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BEPS Action 7: Preventing the artificial avoidance of permanent establishment status

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On May 15, 2015, the OECD, as part of the G20/OECD work on the Action Plan to address Base Erosion and Profit Shifting (BEPS), released a revised discussion draft on Action 7 in relation to preventing the artificial avoidance of permanent establishment (PE) status. This work is focused on updating the definition of taxable presence in Article 5 of the OECD model tax treaty in order to prevent abuses of the threshold for allocating taxing rights for trading activities to different jurisdictions. In addition, the G20/OECD are considering the modernization of the PE threshold in relation to digital cross-border business, in line with the BEPS work on the digital economy (Action 1).

The discussion draft selects - and in some cases refines - proposals from the alternatives proposed in an earlier draft (issued on October 31, 2014) and sets out proposed amendments to Article 5 of the model tax treaty and its associated Commentary. The proposals are described below.

Deloitte's comments

Governments are pressing ahead with changes to the threshold for a PE to exist in order to prevent the artificial avoidance of PEs where a company, or group, has significant activity in a particular country. Some of the changes, such as those that create a PE for a principal where it operates via commissionnaire or undisclosed agent arrangements, were widely anticipated. Some, such as the changes (discussed below) to the exemption for holding a stock of goods, to changes to agents that are considered independent and the new anti-fragmentation rule, 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 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 a stock of goods 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 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.

There will be additional compliance costs for businesses in determining areas of uncertainty such as, for example, where material elements of contracts are

negotiated (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 in their entirety to one country or another, there remains concern 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 model treaty Commentary – rather than the treaty article itself – to clarify some key areas. For example, the policy intent is that limited risk distributors will not create a PE of an overseas principal; it would be helpful to include this in the text of Article 5 so that it becomes binding on countries adopting the new PE threshold. Likewise, the reliance on premises being "at the disposal" of a non-resident (a concept in the Commentary that has been the subject of much comment, debate and dispute) to explain why toll manufacturing should not, of itself, create a fixed place of business PE for the stock of goods-owning principal, would be improved if the concept were included in Article 5 itself.

The proposed changes highlight the potential for differences in treatment between groups with vertically-integrated supply chains that create a taxable presence in a particular country, and those that use third parties (e.g., distributors or warehouses operated by an independent logistics company) in that country. 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 other sectors, but the insurance industry will be relieved that it will not be subject to the excessive compliance burden that would have arisen if the shift from residence to source taxation as proposed in the October 2014 draft had been maintained.

It is very positive that the G20/OECD have agreed to provide further guidance 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 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.

Proposed amendments to Article 5 of the OECD model tax treaty

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 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, changes to the rules on dependent and independent agents are proposed:

- amend the agency PE rules (Article 5(5) of the model tax treaty) 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 negotiates the material elements of contracts**; and

- strengthen the requirements (Article 5(6) of the model tax 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 update the Commentary on Article 5 by including a number of examples to assist with new and uncertain concepts. For example, "negotiating material elements of contracts" would include circumstances where a person acts as the sales force for a non-resident entity and where the negotiation of the material elements of the contracts is limited to convincing the account holder to accept standard terms. The proposed updated Commentary also clarifies that proposed changes to independent agent status do not result in an automatic exclusion for unrelated agents acting exclusively for one enterprise (for example, in the case of start-up companies). Further, 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

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) of the model tax treaty by ensuring that these only apply where the activity in question is **preparatory or auxiliary** in relation to the business as a whole. This is to reflect current business practices, whereby such activities may represent a key part of a business' value chain (including in supply chains involving digital sales).

The discussion draft proposes updated Commentary to provide further guidance on the **meaning of preparatory or auxiliary**. It 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". A number of examples are included in the proposed Commentary. 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.

Fragmentation of activities between related parties

The discussion draft proposes (in new Article 5(4.1) of the model tax treaty and updated Commentary) the creation of PEs where activities in a country are "fragmented" between group companies in order to meet the exemptions for activities that are preparatory or auxiliary. The proposal prevents 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"** provided that 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 in order to circumvent the specific 12-month time period for creating PEs

for building sites, construction or installation projects (Article 5(3) of the model tax treaty). The recommendations are set out in the proposed updated Commentary as follows:

- an example is included to illustrate the application to this planning of the **principal purposes test** for the prevention of treaty abuse (Action 6 of the BEPS Action Plan); and
- an alternative provision (where treaties do not include the principal purposes test) is included 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

As noted above, the discussion draft proposes no specific PE threshold in the model tax treaty for insurance businesses. Instead, insurance businesses will be treated the same as other industries (unless specific variations from the model tax treaty are negotiated in bilateral agreements between specific countries) and the general changes proposed to the PE threshold will apply equally to them.

Profit attribution to PEs and interaction with BEPS 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 activity on transfer pricing, in particular intangibles, risk and capital, will also require consideration. 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 the negotiation of the multilateral instrument that will implement changes to the PE threshold in tax treaties.

Timetable

Comments are invited by June 12, 2015. There will be no 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 October 8, 2015.

Changes to double tax treaties to reflect amendments to the PE threshold are anticipated by 2017 through the multilateral instrument, unless countries choose to use bilateral protocols to implement change more quickly.

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