulings the CRA had opined that subcontractors' days spent in Canada counted toward the 183-day total in article V(9)(b) of the Canada-US treaty.

The memo assumed that USco had no fixed-base PE in Canada. In making this assumption, the CRA cited *Dysert*, where the court said, "[B]ased upon the extensive evidence before this Court, it appears that I would have been bound to follow and apply the Federal Court of Appeal's decision in *Dudney v. The Queen*, 2000 DTC 6169 (FCA), [2000] 2 C.T.C. 56 (FCA)."[158] This supports my theory, noted above, that Canadian courts and the CRA are bound to follow *Dudney* even though the OECD commentary on article 5(1) of the OECD model treaty suggests that it was decided incorrectly.

The memo then considered whether USco had either a construction site PE or a services PE in Canada.

The memo first noted that if USco's employees had been seconded to the Canadian affiliates, then their services could not be counted in determining whether USco had either a construction site PE or a services PE. As noted above, the case law suggests that a true secondment is difficult to achieve.

The memo then noted that there is nothing in the words of article V(3) of the Canada-US treaty to indicate whether services rendered in respect of the construction site have to be rendered at the site and noted that the CRA had found no case law on this point. However, after consulting various textbooks and papers, the CRA concluded that this must be the case.

Next, the memo noted that the Canadian affiliates were paying USco at cost. Given this, the memo suggested that the issue of whether USco had a PE was moot, since there was no net income to tax (although not cited in the memo, this follows clearly from the wording of subsection 247(2), which does not permit the minister to assess the PE of a non-resident so as to increase its profits from services rendered to a Canadian resident). However, the memo noted that the PE could still be

158 *Dysert*, supra note 13, at note 3.

relevant as far as USco's employees go, because their taxation under article XV depended on whether a Canadian PE was bearing (that is, deducting) their salaries.

The memo noted that article V(3) overrides article V(9) (because it says "Subject to paragraph 3"). Therefore, if the construction site lasted more than 12 months, USco would have a construction site PE, but only with respect to services rendered at the construction site. Services rendered in Canada but away from the construction site would be covered by article V(9). This appears to be a correct interpretation of the opening words of article V(9).

However, the memo then stated:

> However, if USCo does not have a PE under paragraph 3 of Article V, then all of the services rendered in Canada, *including those rendered at the construction site*, can be considered when making a determination under paragraph 9 [emphasis added]. The TE [technical explanation] to paragraph 9 implies that days of services on-site would be counted for purposes of paragraph 9. It says,
>
>> Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied.

I disagree with this interpretation. As explained earlier in this article, my view is that the words "Subject to paragraph 3" in article V(9) mean that construction site days count only toward the 12-month rule. The quotation above from the technical explanation is part of an extended comment on paragraph 9, which reads as follows:

> Paragraph 9 applies only to the provision of services, and only to services provided by an enterprise to third parties. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. Paragraph 9 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services by telephone or computer to customers located in the other State, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.[159]

159 Technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V."

In my view, this quotation was not addressing the interaction of articles V(3) and (9), and the memo is using the architect example to support a proposition for which it is not used in the technical explanation itself.

After dealing with whether various (later) changes to the OECD commentary on construction PEs could be taken into account in interpreting an earlier treaty (to which question the CRA's answer was yes), the memo then addressed services PEs. First, the memo looked at the meaning of "enterprise" in article V(9). The taxpayer argued that each of its different divisions was a separate enterprise, so that the test was whether each enterprise, rather than USco as a whole, met the 183-day test. According to the memo,

> [i]n the taxpayer's view, each of the [redacted] different functions should be treated as a separate enterprise because each function:
>
> 1. constitutes a separate division in USCo,
> 2. is led by a separate vice president and managers;
> 3. has distinct and separate staff;
> 4. has separate financial and accounting results; and has separate budgets.

The memo cited an earlier CRA ruling and agreed with the taxpayer:

> Our view is that the term "enterprise" refers to a resident of a contracting state but only in reference to a particular line of business carried on by such resident. Therefore, where a resident of a contracting state carries on two lines of business, that resident may have a permanent establishment in the other contracting state by reference to one of such lines of business, but not the other.

On the basis of this definition, which is supportable but in my view likely incorrect, the memo noted that each of USco's functions would constitute separate enterprises if they could be considered to constitute separate "lines of business." Since the term "line of business" is not defined in the treaty or the technical explanation, the memo suggested that it means the same thing as "separate businesses," so that the decision in *Dupont Canada Inc. v. Canada*[160] and the analysis in *Interpretation Bulletin* IT-206R[161] would be relevant. The memo set out a long list of factors that could be taken into account in determining whether USco had one single business or separate lines of business. The memo noted that the basic test from *Dupont* is whether the aspects of the company's operations that are characteristic of a single integrated business are more substantial than the aspects that are characteristic of separate businesses.

Turning to article V(9), the memo noted that the issue, assuming that USco had only one line of business, and therefore constituted only one enterprise, was whether its various operations in Canada constituted one project, several connected projects, or several unconnected projects. For this purpose, the memo adopted the statement

160 2001 FCA 114.

161 *Interpretation Bulletin* IT-206R, "Separate Businesses," October 29, 1979.

in the technical explanation that only days on which services are provided are to be counted toward the 183-day test; non-working days do not count.

As the memo correctly (and obviously) noted, if USco were providing services for only one "project" (which, as the memo noted, is undefined), then the issue of whether any two projects were connected was irrelevant. The memo suggested that USco had only one contract with one related group to provide one type of product (intellectual services) in one industry in one country (Canada) on a continuous basis, so that an argument could be made that all of those services constituted one project in Canada.

However, the memo noted that the CRA auditor was of the view that the Canadian affiliates operated (at least) two separate projects, so the issue was whether, from USco's point of view, the projects were connected. (Normally, this "point-of-view" rule would assist a non-resident taxpayer in avoiding a PE; here, it seemed to hurt USco because, as the memo noted, from USco's point of view the projects might be connected even though the Canadian affiliates viewed them as being separate projects.)

USco argued that, for the following reasons, the projects were unconnected:

- Each project is run separately.
- The projects are not integrated.
- Each project was managed by a separate team.
- Each project had a separate capital budget.
- Each project had a different scope.
- Each project was executed by a different team.
- Separate project codes were set up.
- USco may be heavily involved in one project, but may not provide services again in a subsequent project.

The memo examined a number of factors in USco's situation but stated that more facts were needed before it could be decided whether the projects formed a coherent whole commercially.

The memo also noted that although the OECD commentary on its suggested services PE provision did not require geographical coherence, geographical coherence was required under article V(9). I agree.

In this context, the memo suggested that even if different projects were in different cities (and presumably, in different provinces?), that by itself would not mean automatically that there was not geographical coherence. The memo suggested that such a rule may apply to fixed-base PEs but that article V(9) should not be interpreted so restrictively: "We believe that the purpose of paragraph 9 [of article V] would not be met by applying a restrictive interpretation."

The memo then adopted this passage from Reimer et al.:

> Geographical diversification does not necessarily create two (or more) sites or projects. As long as two or more building lots in one country, form a coherent whole, that

> is, are operated at one place or for one and the same ordering party, for related parties or for parties who act jointly and in coordination, these places should be aggregated and treated as one single unit for the determination of the minimum period.[162]

Once again, the quotation cited by the memo is incomplete. The quotation continues as follows:

> The OECD Commentary acknowledges one building site for a row of houses, even if the orders have been placed by several persons. Similarly, a mutual agreement between Belgium, Germany and the Netherlands endorses that principle; with regard to works accomplished at entirely different places, provided that they belong to a comprehensive overall project.[163]

In other words, if one project requires construction at a range of locations, there may (or may not) be geographical coherence, but the fact that two projects are carried out by one enterprise for two different (albeit related) customers at different sites on different projects should not, by itself, create geographical coherence.

The memo then concluded that a large area could represent a geographic whole, depending on the nature of the business, provided that it had "some relevant defining physical characteristics." I agree with this.

Lastly, the memo found that there was geographical coherence, but for reasons that, in my view, are completely wrong:

> If the projects in [redacted] and in [redacted] area constitute a coherent whole commercially, then in our view, they would also constitute a coherent whole geographically, since each of the connected projects require services to be provided at the same two geographic areas. Accordingly, all the days of service can be added together for determining whether the thresholds in paragraph 9 of Article V have been met. . . .
>
> We do not have enough information to determine if the various sites are a coherent whole commercially. We have recommended a methodology for you to use to make the determination, based on your knowledge of the taxpayer. If the projects in the [redacted] area and [redacted] area in [redacted] are a coherent whole commercially, then they would also be a coherent whole geographically.

This is simply wrong because it says that if there is commercial coherence, then there must be geographical coherence. The two concepts are distinct and distinguishable. I acknowledge that they may be interrelated, that some factors that apply to one may apply to the other, and that the fact that there is commercial coherence

162 Ekkehart Reimer, Nathalie Urban, and Stefan Schmid, eds., *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*, 3d ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012), at paragraph 212.

163 Ibid. (footnotes omitted).

may in some cases suggest geographical coherence and vice versa; but to say that *because* the projects form a commercial whole, they must also form a geographic whole is a mistake. I simply do not understand the intended meaning of the phrase "since each of the connected projects require services to be provided at the same two geographic areas." This obviously begs the question by assuming that the projects are connected.