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BEPS Action 7: OECD Releases Revised Discussion Draft on Definition of Permanent Establishment

On 15 May 2015, the OECD, as part of the action plan to address base erosion and profit shifting (BEPS), released a revised discussion draft on action 7. Action 7 is focused on updating the definition of taxable presence (i.e. a permanent establishment or PE) in article 5 of the OECD model tax treaty to prevent abuse of the threshold for allocating taxing rights on trading activities to different jurisdictions, in particular, through the use of *commissionnaire* arrangements and benefits from specific activity exemptions. The OECD also is considering the modernization of the PE threshold in relation to digital cross-border business, in line with the work on the digital economy (Action 1).

The discussion draft selects proposals, and in some cases refines them, from the alternatives put forward in the discussion draft issued on 31 October 2014. The revised draft analyzes the comments received, debates the choices made by the Working Group and sets out proposed amendments to article 5 of the model treaty and its associated commentary.

As with other discussion drafts on BEPS actions, the proposals do not represent a consensus view from the G20/OECD governments involved, but are designed to provide substantive proposals for public analysis and comment.

Proposals for amendments to article 5

Artificial avoidance of PE status through commissionnaire arrangements and similar strategies: The discussion draft specifies that, as a matter of policy, where activities performed by an intermediary in a country result in the regular conclusion of contracts to be performed by a nonresident entity, the nonresident entity will have a taxable PE in that country unless the intermediary is an independent agent acting in the ordinary course of its business. As a result, the discussion draft proposes changes to the rules on dependent and independent agents to address commissionaire and other undisclosed agent arrangements by:

- Amending the agency PE rules (article 5(5) of the model treaty) to include not only contracts in the name of the nonresident entity but also contracts for the transfer of, or the granting of the right to use, property, or the provision of services by the nonresident where the intermediary “habitually concludes contracts, or negotiates the material elements of contracts”; and

- Strengthening the requirements (article 5(6) of the model treaty) for an agent to be considered independent, such that this will not be the case where the agent acts "exclusively or almost exclusively for one or more enterprises to which it is connected."

The proposals for an updated commentary on article 5 include a number of examples to assist with new and uncertain concepts, such as "negotiating material elements of contracts." This would include, for instance, a situation where a person acts as the sales force for the nonresident entity and where the negotiation of the material elements of the contracts is limited to convincing the account holder to accept standard terms. The discussion draft also clarifies that the proposed changes to independent agent status will not result in an automatic exclusion for unrelated agents acting exclusively for one enterprise (e.g. in the case of start-up companies). The discussion draft and the proposed commentary specifically note that the extension of the dependent agent PE concept does not include "buy-sell" distributors, even where these are low-risk and "regardless of how long the distributor would hold title in the product sold." Instead, BEPS concerns related to low-risk distributor arrangements will be addressed through the work on the transfer pricing of risks and capital (Action 9 of the BEPS action plan).

Artificial avoidance of PE status through the specific activity exemptions: BEPS concerns have arisen with respect to the activity exemptions in article 5(4) of the model treaty, under which a PE is deemed not to exist where a place of business is used solely for certain activities. The OECD proposes to modernize the PE exemptions for specific activities (such as maintenance of a stock of goods for storage, display, delivery or processing, purchasing or the collection of information) included in article 5(4) by ensuring that these would apply only where the activity (or activities) in question is (are) preparatory or auxiliary in relation to the business as a whole. This would reflect modern ways of doing business, since such activities increasingly may represent a key part of a business's value chain (including supply chains involving digital sales).

The discussion draft proposes updating the commentary by including additional guidance on the meaning of "preparatory or auxiliary," as well as examples. The draft notes that:

> *"…an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole' and 'an activity that has an auxiliary character… generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole."*

Storing and delivering goods to fulfill online sales may not be considered preparatory or auxiliary if such activities are an essential part of the company's sales or distribution business.

Fragmentation of activities between related parties: The discussion draft proposes (in a new paragraph 4.1 to article 5 of the model treaty and updated commentary) the creation of a PE where activities in a country are "fragmented" between group companies to meet the exemptions for activities that are preparatory or auxiliary. The proposal would prevent the specific activity exemptions from applying where the "overall activity resulting from the combination of the activities carried on …by the same enterprise or connected enterprises…is not of a preparatory or auxiliary character" (which includes activities of locally resident entities) provided the activities constitute "complementary functions that are part of a cohesive business operation."

Splitting up of construction contracts: The discussion draft addresses the splitting up of contracts between group companies to circumvent the specific 12-month time period for creating a PE for a building site, construction or installation project (article 5(3) of the model treaty). The recommendations set out in the proposed updated commentary are as follows:

- Adding an example to illustrate the application of the "principal purpose" test for the prevention of treaty abuse (Action 6 of the BEPS action plan) to deal with the splitting up of contracts; and

- Suggesting an alternative provision (where treaties do not include the principal purpose test) to add connected activities (exceeding 30 days' duration) carried on by connected enterprises to the period of time on site for the purposes of determining the 12-month period.

Insurance: The discussion draft considers whether a specific PE threshold is required in relation to insurance businesses. The draft proposes no specific PE threshold for insurance businesses in the model treaty; instead, insurance businesses would be treated like businesses in any other industry (unless specific variations from the model treaty are negotiated in bilateral agreements between specific countries), and the general changes proposed to the PE threshold would apply equally to them.

Profit attribution to PEs and interaction with action points on transfer pricing

The G20/OECD Working Party acknowledges that further guidance and examples are required in respect of the attribution of profit to PEs, particularly in relation to businesses outside the financial services industry. The discussion draft comments that the outcome of the BEPS work on transfer pricing, in particular intangibles, risk and capital, also will need to be taken into account. The OECD has agreed to undertake follow-up work on the application of the principles for the attribution of profit to PEs after final recommendations on transfer pricing are released in September 2015. The work on the new guidance is expected to be completed by the end of 2016, in line with the timetable for negotiation of the multilateral instrument that will implement changes to the PE threshold in tax treaties.

Comments and business next steps

Governments are pressing ahead with changes to the threshold for a PE to prevent the artificial avoidance of PEs where a company, or group, has significant activity in a country. Some of the changes, such as those that create a PE for a principal where it operates via commissionaire or undisclosed agent arrangements in market countries, were widely anticipated. Some, such as the changes to the exemption for holding stock, changes to agents that are considered independent and the new anti-fragmentation rule, are believed necessary to ensure that a group's complex supply chain does not allow it to artificially avoid a taxable presence in a country where significant activities take place. Businesses will welcome the clear statement of the policy intention that buy-sell distributors, including limited risk distributors, should not create a PE of their principals (although the simultaneous holding of stock locally by a principal is likely to create a PE due to the anti-fragmentation rule). Similarly, principals operating toll manufacturing arrangements may, subject to other local activities and factors, continue to be exempt from having PEs in the toll manufacturing country.

However, the changes outlined in the discussion draft are wide-reaching and, because of the potential impact on commercial trading arrangements, remain a key area of concern for all businesses, including those that are not undertaking BEPS strategies. Additional compliance costs will be created for businesses, for example, when they have to determine who (and where) material elements of contracts are negotiated, what is preparatory or auxiliary in the context of the business and what is a cohesive business operation. Administration costs will arise for the tax authorities that will have to monitor and audit these areas. In addition, since the PE threshold is the standard by which primary taxing rights over trading profits are allocated to one country or another, concerns remain that the uncertainty inherent in the new definitions will lead, in the short to medium term at least, to disputes between tax authorities and businesses, and between tax authorities, that may result in double taxation.

One specific area of concern is the use of the commentary—rather than the treaty article itself—to clarify some key areas. For example, the policy intention is that limited risk distributors would not create a PE of an overseas principal, but it would be helpful to include this in the text of article 5 itself so that it becomes binding on countries adopting the new PE threshold. Likewise, the further reliance on premises being “at the disposal” of a nonresident (a concept that has been subject to considerable comment, dispute and debate over its use in the commentary for many years) to explain why toll manufacturing should not, of itself, create a fixed place of business PE for the stock-owning principal would be improved if “at the disposal” were included in article 5.

The proposed changes to article 5 highlight the potential for differences in treatment between groups with vertically-integrated supply chains where group companies may, in the future, create a local country taxable presence of a nonresident, and those that use third parties (e.g. third party distributors or, potentially, third party warehouses operated by an independent logistics company), which may not. This, and the reliance on the “at the disposal” test, does not appear to be a satisfactory distinction to draw.

It was anticipated that the OECD would choose to continue to treat insurance businesses in the same way as businesses in other sectors, but the insurance industry will be relieved that it will not have to deal with the excessive compliance burden that would have been placed on it if the shift from residence to source taxation proposed in the October 2014 draft had been taken forward.

It is very positive that the OECD has agreed to provide further guidance, with appropriate time for analysis, on applying the principles for attributing profit to PEs (as set out in the 2010 *Report on the Attribution of Profits to Permanent Establishments*) to nonfinancial services businesses by December 2016. It is possible that there will be limited additional profit attributed to some of the newly-created PEs in practice, particularly where there are no significant people functions in the local country, and, as such, the changes may become a question of compliance only.

Comments on the revised discussion draft must be submitted by 12 June 2015. There will not be a public consultation meeting, but comments received will be discussed by the G20/OECD Working Party before final recommendations are delivered to the G20 Finance Ministers' meeting on 8 October 2015. Changes to bilateral tax treaties to reflect amendments to the PE threshold are likely from 2017 through the multilateral instrument, unless countries choose to use bilateral protocols to implement change more quickly.

For multi-national companies with Chinese operations, it is important to understand how the suggestions by OECD in BEPS Action 7 would potentially impact the existing treaty interpretation by SAT (i.e. Guoshuifa [2010] No. 75 ("Circular 75"), the SAT interpretation of China-Singapore double tax treaty, which generally applies to other China treaties with similar terms).

Some of the proposed amendments appear to have already been reflected in Circular 75. For example, the SAT suggests in Circular 75 that each of the exceptions listed in paragraph 4 of PE article to be the activity of a preparatory or auxiliary character in order for such an exception to apply. It also clarifies the activities being considered an essential or significant part of the enterprise should not be viewed as with preparatory or auxiliary character. These provisions are consistent with the suggestions in the latest BEPS Action 7 discussion draft.

How the SAT will respond to the suggestions by OECD remains to be observed with the evolvement of BEPS project. Multi-national companies should closely follow the developments of BEPS project and assess the necessity of change of existing business model from time to time.

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