
Chapter 5

Characterisation of a Cross-Border Pipeline as Preparatory or Auxiliary Character, Immovable Property, Passive Income or as Other Income

5.1. Introduction

In the previous chapter, 4.3. showed that Art. 5(4) prevails over Art. 5(1) (PE), as the former lists different business activities, which are treated as exemptions to the basic rule in Art. 5(1) even if the activities are carried out through a fixed place of business. The activities listed in Art. 5(4) are of preparatory or auxiliary character and are therefore not part of the core business activities which normally create a PE. The starting point in any characterisation, therefore, is to consider whether the activity is of preparatory or auxiliary character. This chapter will look into the meaning of the term “of preparatory or auxiliary character”, followed by a discussion of the key issue; namely, the distinction between core business activity and activity of auxiliary and preparatory character, a distinction which is far from clear but nevertheless important. Following the introduction, another key question will be addressed, namely, whether the transportation of oil and gas in a pipeline is remote from the purpose of the company and therefore of preparatory or auxiliary activity.

The answers to these questions are important and, as shown in 5.7., the consequences for both the oil industry and government are significant if either the activity is defined as core business activity and therefore a PE or as of preparatory or auxiliary character with no PE. If the answer to this key question is that the activity performed is of preparatory or auxiliary character, there is no need to consider whether the pipeline is a PE according to the basic rule in Art. 5(1) and, in that case, the pipeline will not create an immovable property either.³⁶⁶ If the “preparatory or auxiliary” alternative can be ruled out, it will then be necessary to determine whether the assets or pipeline should be characterised as an immovable property according to Art. 6, passive income or a PE according to the basic rule in Art. 5(1).

The OECD Commentaries are inconsistent in this regard, as they suggest in one paragraph that a pipeline might be of preparatory or auxiliary character

³⁶⁶ OECD Commentaries, Art. 5(4), Para. 26.1 (2008).

according to Art. 5(4), but then in the next sentence suggest that a pipeline creates a PE or an immovable property without giving a clear guideline or recommendation,³⁶⁷ which creates uncertainty, inconsistent characterisation, possible taxation in the wrong jurisdiction, disputes and even double taxation or less than a single taxation.

Chap. 6 will then discuss the main question of this thesis, namely, whether a cross-border pipeline can be characterised as a PE according to the basic rule.

5.2. Art. 5(4) – The negative list

Art. 5(4) of the OECD Model provides some examples of activities that do not constitute a PE even if they are carried out through a fixed place of business. These activities are sometimes referred to as the “negative list” and Para. 4 states that the term PE shall be deemed not to include:

- 5(4)(a): the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- 5(4)(e): the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; and
- 5(4)(f): the maintenance of a fixed place of business *solely* for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The characteristics whether these activities are of preparatory or auxiliary character either separately or in combination, and a pipeline might be considered as of preparatory or auxiliary character according to Art. 5(4),³⁶⁸ is an issue which will be discussed below.

5.3. Lack of a common international approach – Art. 5(4)

Neither the term “transport facility” nor the expression “of auxiliary or preparatory character” are defined in the OECD Model, which means that the term shall have the meaning that it has at the time under the law of the con-

367. Id.

368. Id., Para. 26.

tracting states.³⁶⁹ As underlined above, this means that different jurisdictions might have different definitions in their domestic law. However, the Commentary to Art. 5(4) provides some guidelines for the expression “of auxiliary or preparatory character” and it is uncertain whether the guidelines in the Commentary should prevail or the definition in domestic law should prevail, as Art. 3 refers to the treaty and not to the Commentaries.

5.4. Preparatory or auxiliary character – Art. 5(4)

Neither Art. 5(4) nor the Commentaries to this article define the expression “of preparatory or auxiliary character”, but only give some vague examples to clarify it. “Preparatory” or “auxiliary” are two independent, separate criteria, which must be considered separately. The general meaning of the former is “serving as or carrying out preparation”³⁷⁰ and the latter as “aiding” or “supporting”.³⁷¹ In addition to the examples mentioned under Art. 5(4)(a)-(f), the Commentaries offer some illustrations of the expression “of preparatory or auxiliary character”:³⁷²

- (i) The overall activity must be of preparatory or auxiliary character.
- (ii) The activity is of such insignificance that it should not undergo source taxation.
- (iii) The activity is only completed in order to support its own business and purpose and not that of a third party.
- (iv) The activity has no purpose other than to act as one of many “tentacles”.
- (v) The services it performs are so remote from the actual realisation of profit that it is difficult to allocate any profit to the fixed place of the business. This point was also underlined in the Indian case *Sojiz Corporation v. Assistant Director of Income Tax*,³⁷³ in which the court held that the taxpayer only undertook auxiliary activities and not principal operations of the business of the entity.

369. OECD Model Art. 3(2) (2008).

370. Oxford English Dictionary online; available at: http://www.askoxford.com/concise_oed/preparatory?view=uk (last visited 6 Nov. 2009).

371. Gardner, B.A., *Black's Law Dictionary*, second reprint, 8th ed., 2007.

372. OECD Commentaries, Art. 5(4), Paras. 21-24 (2008).

373. ITA No. 1252/Kol/2006, 30 Oct. 2007, Income Tax Appellate Tribunal.

- (vi) The purpose of the foreign activity is remote from the general purpose of the whole enterprise.
- (vii) The services or activities do not constitute an essential part of the business operations of the whole enterprise.

In the decision in *UAE Exchange Centre Ltd v. Union of India*, the court held that a liaison office was an “aid” or “support” activity, which did not create a PE;³⁷⁴ an opinion which is in line with the general meaning of the words “preparatory” and “auxiliary”.

Another case is from the *Hoge Raad*, in which two Dutch residents bought flowers in Holland and travelled to Germany, where they had a shed for storage and preparatory work, and they borrowed a room from a friend and operated a licensed market stall. The *Hoge Raad* held that these activities in Germany were more than auxiliary and preparatory and therefore constituted a PE.³⁷⁵

These activities will therefore not be considered as of preparatory or auxiliary character according to Art. 5(4). All of these examples would probably be relevant when determining the characterisation of a cross-border pipeline, as they underline that the threshold for establishing a PE is low.

The listed examples are only meant to be illustrative and not exhaustive, which indicates that each case has to be examined on its own merits based upon the facts and circumstances.

The reasons why these activities are treated as exceptions and are therefore not considered as PEs are explained in the Commentaries:³⁷⁶

The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in subparagraph e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1.

Further:

It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the

374. WP(C) No. 14869 / 2004, 13 Feb. 2009, Delhi High Court.

375. Decision of 24 March 1976, BNB 1976/121. Quoted from Baker, P., *Double Taxation Conventions*, R3, 5-2/10, Sept. 2002.

376. OECD Commentaries, Art. 5(4), Para 21 (2005).

actual realisation of profits that it is difficult to allocate any profit to the fixed placed of business in question.³⁷⁷

The distinction between “of preparatory and auxiliary character” and core activity is complicated and far from clear. As Art. 5(4) and its Commentaries only give some general guidelines, it is necessary to consider each separate situation based on actual fact and circumstances. Different states might therefore choose different approaches and interpretation, which may lead to different characterisations of a pipeline.

5.5. Distinguishing between core business activity and activity of auxiliary and preparatory character

As will be discussed in 6.2., Art. 5(4) lists a number of business activities that are considered as exemptions to the basic rule in Art. 5(1).³⁷⁸ All activities listed in Art. 5(4) are activities that are of auxiliary or preparatory character and therefore do not create a PE and the article specifically mentions transport activities as of auxiliary or preparatory character or a combination of these activities. Therefore, it is important to ask how to distinguish between activities of auxiliary or preparatory nature under Art. 5(4) and activities under Art. 5(1) or, as will be explained in Section 6.3.9.3., the key question that needs to be answered is whether the activity is part of the core activity or whether it is of preparatory or auxiliary character and therefore “remote from the general purpose of the business”.³⁷⁹

There is no clear evidence, neither in the OECD Model nor in the Commentaries, as to how this distinction should be made. The principles in Arts. 5(1), 5(4) and 6, including the Commentaries, express that a pipeline can be considered as a PE or as of auxiliary and preparatory character without giving a clear recommendation or guidelines; however, as mentioned above, the Commentaries give some examples. Vogel explains that Art. 5(4) is designed to ensure that business activities will not be taxed by a state unless and until they have created significant economic bonds between the enterprise and that state.³⁸⁰ Conversely, if economic bonds with a foreign country are only loose, taxation is reserved for the state of residence. Furthermore, Vogel states that the existence of a PE is a condition of

377. *Id.*, Para. 23.

378. *Id.*, Para. 21.

379. *Id.*, Para. 23.

380. Vogel, *op. cit.*, p. 280.

taxation only to the extent it involves income from the business activities or an enterprise and the assets on which such business is based.

However, even if the Commentaries do not give a clear answer, they provide some vague guidelines:³⁸¹

It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

The remaining key question that needs to be answered is whether the transportation in a cross-border pipeline forms an essential and significant part of the activity of the oil company and therefore constitutes a PE according to the basic rule in Art. 5(1), or whether the transportation is so remote from the oil company's purpose and core activities that it is considered as of a preparatory or auxiliary character in accordance with Art. 5(4), which will be discussed below.

In *Galileo International Inc.*,³⁸² the Tax Appellate Tribunal considered whether the company had established a PE in India and in particular whether the activities performed in India were of a preparatory or auxiliary character. The appellant argued that the existence of computers in India was merely for the purpose of advertising and that the activities were of a preparatory or auxiliary character. The Appeal Court was unable to accept such a contention and expressed that the activities in India were for the purpose of developing and maintaining a fully automatic reservation and distribution system with the ability to perform comprehensive information, communication, reservation, ticketing, distribution and related functions, and the computers installed at the premises of the subscribers were connected to the global computerised reservation system and operated by the appellant. The court's opinion was that, "These activities are not in the nature of 'preparatory or auxiliary character'."

Furthermore, the court expressed:

It is difficult to distinguish between the activities which are "preparatory or auxiliary" character and those which are not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential

381. OECD Commentaries, Art. 5(4), Para. 24 (2010).

382. *Galileo International Inc. v. Deputy Commissioner of Income Tax, Non-Resident Circle, New Delhi*, Case IT Appeal Nos. 2473 to 2475 (Delhi) of 2000, 1733 (Delhi) of 2001 and 820 (Delhi) of 2005 C.O. Nos. 47 to 54 (Delhi) of 2006, 30 Nov. 2007, Income Tax Appellate Tribunal (ITAT) Delhi Bench "B".

and significant part of the activity of the enterprise as a whole. Since part of the function is operated in India which directly contributes to the earnings of revenue, the activities as narrated above carried out in India are in no way of “preparatory or auxiliary character” ... and the assessee shall be deemed to have a PE in India.³⁸³

In the same way, cross-border pipelines might be said to contribute to the earnings of the revenue of the oil company and perhaps be treated in the same way, i.e. the interpretation of Art. 5(4) should not be different for a cross-border pipeline.

As will be shown in Chap. 7, the taxation and allocation of income and expenses among the contracting states will depend on how the parties differentiate between core business activity and activity of auxiliary and preparatory character.

5.6. Is transportation of oil or gas in a pipeline of auxiliary or preparatory character in accordance with Art. 5(4)?

A question that needs to be asked is whether the transportation of oil or gas in a cross-border pipeline might be characterised as of a preparatory or auxiliary character due to the following alternatives in Art. 5(4):

- (i) 5(4)(a): storage of goods; and
- (ii) 5(4)(a): delivery of goods; and
- (iii) 5(4)(e): for the purpose of carrying on *any* other activity of a preparatory or auxiliary character; and
- (iv) 5(4)(f): any combination of activities of preparatory or auxiliary character.

Each of the alternatives will be analysed below in order to answer this question.

383. Quoted from IBFD Tax Treaty Case Law database; available at: www.ibfd.org (subscription required).

5.6.1. Is transportation of oil and gas in a pipeline storage of goods – Art. 5(4)(a)?

Both oil and gas pipeline systems contain a number of different tanks, which are part of the total transport system, and the question is whether Art. 5(4)(a) will govern, as it states that the term “permanent establishment” shall be deemed not to include the use of facilities for the purpose of storage of goods (preparatory or auxiliary character). The UK Sullom Voe Terminal, for example, has 16 floating roof storage tanks with a capacity of 80,000 tonnes (or 528,000 barrels) each. In one day, the total energy used in the United Kingdom is equivalent to the oil contained in less than eight of these storage tanks,³⁸⁴ which means that the storage is very limited both in time and in volume and is a necessary part of the transportation system. Separating such storage from oil or gas transportation for tax purposes is probably neither practicable nor possible, as all of it is a part of the transportation system and it is doubtful that Art. 5(4)(a) is meant to cover such kinds of “storage”.

Separating these tanks from the rest of the transport system and considering them as of a preparatory or auxiliary character, while the rest of the pipeline might be considered as a PE or immovable property, would trigger a very complex tax situation and cause even more uncertainty and a more difficult tax situation, which would make it extremely complicated to allocate the income and expenses between the countries involved.

Furthermore, there is nothing in Art. 5 or in its Commentaries that suggests or opens up the possibility for an asset to be split and characterised individually. The opinion of this author is therefore that such tanks are a natural part of the whole transport system and must be considered together with the rest of the pipeline system as one single asset. For these reasons, these kinds of tanks should not be considered separately as of a preparatory or auxiliary activity according to Art. 5(4)(a), unless the whole transport system is considered as of a preparatory or auxiliary activity. It also follows from the Commentaries that a fixed place of business, used for both activities, which rank as exceptions (Para. 4) and for other activities, would be regarded as a single PE and taxable as regards both types of activities.³⁸⁵

384. BP Sullom Voe Terminal information package (distributed at the CEPMLP UK Petroleum Tax Conference, 2004).

385. OECD Commentaries, Art. 5(4), Para. 30 (2008).

5.6.2. Is transportation of oil and gas in a pipeline delivery of goods – Art. 5(4)(a)?

The next question is whether a pipeline should be characterised as a transport facility with preparatory or auxiliary character according to Art. 5(4) (a). The article states that there is no PE if the use of facilities is solely for the purpose of delivery of goods or merchandise belonging to the enterprise, because this is considered as being of a preparatory or auxiliary character. Four different situations might occur, which need to be considered separately.

The first situation is where the owner or operator of the pipeline transports its own oil or gas in addition to transportation on behalf of a third party. Accordingly, Art. 5(4)(a) expresses that only when the company stores or delivers goods *belonging to the company itself*, can the activity be considered as of a preparatory or auxiliary activity, which is also repeated in the Commentaries:³⁸⁶

Where these facilities are used to transport property, belonging to other enterprises, subparagraph a), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities.

When the owner or operator also uses the pipeline for transportation for other enterprises, the transportation facilities cannot be considered as of a preparatory or auxiliary character and consideration must be given as to whether they establish an immovable property or PE.

The second situation is where several enterprises establish a partnership or a joint company that operates a pipeline and organises the transportation. If this partnership or joint company only transports oil or gas for partners or owners of the company, the question is whether Art. 5(4)(a) will govern. It might be possible to argue that the partnership or company only delivers goods that belong to the enterprise (partnership).

However, this opinion could be disputed, as the oil companies that establish the partnership legally would be independent and separate parties and, when the partnership is transporting goods that belong to the different oil companies, they would not be transporting goods that belong to the partnership but to the owners of the partnership, which is different. It is the oil companies that establish the partnership that own the oil or gas and not the

386. Id., Para. 26.1.

partnership, the partnership is only taking care of the transportation. As the partnership or the jointly incorporated company does not own the oil or gas, but only cooperates and coordinates the transportation, it is probably right to say that they are not transferring goods belonging to *the* enterprise (the partnership), but they are delivering goods that belong to other legal entities. Consequently, the transportation cannot be considered as of a preparatory or auxiliary character according to Art. 5(4)(a).

The third situation is where an operator only transports oil or gas on behalf of third parties and does not transport its own oil or gas. In such situations, the transportation cannot be characterised as of a preparatory or auxiliary character, as Art. 5(4) will govern only when the company transfers its own oil and gas.

The last situation is where the enterprise only transports its own oil or gas and, according to Art. 5(4), such transportation might be considered as of a preparatory or auxiliary character, which is also confirmed in the Commentaries to Art. 5(4):³⁸⁷

The situation is different, however, where an enterprise owns and operates ... a pipeline that crosses the territory of a country solely for the purpose of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such a case, subparagraph a) would be applicable.

The OECD's point of view is that transportation of oil or gas might be considered as of a preparatory or auxiliary character according to Art. 5(4)(a) as long as the company only transports its own oil or gas and the transport is merely incidental, rather than being a PE according to the basic rule in Art. 5(1). If so, the transportation activities must be of a preparatory or auxiliary character and the service they perform so remote from the actual realisation of profit, that it is difficult to allocate any profit to the fixed place of business in question.³⁸⁸ As discussed in several other places in this thesis, the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.³⁸⁹ As the Commentary states: "In any case, a fixed place of business whose general purpose is one which is identical to

387. Id.

388. OECD Commentaries, Art. 5(4), Paras. 21 and 23 (2010).

389. Id., Para. 24.

the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.”³⁹⁰

As mentioned in 6.12., there might be situations, for example, when a pipeline is laid in transit offshore, that it can be considered as of a preparatory or auxiliary character, but even that would be rare.

5.6.3. Is transportation of oil and gas in a pipeline considered as any other activity of a preparatory or auxiliary character – Art. 5(4)(e)?

The transportation of oil or gas in a cross-border pipeline might be considered as of a preparatory or auxiliary character according to Art. 5(4)(e), given that they meet the normal requirements mentioned above, i.e.:

- the activity is not part of the enterprise’s core business activity;
- the transportation is only for goods belonging to the enterprise itself and not for a third party; and
- the economic bonds are loose.

Subparagraph e) is based on the same discussion as subparagraph a), and the former states that “any other activity of preparatory or auxiliary character” will be deemed not to constitute a PE, which might also include transportation of oil and gas in a cross-border pipeline.

Again, the author of this thesis disagrees that a cross-border pipeline is normally considered as of a preparatory or auxiliary character. There will of course be situations where the transportation of oil and gas in a cross-border pipeline can be considered to be of a preparatory or auxiliary character. If, for example, you have a short trans-boundary pipeline transporting just a few thousand barrels per day from a huge field, it might be considered by the tax authorities and courts as of a preparatory or auxiliary character. However, as mentioned in 6.4. below, the threshold for establishing a PE is low and even if the pipeline is laid over only ten or even five kilometres within a jurisdiction, it might very well be considered as part of the company’s core activities within that jurisdiction. A specific consideration must of course be fulfilled in each situation based on the facts and the circumstances, the legislation in the contracting states and the wording of the tax treaty in force.

³⁹⁰. Id.

However, the opinion of this author is that the transportation of oil or gas in a cross-border pipeline is just too significant to be considered as of a preparatory or auxiliary character. The pipeline is significant for investment and the operating and maintenance costs, as well as for the profit and risks it creates. It is in fact a significant (core) part of the whole petroleum business. Such transportation should only be considered as of a preparatory or auxiliary character in rare situations; the transportation would normally be part of the corporation's core business activity and therefore in general not of a preparatory or auxiliary character.

5.6.4. Is transportation of oil and gas in a pipeline a combination of delivery of goods and of a preparatory or auxiliary character – Art. 5(4)(f)?

Even if there is a combination of activities mentioned under subparagraph a) to e) in Art. 5(4), the activities might be deemed not to establish a PE, provided that the overall activity is of a preparatory or auxiliary activity and the activity is only completed on behalf of the owner or operator and not on behalf of a third party. A requirement in these subparagraphs is that the maintenance of the fixed place of business is *solely* completed for the combination of a preparatory or auxiliary activities, which means that even in the case of a small non-preparatory or non-auxiliary activity, Art. 5(4) is not applicable.

This was illustrated in a decision by the *Bundesfinanzhof* (Federal Tax Court) in Germany,³⁹¹ where the issue was whether a foreign editorial office established a PE or whether the activity was of a preparatory or auxiliary character. The court expressed that if the establishment only obtained or produced information, it would be of a preparatory or auxiliary character, but as the office also translated and wrote messages, reports and comments, the court's opinion was that the activities the office fulfilled were the main activities of the newspaper and therefore constituted a PE. The decision illustrated clearly that even some minor core activities could trigger a change from being of a preparatory or auxiliary activities to become core activities.

391. IR 292/81, 23 January 1985.