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BEPS action 7: Preventing the artificial avoidance of PE status

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima on 8 October, the OECD published 13 papers and an explanatory statement outlining consensus actions under the base erosion and profit shifting (BEPS) project.[1] These papers include and consolidate the first seven reports presented to and welcomed by the G20 leaders at the Brisbane Summit in 2014.

The output under each of the BEPS actions are intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. They are broadly classified as "minimum standards," "best practices" or "recommendations" for governments to adopt. The G20/OECD and other governments will be continuing their work on some specific follow-up areas during the remainder of 2015, 2016 and into 2017.

As part of the 2015 output, the OECD issued a final report in relation to preventing the artificial avoidance of permanent establishment (PE) status (action 7), which introduces changes to the model treaty. The report builds on proposals put forward in the G20/OECD's discussion drafts from October 2014 and May 2015 and updates the definition of PE (taxable presence) in article 5 of the OECD model tax treaty and associated commentary.

Proposals for amendments to article 5 of the OECD model tax treaty

Artificial avoidance of PE establishment status through commissionnaire arrangements and similar strategies: The report 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 report includes changes to the rules on dependent and independent agents intended to address *commissionnaire* and other undisclosed agent arrangements by:

- Tightening the agency PE rules 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 habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"; and

[1] See Tax Analysis dated 7 October 2015: http://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2015/deloitte-cn-tax-tap2292015-en-151007.pdf

- Narrowing the requirements 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 “closely related.” Closely related (which replaces “connected” from the previous discussion draft) is broadly defined on the vote and value of a company’s shares (directly or indirectly more than 50%) or on de facto control.

The commentary provides limited guidance and examples on the phrase, “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.” (This replaces “negotiates material elements of contracts” included in the previous discussion draft). The commentary notes that this phrase will “typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise” (i.e. “acts as the sales force”). For example, this would include a person who “solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions.”

The commentary clarifies the following important aspects:

- The changes do 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);
- Where an agency PE is created, it is not the case that the entire profits will be attributed to the PE (usual principles for business profits will apply); and
- Amendments to independent agent status do not result in an automatic exclusion for an agent acting exclusively for one unrelated enterprise (for example, in the case of start-up businesses).

Artificial avoidance of PE status through the specific activity exemptions: Changes to the model treaty will mean that exceptions from creating a fixed place of business PE for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) will apply only where the activity (or activities) in question is preparatory or auxiliary in relation to the business as a whole. This is to reflect modern ways of doing business, where such the activity (or activities) may represent a key part of a business’ value chain (particularly relevant for supply chains involving digital sales). The commentary includes an alternative for countries that consider that the specific activities referred to are intrinsically preparatory or auxiliary and prefer the certainty of retaining their blanket exception status. Such countries’ consider that BEPS concerns will be sufficiently addressed by the anti-fragmentation rule (see below).

A number of helpful examples are included in the revised commentary, together with limited guidance on the meaning of “preparatory or auxiliary.” For example, storing and delivering goods to fulfill online sales may not be considered preparatory or auxiliary in character if such activities are an essential part of the company’s sales or distribution business, whereas storing of goods in a bonded warehouse during the custom clearance process would be considered preparatory and auxiliary.

Fragmentation of activities between related parties: The model treaty will include a far-reaching anti-fragmentation rule that covers situations where activities in a country are “fragmented” between group companies to meet the exceptions for activities that are preparatory or auxiliary. Broadly, the proposal prevents the exceptions from applying where there is (a) an existing PE in the local country, or (b) the “overall activity resulting from the combination of the activities carried on …by the same enterprise or closely related enterprises…is not of a preparatory or auxiliary character” (which includes activities of locally resident entities). In both cases, for the rule to apply the activities must constitute “complementary functions that are part of a cohesive business operation.”

Splitting up of construction contracts: The report addresses the splitting up of contracts between group companies to circumvent the specific 12-month time period for creating PEs for building sites and construction or installation projects by updating the commentary as follows:

- Adding an example to illustrate the application of the principal purposes test for the prevention of treaty abuse (action 6 of the BEPS action plan) to deal with splitting up of contracts; and
- Suggesting an alternative provision (for treaties that do not include the principal purposes test) to add connected activities (exceeding 30 days’ duration) carried on by closely related enterprises to the period of time on site for the purposes of determining the 12-month period.

Insurance: The report confirms that there will be no specific PE threshold for insurance businesses in the model tax treaty. Instead, insurance businesses will be treated in the same way as any other industry (unless variations are negotiated in bilateral agreements between specific countries).

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

Further guidance will be issued in respect of the attribution of profits to PEs. The report notes that, although substantive modifications are not required to the OECD's existing rules for determining the profits that should be allocated to PEs, additional guidance is necessary on how the rules will apply to new PEs resulting from the threshold changes. This guidance will focus on businesses outside the financial services sector and take into account BEPS revisions to transfer pricing guidelines on intangibles, risk and capital.

The work on the new guidance is expected to be completed by the end of 2016, in time for the multilateral instrument to implement changes to the PE threshold in tax treaties.

Comments and business next steps

The final report makes wide-reaching changes to the existing threshold for creating a PE to tax the trading profits of a company in an overseas country. Groups may find that, in the future, some trading profits are to be taxed primarily in a different country from the one under the current rules. The report introduces changes that are believed necessary to ensure that a group's complex supply chain does not allow it to artificially avoid a taxable presence in a local country (often but not exclusively a market country) where significant activities take place.

As anticipated, *commissionnaires* and other forms of undisclosed agency arrangements will create a PE of their principal. These and other arrangements will be determined by a new test of which party "habitually plays the principal role" in generating sales or making purchases where the contracts are "routinely concluded without material modification" by the contracting entity. (This is a significant improvement on the draft proposals as it focuses on one party taking the lead, rather than allowing for the actions of multiple parties to generate multiple claims over the taxing rights). The commentary to the model tax treaty (but not the treaty wording itself) contains a 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).

There are a number of changes limiting the exemption for "independent agents" in group situations (including that references to "brokers" have been removed, independence can be assumed only where at least 10% of sales are to unrelated parties and a new test of "closely connected") that will have particular relevance for financial services businesses.

The stock-holding changes are potentially far-reaching. The first test for most multinationals will be whether the premises in the local country (e.g. a warehouse, or toll manufacturing facility) is "at the disposal" of the nonresident entity. "At the disposal" remains a concept introduced in the commentary, and does not form part of the model treaty wording, but again the policy intent is clear. Even if the premises are "at the disposal," exceptions are available for preparatory or auxiliary activities (although there is new optionality for countries to retain exceptions for stock-holding more generally, where both treaty partners agree to the approach). However, the anti-fragmentation rule may apply to these exceptions, and for large multinationals it is likely that there will be other activity by group companies in the same country such that the exceptions will not apply. This may mean significant additional compliance for principals of toll manufacturing operations, and those that hold stock overseas for other reasons.

Because of the potential impact on commercial trading arrangements, these changes remain a key area of concern for all businesses, despite the changes. There will be additional compliance costs for businesses in determining areas of uncertainty. This may include, for example, by whom (and where) the principal role leading to the conclusion of contracts is played (particularly in relation to business travel by sales people), what is preparatory or auxiliary in the context of the business, and what is a cohesive business operation. Similarly, there will be administration costs for tax authorities in monitoring and auditing these areas. In addition, as the PE threshold is the boundary that allocates primary taxing rights over trading profits to one country or another in their entirety, there remains concern that the new definitions will lead, in the short to medium term at least as the changes are refined by practice, to disputes between tax authorities and businesses, and between tax authorities, that may result in double taxation.

One area of concern is the use of the commentary—rather than the treaty article itself—to establish key points. For example, the further reliance on premises being "at the disposal" of a nonresident (a concept that has been subject to much comment, dispute and debate over its use in the commentary for many years) would be improved if "at the disposal" were included in article 5 itself, as would the reference to limited risk distributors.

The proposed changes highlight the potential for differences in treatment between groups with vertically-integrated supply chains where group companies may in 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 is very positive that the G20/OECD have agreed to provide further guidance, with appropriate time for analysis, on applying the principles for attributing profit to PEs (as set out in the OECD’s 2010 *Report on the Attribution of Profits to Permanent Establishments*) to nonfinancial services businesses by December 2016. It remains possible that there will be limited additional profit attributed to some of the newly-created PEs, particularly where there are no “significant people functions” in the local country.

The report note that the changes it sets out are “prospective only” and do not affect the interpretation of the former provisions of the OECD model tax treaty and treaties in which those provisions are included.

It is expected that the G20 leaders will give final approval to the content of the paper in November 2015. Changes to double 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.

During the State Administration of Taxation (SAT) BEPS Conference that followed the publication of the G20/OECD BEPS Deliverables, the SAT noted that its current position concerning PE issues already reflects the action 7 recommendations. The SAT's position in this regard is contained in Circular 75 (Guoshuifa [2010] No. 75). The SAT also indicated that it is reviewing the appropriateness of the longstanding practice in China of attributing profits to Chinese PEs on a "deemed profit" basis, whether based on cost or on revenue. The SAT is also taking this opportunity to enhance compliance in relation to multinational enterprises which have PEs in China. Accordingly, multinational enterprises, in particular, those which sell goods or provide services to Chinese customers from offshore, supported by Chinese marketing services companies, should review their current business models in light of action 7, as well as the SAT's comments during the conference referred to above.

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