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Schmidt, Peter Koerver

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The Creation of a Permanent Establishment Through the Use of Subcontracting – A New Danish Ruling Adds to the Discussion

Peter Koerver Schmidt¹

In a recent Danish decision, the National Tax Board found that a foreign company should be considered to have a permanent establishment in Denmark, despite the fact that the foreign company had subcontracted all its activities in Denmark to an independent third party. This contribution critically examines the decision in light of the OECD Model Convention with commentaries, including the recently published draft update.

1 Subcontracting and Permanent Establishments

In recent years, many states and tax authorities around the world seem increasingly determined to claim what they believe to be a fair share of the possible tax revenue arising in cross-border transactions.² This trend concerns several aspects of international tax law, including taxation of permanent establishments (PEs).³

In the last couple of years, a number of decisions from the Danish National Tax Board have caused debate with respect to the question on whether or not a PE should be considered to exist in Denmark,⁴ and recently a new Danish decision has been issued addressing the delicate question on whether the use of subcontractors can lead to the

¹ Associate Professor, Copenhagen Business School and Academic Advisor, CORIT Advisory.

² Cf. Yariv Brauner, "BEPS: An Interim Evaluation", World Tax Journal, 2014, p. 10-39 and Christoph Schelling et al. in Robert Danon (ed.), "Base Erosion and Profit Shifting (BEPS)", 2016, Schulthess.

³ Cf. OECD/G20, "Preventing the Artificial Avoidance of Permanent Establishment Status – BEPS Action 7", 2015.

⁴ Cf. for example concerning a home office as a PE, PE for private equity investors and the agency-PE rule. See among others Anders Nørgaard Laursen, "Kommentarer til udvalgte afgørelser", Revision og Regnskabsvæsen, 2016, SM1, Jens Wittendorff, "Fast driftssted for investorer i private equity funds – vidtrækkende praksisændring", SR-Skat, 2014, p. 112 et seq. and Vicky From & Ines Bigaard, "Fast driftssted, agentreglen og BEPS Action 7,- status og en praktisk indfaldsvinkel", SR-Skat, 2015, p. 21 et seq.

creation of a PE.⁵ This question has previously been discussed at international fora such as the OECD,⁶ and the issue was also debated at the IFA Congress in 2009. In this regard, the IFA General Report noted that, as a starting point, no PE should be considered to be created, when a foreign enterprise concludes a contract with a customer in a another country and then subcontracts the performance of the contract, and the delivery under the contract. The reason for this is that the foreign enterprise is not physically, but only legally, present in the other country to perform a business activity. However, the General Report also noted that the national reports reflected different views in this respect.⁷

In light of the recent Danish decision on the use of subcontracting, this article picks up on this discussion once again. First, the facts and the outcome of the Danish case are presented. Then, the Danish decision is analyzed and discussed, mainly against the background of the OECD Model Tax Convention with commentaries and case law from a number of other jurisdictions. Finally, some concluding remarks are made.

2 A Recent Decision from the Danish National Tax Board

2.1 The Facts of the Case

On 27 June 2017, the Danish National Tax Board issued an advance binding ruling to a company domiciled in Austria (“the Austrian company”), in which the National Tax Board concluded that a PE should be considered created in Denmark, if the Austrian company hired a subcontractor to perform its contemplated activities in Denmark.

The Austrian company had carried out a construction project in Denmark from 2014 to 2016, and the income concerning this project had been taxed in Denmark. Subsequently, the Austrian company intended to enter into a service contract concerning the cleaning

⁵ Cf. decision of the National Tax Board dated 27 June 2017, SKM2017.509.SR.

⁶ Cf. OECD – Committee of Fiscal Affairs, Working Party 1, “Revised Proposal Concerning the Interpretation and Application of Article 5 (Permanent Establishment)”, 2012, p. 17-19. In the proposal it is mentioned that this issue has also been discussed previously by the Working Party.

⁷ Cf. Jacques Sasseville & Arvid A. Skaar in International Fiscal Association (ed.): “Cahiers de droit fiscal international”, General Report, 2009, vol. 94a, Sdu Fiscale & Financiële Uitgevers, p. 40.

and maintenance of the facades of the newly constructed building. According to the service contract, the duration of the above mentioned services should be 10 years.

The Austrian company would not carry out these services itself. Instead, the entire task would be subcontracted to a foreign company that was not part of the Austrian company's corporate group. The subcontracting of the tasks would require consent from the Danish customer (the owner of the building). It was understood that the Austrian company would still be responsible towards the Danish customer. In other words, no rights or responsibilities towards the customer would be transferred to the subcontractor, and the subcontractor would not have any rights or responsibilities towards the Danish customer.

In the request for the advance binding ruling, the Austrian company had explained that the company would not have any office or other premises at its disposal in Denmark, and that no employees of the Austrian company would be stationed in Denmark. However, and as pointed out by the National Tax Board, the service contract stipulated that the customer would make offices, as well as a storage room available for the Austrian company. Faced with this, the Austrian company explained that the offices and the storage room in the Danish building would only be used by the foreign subcontractor. Moreover, none of the Austrian company's employees would be present at these premises, and the stored equipment would be owned by the subcontractor or the customer.

2.2 The Reasoning of the National Tax Board

The National Tax Board initially stated that companies resident abroad are subject to limited Danish tax liability, if they have a PE in Denmark, cf. sec. 2(1)(a) of the Danish Corporate Tax Act, and that the Danish PE-concept should be interpreted in line with art. 5 of the OECD Model Convention with commentaries.⁸ In addition, the PE-definition found in the tax treaty between Austria and Denmark was also similar to the definition in the OECD Model Convention. Accordingly, pursuant to the main PE-rule in art. 5(1-2) of

⁸ For a thorough study of the Danish PE-concept see Anders Nørgaard Laursen, "Fast driftssted", 2011, Jurist- og Økonomforbundets Forlag.

the OECD Model Convention, a PE in Denmark would exist if the Austrian company should be considered to have a fixed place of business in Denmark through which the business of the Austrian company was wholly or partly carried on.⁹

In brief, the National Tax Board attached great importance to the fact that the service contract stipulated that the customer would make offices as well as a storage room available for the Austrian company. Thus, the fact that the Austrian company itself would not be physically present in Denmark, as all the tasks were subcontracted, did not change that the Austrian company should be seen as having a fixed place of business in Denmark at its disposal. Further, as the Austrian company would still be responsible towards the Danish customer, the National Tax Board found that the subcontractor in effect would undertake the tasks of the Austrian company through the fixed place of business, as the tasks carried out by the subcontractor should be considered a part of the overall tasks provided by the Austrian company to the Danish customer. In other words, the condition that the Austrian company's business should be carried out through the fixed place of business was also considered to be fulfilled.

The National Tax Board therefore concluded that the activities of the subcontractor would create a PE in Denmark for the Austrian company.¹⁰

3 Legal Analysis of the Recent Danish Decision

3.1 Was there a fixed place of business?

⁹ The National Tax Board assessed the case pursuant to the main PE-rule in art. 5(1-2) and not art. 5(3) on construction PEs, as the activities did not concern a building site or a construction or installation project. Thus, the construction activities were finalized at the time the new service was considered. A decision dated 25 April 2017, SKM2017.349.SR, deals with the question of creation of PE in Denmark with respect to a construction project, in which the foreign enterprise had employees present in Denmark in order to superintend the work of a subcontractor. No PE in Denmark was found to exist, as the activities were seen as preparatory and auxiliary.

¹⁰ In this regard the National Tax Board made references to the commentaries to art. 5 of the OECD Model Convention (2014), in particular para. 4, and to the OECD – Committee of Fiscal Affairs, Working Party 1, "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model – Draft ", 2011, para. 45-51.

Initially, it seems appropriate to consider whether the Tax Board was correct when stating that the Austrian company should be considered to have a fixed place of business in Denmark. In connection to this question, it is worth noting that the commentaries to the OECD Model Convention state that the term “place of business” covers any premises, facilities, or installations used for carrying on the business of the enterprise. This includes whether or not it is used exclusively for that purpose, and that it is immaterial whether the premises, facilities, or installations are owned or rented by or are otherwise at the disposal of the enterprise. In addition, it is directly stated in the commentaries that the place of business may be situated in the business facilities of another enterprise.¹¹

Against this background – and taking into account that the service contract stipulated that the Danish customer would make offices as well as a storage room available for the Austrian company – it appears appropriate to conclude that the Austrian company had a place of business at its disposal at the premises of the Danish customer.¹² Moreover, it seems correct to consider the place of business to be fixed, as it must be assumed from the description of the facts that the offices and the storage room are located in a distinct building owned by the customer, and that all relevant activities would take place on the premises of this building. Furthermore, these premises would be available for the Austrian company for the whole duration of the contract, i.e. for 10 years.¹³

3.2 Whose business is carried out through the fixed place?

Assuming that the Austrian company would have a fixed place of business in Denmark at its disposal, it becomes decisive to determine whether it is in fact the business of the

¹¹ Cf. para. 4 in the commentaries to art. 5 of the OECD Model Convention (2014). For a discussion of the requirement to have a/any place of business at its disposal see Brian Arnold & Carl MacArthur in Richard Vann (ed.), “Global Tax Treaty Commentaries”, 2017, IBFD, ch. 5 (online version).

¹² Unfortunately, the description of the facts in the published decision is rather limited. Thus, it is not clear for what purposes exactly the offices and the storage room would be used by the subcontractor. Moreover, it does not seem completely clear whether the activities are performed continuously or are interrupted at some points.

¹³ The use of the term “fixed” entails that the place of business must be established at a distinct place with a certain degree of permanence, cf. para. 4.1 in the commentaries to art. 5 of the OECD Model Convention (2014). Experience has shown that PEs normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months, cf. para. 6 in the commentaries to art. 5 of the OECD Model Convention (2014).

Austrian company that is carried out through the fixed place of business (or instead the business of someone else). The 2014-version of the commentaries to the OECD Model Tax convention does not explicitly address the situation where (all) business activities are carried out by a subcontractor. Instead, it is just generally stated in the commentaries that the business of an enterprise is carried out mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). In addition, it is stated that such personnel includes employees, as well as other persons receiving instructions from the enterprise, and that the powers of such personnel, in its relationship with third parties, are irrelevant.¹⁴

Even though these statements in the commentaries highlight that the business of an enterprise is carried out mainly by its employees, it is worth noticing that the commentaries also mention that other persons, who are receiving instructions from the enterprise, may be considered to carry out the business of the enterprise. Accordingly, based on these statements in the commentaries, it cannot be excluded that a subcontractor, who is responsible for all aspects of a service contract, could be considered to carry out the business of the main contractor.

As a matter of fact, Working Party 1 under the OECD Committee of Fiscal Affairs has conveyed the opinion that even if all activities, taking place at an enterprise's fixed place of business, have been subcontracted, the activities could still be considered part of that enterprise's business. Accordingly, Working Party 1 has proposed that a new paragraph should be included in the commentaries to art. 5 of the OECD Model Convention in order to address this issue.¹⁵ This proposal is reflected in the Draft 2017 Update to the OECD Model Tax Convention, which includes the following new paragraph 40:¹⁶

¹⁴ Cf. para. 10 in the commentaries to art. 5 of the OECD Model Convention (2014).

¹⁵ Cf. OECD – Committee of Fiscal Affairs, Working Party 1, "Revised Proposal Concerning the Interpretation and Application of Article 5 (Permanent Establishment)", 2012, p. 17-19.

¹⁶ Cf. OECD – Committee of Fiscal Affairs, Working Party 1, "Draft Contents of the 2017 Update to the OECD Model Tax Convention", para. 40 to art. 5.

An enterprise may also carry on its business through subcontractors, acting alone [own underlining] or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met... In the context of paragraph 1, the existence of a permanent establishment in these circumstances will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise. Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 12; in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. [own underlining] Paragraph 54 illustrates such a situation in the case of a construction site; this could also happen in other situations. An example would be where an enterprise that owns a small hotel and rents out the hotel's rooms through the Internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis.

In the view of Working Party 1, the above cited text is intended to clarify the interpretation of the article, and the contents of the clarification should therefore also be taken into account for the purposes of the interpretation and application of tax treaties concluded before the adoption of the new commentaries, because it reflects the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations.¹⁷ In other words, an ambulatory interpretation should be made in line with the statement found in para. 35 of the introduction to the OECD Model Convention.¹⁸

¹⁷ Cf. OECD – Committee of Fiscal Affairs, Working Party 1, "Draft Contents of the 2017 Update to the OECD Model Tax Convention", para. 3 to art. 5.

¹⁸ This ambulatory approach of interpretation, which can find support in the introduction to the OECD Model Convention, has been subject to criticism, among other things for lacking democratic legitimacy. See Peter J. Wattel & Otto Marres, "The Legal Status of the OECD Commentary and Static and Ambulatory Interpretation of Tax Treaties", *European Taxation*, 2003, p. 222-235. See also Ulf Linderfalk & Maria Hilling: "The Use of the OECD Commentaries as Interpretive Aids- The Static/Ambulatory-Approaches Debate Considered from the Perspective of International Law", *Nordic Tax Journal*, 2015, p. 34-59, which argue that the discretion to choose between a static and ambulatory interpretation is not absolute, as the discretion is limited by the principle of good faith.

Provided that the new paragraph 40 to art. 5 in the 2017-version of the commentaries in fact only constitutes a clarification,¹⁹ and not an actual amendment, the wording in some ways appears to support the conclusion reached by the Danish National Tax Board concerning the interpretation of the PE-definition in the tax treaty between Austria and Denmark, which is similar to the definition used in the OECD Model Convention with commentaries.²⁰

Accordingly, the new paragraph 40 explicitly mentions that an enterprise may also carry on its business through subcontractors that are acting alone which was exactly the situation for the subcontractor hired by the Austrian company. In such situations, however, the new paragraph explicitly adds that it will be necessary to include other factors showing that the enterprise clearly has the effective power to use that site, for example because the enterprise owns or has legal possession of that site and controls access to and use of the site. As the service contract between the Austrian company and the customer stipulated that offices as well as a storage room would be made available for the Austrian company, the contract indicates that the Austrian company actually did have such legal possession of the site.²¹ Finally, the fact that the responsibilities towards the

¹⁹ In the Danish literature it is generally accepted that Denmark would and should follow the request set forth in para. 35 of the Introduction to the OECD Model Convention as regards a dynamic approach to interpretation, cf. for example Aage Michelsen in Michael Lang (ed.): "Tax Treaty Interpretation", 2000, Kluwer Law, p. 63-76. The leading precedent is the so-called *Texaco* decision issued by the Danish Supreme Court on 18 December 1992, Tfs 1993,7.

²⁰ The current tax treaty between Austria and Denmark was signed by the parties in 2007, and entered into force in 2008. It is stated directly in the protocol to the treaty that the parties agree that it is understood that provisions of the treaty, which are drafted according to the corresponding provisions of the OECD Model Convention, shall generally be expected to have the same meaning as expressed in the OECD commentary thereon. Accordingly, it must be assumed that the treaty is based on the 2005-version of the OECD Model Convention with commentaries. The 2005-version of the commentaries to art. 5 included the same para. 10 that can be found in the current 2014-version of the OECD-Model with commentaries. In fact para. 10 was introduced in the commentaries as part of the 1977-update. For more on the historic development of art. 5 and its commentaries see Federico Otegui Pita in Thomas Ecker & Gernot Ressler (ed.), "A History of Tax Treaties", 2011, Linde Verlag, p. 229-256.

²¹ However, it is not completely clear whether para. 40 presupposes that the foreign enterprise has entered into an actual rental agreement or the like.

customer remained with the Austrian company also seems to support the conclusion reached by the National Tax Board.²²

On the other hand, it could be argued that the subcontractor should only be considered to carry out the business of the Austrian company, if the subcontractor is subject to detailed instructions or to comprehensive control by the Austrian company.²³ From the limited description of the facts in the published decision, it is not completely clear, to what degree the subcontractor would be subject to instructions and control, but it is difficult to see how the Austrian company should be able to conduct comprehensive control, when no employees of the Austrian company are present in Denmark. However, it seems hard to reconcile such a requirement (instructions and control) with the above-quoted statement which was made in the draft 2017-version of the commentaries that an enterprise may also carry out its business through subcontractors acting alone. In addition, it should be noticed that the “hotel-example” made in the new paragraph concerns a situation where an enterprise has subcontracted the on-site operation of the hotel, and where no employees of the enterprise appear to be physically present at the hotel (which probably would make it difficult to conduct comprehensive control with the on-site operations).²⁴

²² The new para. 40 makes a direct reference to the new para. 54 which states that “...the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period.” See OECD – Committee of Fiscal Affairs – Working Party 1, “Draft Contents of the 2017 Update to the OECD Model Tax Convention”, para 54 to art 5. In older Danish case law concerning a main entrepreneurs’ use of subcontractors, it seems to be a prerequisite for constituting a PE that the main entrepreneur retains the economic responsibility towards the customer. See Anders Nørgaard Laursen, “Entreprisevirksomhed og fast driftssted”, SR-Skat, 2014, p. 31 et seq.

²³ Cf. the criteria used for assessing independence with respect to agents after art. 5(6) of the OECD Model Convention. These criteria do not aim only at delimiting the scope of application of art. 5(5) but also aims at assessing who is performing the business in the source country, cf. Arvid Aage Skaar, “Permanent Establishment”, 1991, Kluwer Law, p. 508 et seq. and 513 et seq. and Anders Nørgaard Laursen, “Fast driftssted”, 2011, Jurist- og Økonomiforbundets Forlag, p. 233 et seq.

²⁴ The “hotel example” in the draft 2017-commentaries does not mention where the subcontractor operating the hotel is resident. However, from the earlier reports issued by Working Party 1 it seems to be assumed that the subcontractor is a local independent company resident in the state where the hotel is located, cf. OECD – Committee of Fiscal Affairs – Working Party 1, “Revised Proposal Concerning the Interpretation and Application of Article 5 (Permanent Establishment)”, 2012, para. 50. In the Danish case the subcontractor was not resident in Denmark, even though it would perform activities in Denmark. It is not clear whether the new draft commentaries find it to be

More generally, it seems appropriate to question whether the new paragraph 40 is actually a clarification, as claimed by Working Party 1, or whether the statements made in the paragraph differ so much from the previously followed interpretation that the new statements should be considered to constitute an amendment.²⁵ Comparing the wording of the current version (para. 10 to art. 5) and the new draft version (para. 40 to art. 5) of the commentaries does not give a definitive answer, as both statements leave behind interpretive uncertainty. It seems that some states, at least until now, have been of the opinion that no PE should be considered to exist, when a foreign enterprise concludes a contract with a customer in another country and then subcontracts the entire performance of the contract and the delivery under the contract to a subcontractor.²⁶ However, other countries appear to have the opposite view.²⁷

Based on the above, it must be concluded that uncertainty exists when considering whether the use of subcontracting can lead to the creation of a PE.²⁸ However, it would be no great surprise if the Danish courts would decide to agree with the view of the Danish National Tax Board if presented with a case similar to that of the Austrian company's

decisive that the subcontractor is a local company. However, in my view it would not be convincing to place decisive emphasis on the residency of the subcontractor, as it would be more expedient to place emphasis on the actual location of the relevant business activities performed by the subcontractor.

²⁵ Cf. Anders Nørgaard Laursen, "Fast driftssted – foreslåede ændringer af kommentarerne til OECD's modeloverenskomst", SR-Skat, 2012, p. 45 et seq. who argues that Working Party 1 has stretched the changes to the commentaries too far to consider the changes to be mere clarifications.

²⁶ Cf. the national reports of Japan and Russia prepared for 2009 IFA Congress, cf. Akira Akamatzu in International Fiscal Association (ed.); "Cahiers de droit fiscal international", Japanese Branch Report, 2009, vol. 94a, Sdu Fiscale & Financiële Uitgevers, p. 414 and Boris Bruk & Oleg Konnov, "Cahiers de droit fiscal international", Russian Branch Report, 2009, vol. 94a, Sdu Fiscale & Financiële Uitgevers, p. 545. The latter branch report refers the so-called *Stora Enso* case, cf. decision of the North-Western District Commercial Court no. A26-6181/01-02-03/380 dated 8 July 2003.

²⁷ Cf. the national reports of Korea and Norway prepared for the 2009 IFA Congress, cf. Hun Park & Sang-Woo Song in International Fiscal Association (ed.); "Cahiers de droit fiscal international", Korean Branch Report, 2009, vol. 94a, Sdu Fiscale & Financiële Uitgevers, p. 427 and Stig Sollund in International Fiscal Association (ed.); "Cahiers de droit fiscal international", Norwegian Branch Report, 2009, vol. 94a, Sdu Fiscale & Financiële Uitgevers, p. 489-490. The latter report refers to the so-called *Safe Service* case decided by the Norwegian Supreme Court, cf. Rettstidende 2001/512. The issue concerned the deemed PE rule in the special article on offshore activities in the Nordic Tax Treaty, but the reporter seems to consider the considerations of the court to have a more general relevance. Thus, apparently the court took the view that even in a case where the entire contract had been subcontracted the activities of the subcontractor were attributable to the main contractor.

²⁸ See also Amar Mehta, "Permanent Establishment Controversy: Subcontracting of Services Causes an Austrian Company's Fixed Place in Denmark", blog at dramarmehta.com, September 8, 2017, who seems to acknowledge the uncertainty, but at the same time concludes that the Danish decision seems to be questionable.

subcontracted activities in Denmark. Among the main reasons is the fact that the 2017 draft version of the OECD Model Convention with commentaries states that the new paragraph 40 on subcontracting only constitutes a clarification, and that it does not seem possible to falsify that view, despite the fact that the correctness of the view could be questioned. Taking into account that the Danish courts generally appear quite willing to take on an ambulatory approach, it may therefore be expected that the Danish courts would follow the interpretation expressed in the 2017 draft version of the OECD Model Convention with commentaries – provided that the version is adopted in its current form.

4 Concluding Remarks

The above-examined decision from the National Tax Board is interesting for a number of reasons. To begin with, it is worth noticing that the National Tax Board reaches the conclusion that the foreign company should be considered to have a PE in Denmark, despite the fact that all business activities in Denmark were subcontracted to an independent third party. On top of that, it is remarkable that the National Tax Board relied heavily on a new version of the commentaries to art. 5 of the OECD Model which has not even been adopted yet, and where it could be argued that the change in the commentaries possibly goes beyond a mere clarification.

To that end, it will be interesting to see whether other tax authorities around the world will be inclined to follow in the footsteps of the Danish decision and start scrutinizing whether foreign enterprises, which have fully or partly used subcontractors to perform their activities in the source country, should be considered to have a PE. No matter what, the contemplated change in the draft 2017-version of the commentaries to art. 5 of the OECD Model Convention appears to entail increased risk for taxpayers concerning the possibility of creating a PE abroad via the use of subcontractors. Accordingly, also in this regard taxpayers need to pay increased attention to their cross-border activities.