Canada
International Tax

Contacts

National tax policy leader
Albert Baker
416-643-8753

National leader - International Tax
Olivier Labelle
403-267-1790

Canadian Desk leader Hong Kong
Chris Roberge
852-285 25627

Quebec
François Champoux
514-393-5019

Eastern
Mark Noonan
613-751-6688

Tony Maddalena
905-315-5734

Toronto
Tony Ancimer
416-601-5945

Sandra Slaats
416-643-8227

Prairies
Andrew McBride
403-503-1497

British Columbia
Brad Gordica
604-640-3344

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Final report on BEPS Action 7: Preventing the artificial avoidance of PE status

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On October 5, 2015, ahead of the G20 Finance Ministers' meeting in Lima on October 8, the Organisation for Economic Co-operation and Development (OECD) Secretariat **published** thirteen papers and an Explanatory Statement outlining consensus Actions under the base erosion and profit shifting (BEPS) project. The output is intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the OECD Model Treaty and transfer pricing guidelines. They are broadly classified as "minimum standard", "best practices" or "recommendations" for governments to adopt. The OECD will be continuing its work on some specific follow-up areas in future years.

Included in the package is a final report in relation to preventing the artificial avoidance of permanent establishment (PE) status (Action 7), which introduces changes to the OECD Model Tax Convention. 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's Model Tax Convention and associated Commentary.

Deloitte's comments

The final report makes wide-reaching changes to the existing threshold for creating a PE to tax the trading profits of a company in another 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 in order 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. Similarly, the activities of a sales force acting in the other country are more likely to create a PE. 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 Convention (but not the wording in the Convention 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 goods 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 the removal of references to “brokers”, the requirement that independence can be assumed only where at least 10% of sales are to unrelated parties and a new test of “closely connected”).

The changes relating to the holding of goods are potentially far-reaching. The first test for most multinational enterprises will be whether the premises in the local country (e.g., a warehouse or toll manufacturing facility) is **“at the disposal”** of the non-resident entity. “At the disposal” remains a concept introduced in the Commentary, and does not form part of the Model Tax Convention wording, but again the policy intent is clear. Even if the premises are “at the disposal” of the non-resident, exceptions are available for **preparatory or auxiliary activities** (although there is new optionality for countries to retain exceptions for the storage of goods more generally, where both treaty partners agree to the approach). However, the **anti-fragmentation rule** may apply to these exceptions, and for large multinational enterprises, 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 goods 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 carried out (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. There will similarly 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 Model Tax Convention article itself – to establish key points. For example, the further reliance on premises being “at the disposal” of a non-resident (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 of the Convention itself. The same case can be made for 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 non-resident, 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 non-financial 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 notes that the changes it sets out are "prospective only" and do not affect the interpretation of the former provisions of the OECD Model Tax Convention and treaties in which those provisions are included.

Proposed changes to Article 5 of the OECD Model Tax Convention

Artificial avoidance of PE status through *commissionnaire* arrangements, sales agents 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 non-resident entity**, then the non-resident 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 by:

- tightening the agency PE rules to include not only contracts in the name of the non-resident entity but also contracts for the **transfer of, or the granting of the right to use, property, or the provision of services** by the non-resident 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

- 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 based on votes 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 finalize) 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 changes to the Commentary make the following important clarifications:

- 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 Tax Convention will mean that exceptions from creating a fixed place of business PE for specific activities (such as the maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) will only apply where the activity or activities in question is **preparatory or auxiliary** in relation to the business as a whole. This is intended to reflect modern ways of doing business, where such 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 are of the view 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 fulfil online sales may not be considered as preparatory or auxiliary in character if such activities are an essential part of the company's sales or distribution business, whereas the storing of goods in a bonded warehouse during the custom clearance process would be considered preparatory and auxiliary in nature.

Fragmentation of activities between related parties

The Model Tax Convention will include a far-reaching anti-fragmentation rule that covers situations where activities in a country are "fragmented" between group companies in order to meet the exceptions for activities that are preparatory or auxiliary. Broadly, the proposal prevents the exceptions from applying where there is (i) an existing permanent establishment in the local country of the enterprise or a closely related enterprise (including residents of the local country), or (ii) 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**". 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 in order to circumvent the specific 12-month time period for creating a PE 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 there will be **no specific PE threshold for insurance businesses** in the Model Tax Convention. 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 transfer pricing Actions

Further guidance will be issued in respect of the attribution of profits to PEs. The report notes that although substantive modifications to the OECD's existing rules for determining the profits that should be allocated to PEs are not required, 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.

Next steps

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.

Albert Baker, Toronto

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2 Queen Street East, Suite 1200
Toronto, ON M5C 3G7 Canada