

Update on BEPS Action 7 (Preventing the Artificial Avoidance of PE Status)

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The main purpose of the PE concept under the OECD Model Tax Convention ("OECD-MC") is to determine whether a Contracting State has the right to tax the profits of an enterprise that is resident in the other Contracting State. According to Article 7 of the OECD-MC, a Contracting State cannot tax business profits of enterprises resident in the other Contracting State unless it carries on its business through a PE located in its territory.

The history of Article 7 of the OECD-MC and the related definition of PE provided in Article 5 of the OECD-MC dates back to the work of the League of Nations in the 1920s.⁽¹⁾ From the very beginning, the term PE has been at the heart of the discussions on the attribution of taxation rights in tax treaties.⁽²⁾ However, there has always been a general tendency to narrow the scope of the PE concept, which can be easily explained with the balanced import and export activities of OECD member countries.⁽³⁾

Action 7 of the BEPS (Base Erosion and Profit Shifting) Action Plan calls for developing changes to the PE concept in the OECD Model Convention in order to prevent perceived abuses of the threshold that needs to be exceeded for a PE to exist. On 31 October 2014, the OECD released a first discussion draft (the "2014 Discussion Draft") regarding Action 7 for public consultation. The 2014 Discussion Draft included initial proposals for changes to broaden the definition of permanent establishments ("PE") found in the OECD Model Tax Convention.

More than 850 pages of public comments have been provided by multinationals, business associations and other interested parties. The large majority of these public comments expressed significant concerns regarding the proposals that would considerably lower the PE threshold. These concerns have been voiced during a public consultation meeting held on 21 January 2015.

On 15 May 2015, the OECD released a second discussion draft (the "2015 Discussion Draft") that provides for only one specific proposal with respect to each purported PE avoidance strategy. This article provides a critical overview of the proposals made in the 2015 Discussion Draft.

Commissionaire arrangements

Under commissionaire arrangements⁽⁴⁾, the distributing entity (that is the commissionaire) concludes sales contracts with the final customers in its own name but relies on the commissionaire agreement with the principal entity to fulfil its obligations towards the final customer.⁽⁵⁾ Although the principal remains generally undisclosed, the commissionaire does not, at any stage, take legal title to the inventory. Instead, goods are delivered directly from the principal entity to the customer. Therefore, the principal entity may, for practical reasons, need to maintain a stock of goods in the State where the commissionaire is located.⁽⁶⁾

In accordance with recent case law, the normal operation of a civil law commissionaire, that acts in his own name and who does not legally bind the principal, does not constitute a PE of the principal.⁽⁷⁾ As the contracts were "in the name of" the commissionaire, the sales entities did not have and did not habitually exercise the authority to conclude contracts "in the name of" the principal. Therefore, a commissionaire is not a dependent agent PE of the principal (Article 5 (5) OECD-MC).

The Focus Group on the Artificial Avoidance of PE Status considers that in many cases *commissionaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place. The position of the Focus Group is that when an intermediary exercises activities in a country which are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have sufficient taxable nexus in that country to be taxable unless the intermediary is performing these activities in the course of an independent business.

In the 2014 Discussion Draft, four alternative options (Options A – D) have been proposed that contain language which would significantly narrow the definition of an independent agent. Under each of these proposals, commissionaire arrangements with related parties would constitute a PE of the principal. All four proposals have been significantly criticised in the large majority of public comments.



In the 2015 Discussion Draft, the OECD proposes only a modified version of Option B, as provided in the 2014 Discussion Draft. In this regard, the 2015 Discussion Draft explains that the vast majority of commentators who expressed a preference for one of the options supported Option B. It has, however, been acknowledged that support for any of the options was qualified by conditions as to changes that should be made or clarifications that should be provided.

As such, the proposal in the 2015 Discussion Draft disregards the legitimate commercial reasons for businesses to use an agent when doing sales in another country (legal reasons, limiting administrative burden, risk protection, testing new markets, etc.). A fair allocation of taxing rights among Contracting States is already achieved through the remuneration of the agent at arm's length. Even if a PE were found to exist in accordance with the proposals, it may be expected that in the large majority of cases only minor profits could be attributed to such PE notwithstanding the intention to shift more taxing rights to the source state.⁽⁸⁾

It follows that commissionaire arrangements should often not raise any BEPS concerns as the country where sales are made may not expect additional taxing rights even if these proposals would be implemented. All in all, it may be questioned whether the limited additional tax revenue which may reasonably be expected may justify the massive legal uncertainty and the significant administrative burden that would be the consequence of any of the proposed changes to the PE definition.

Specific activity exemptions

Article 5 (4) of the OECD-MC contains exceptions to the general rule provided under Article 5 (1) of the OECD-MC, listing a number of activities of a preparatory or auxiliary nature which may be carried out through a fixed place of business but which nevertheless do not create a PE. Even if the conditions of Article 5 (1) of the OECD-MC are met and the activity is carried on through a fixed place of business, no PE is constituted.⁽⁹⁾

The activities listed in Article 5 (4) of the OECD-MC share the common characteristic that the services performed are so remote from the actual realization of profits that it is difficult to allocate any profit to them. Therefore, Article 5 (4) of the OECD-MC is designed to prevent an enterprise of a Contracting State from being taxed in the other Contracting State.

The 2014 Discussion Draft proposed six alternative options (Options E – J) for changes to Article 5 (4) of the OECD-MC that range from expressly stating that all activities listed therein need to be of "preparatory or auxiliary" nature to more targeted changes that would eliminate specific activities from the PE exemption (in particular, warehouses, purchasing offices, offices used for gathering information). The public comments expressed strong objections to each of these alternatives.

The 2015 Discussion Draft acknowledges the strong objections to all of the proposals in the 2014 Discussion Draft. However, the working group perceived fewer objections against the proposal that all activities listed in Article 5 (4) of the OECD-MC have to be of "preparatory or auxiliary" nature although it is acknowledged that commentators complained about the significant uncertainty that this proposal entails. Therefore, the 2015 Discussion Draft provides for additional guidance as to what is exactly meant by this. Nevertheless, this change to the PE concept would result in a significant increase of PEs, whereas only very limited profits could be attributed at arm's length to such a PE.

The 2014 Discussion Draft further considered two options (Options I and J) that would deny the application of the exceptions of Article 5 (4) of the OECD Model Convention where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or associated enterprises at different locations. Both alternatives suggest adding a new paragraph 4.1 to Article 5 of the OECD-MC.

The 2015 Discussion Draft favors alternative J which amalgamates the operations of related parties within the same country where the "overall activity resulting from the combination of the activities ... is not of a preparatory or auxiliary character". Accordingly, alternative J does not even require that any of the related entities has a PE on its own. This option challenges the separate enterprise approach and treats third party transactions more favourably than arm's length transactions between related parties.

Splitting up of contracts

According to Article 5 (3) of the OECD-MC, building sites, constructions and installation projects constitute a PE, provided that they last more than twelve months. Once the twelve month period is exceeded, a PE is deemed to exist (from the first day of activity) even if the general conditions laid down in Article 5 (1) of the OECD-MC are not met. The 2014 Discussion Draft proposed two options for changes in this respect. The first option is an "automatic" rule to be included in Article 5 of the OECD-MC according to which periods of time spent by associated enterprises at a place that constitutes a building site or construction or installation project shall be added for the (sole) purpose of the twelve-month test.

The second option proposed in the 2014 Discussion Draft would rely on the Principal Purposes Test ("PPT", a general anti-abuse rule proposed in regard to BEPS Action 6 relating to Preventing Treaty Abuse) through the addition of an example in the Commentary. The 2015 Discussion Draft proposes to pursue this second option and to include a modified version of the "automatic" rule option as an alternative provision in the Commentary.

At first sight, the second option would only address cases where the splitting-up of contracts is tax-motivated and exclude situations where there are legitimate business purposes for the involvement of associated enterprises in the same project. However, the PPT opens the door for tax administrations to disqualify taxpayers from treaty benefits where "one of" the main purposes of an arrangement or a transaction is considered to be a given treaty benefit. Obviously, this injects a subjective element into every aspect of determining whether treaty benefits are available and not much guidance is provided with regard to when treaty benefits will be granted.

Furthermore, the PPT imposes a significant burden on the taxpayer ("establish that the granting of tax benefit would be in accordance with the object and purpose of provision in the convention"), whereas the onus on the tax administration is set low ("reasonable to conclude", "one of the main purposes", "directly or indirectly"). As such, the PPT would create significant uncertainty for taxpayers (and their advisors) because of the extremely unpredictable outcomes and cause serious concerns for *bona fide* businesses.

Profit attribution to PEs

According to the 2014 Discussion Draft, BEPS concerns regarding the PE rules relate primarily to situations where one member of a group clearly has a physical presence and tax nexus within a jurisdiction, whereas another member of the MNE group is shielded from tax in the absence of a PE, and the first-mentioned entity is allocated limited profits (because of limited functions and risks) while the foreign entity is allocated a large share of the income. However, this outcome is in line with the arm's length principle according to which associated enterprises should price controlled transactions as comparable transactions on the open market.

The 2014 Discussion Draft states that no substantial changes would be needed to the existing guidance concerning the attribution of profits to a PE. This statement is positive as the Authorized OECD Approach regarding the attribution of profits to a PE was adopted only on 22 July 2010 after a more than 10 year negotiation process.⁽¹⁰⁾

The 2015 Discussion Draft states that additional guidance would be required to clarify how the arm's length principle should be applied in case of a "new generation" PE. Given the interdependencies with BEPS Actions 8 – 10 that concern transfer pricing matters, it is acknowledged that such additional guidance can only be developed once the work on the transfer pricing related actions is completed.

Conclusion and outlook

Whether or not a PE is found to exist is an important question and probably one of the most frequent tax treaty issues. The 2014 Discussion Draft set out a number of proposals for changes to Article 5 of the OECD Model Convention with a view to significantly lower the PE threshold in a tax treaty context. Hence, the proposals aim at shifting taxing rights to the source state rather than capturing untaxed profits which is the purported target of the BEPS Action Plan. The 2015 Discussion Draft provides for only one specific proposal with respect to each purported PE avoidance strategy.

The proposal regarding commissionaire arrangements seems overbroad and would undermine the current rules in relation to dependent agents. The vague language that is proposed to be added to Article 5 is open to interpretation by local tax administrations and would result in legal uncertainty, long lasting disputes and double taxation. Similar uncertainty would occur if the "auxiliary and preparatory" requirement were to be added to Article 5 (4) of the OECD-MC. Moreover, the proposed anti-fragmentation rule would not even require that any of the related entities has a PE on its own.

The proposed changes to the PE concept may result in a PE being constituted in every country in which a company is doing business. In the majority of these cases only very limited profits will be attributed to the PE in accordance with the arm's length principle. The administrative burden for both taxpayers and tax administrations will be disproportionate, especially in cases where no or only little (additional) profits can be attributed to a PE. Furthermore, there exists a real risk that tax authorities could be tempted to deem a PE to exist even if the involvement of a foreign enterprise is very limited (for increasing tax revenue) or to attribute more profits to a PE than appropriate in accordance with the arm's length standard.

Businesses need legal certainty about the threshold that gives rise to the constitution of a PE as the existence of a PE entails tax consequences and compliance obligations. As such, the proposed changes would be an impediment for international trade and investment without shifting significantly more taxing rights to the source state. In the authors' opinion, the OECD should carefully analyse the impact of the proposals on businesses and tax revenue before adopting any changes to the established PE definition.

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- 1) See Raffaele Russo, "Chapter 2: Historical Development of Article 7 of the OECD Model" in "The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings", IBFD, 2005, p. 5.
- 2) See Hans Pijl, "Agency Permanent Establishments: in the name of and the Relationship between Article 5 (5) and (6) – Part 1", Bulletin for International Taxation, January 2013, p. 3.
- 3) See Hans Pijl, "Agency Permanent Establishments: in the name of and the Relationship between Article 5 (5) and (6) – Part 1", Bulletin for International Taxation, January 2013, p. 12.
- 4) A commissionaire agreement is a form of contractual arrangement that exists under civil law.
- 5) The sales contracts entered into by the commissionaire are for the benefit of the principal entity, but do not legally bind it.
- 6) See Joel Cooper, Shee Boon Lau, "Business Restructuring and Permanent Establishments", International Transfer Pricing Journal, July/August 2010, p. 250; see Jonathan Schwarz, Elna Castro, "Re-engineering Multinational Supply Chains", Bulletin for International Taxation, May 2006, p. 188; the commissionaire operates similar to a commission agent with the difference that the principal is generally not disclosed; see Monique van Herksen, "Business Models", (Chapter 2) in "Transfer Pricing and Business Restructurings: Streamlining all the ways", IBFD, Amsterdam 2009, p. 27.
- 7) See Hans Pijl, "Agency Permanent Establishments: in the name of and the Relationship between Article 5 (5) and (6) – Part 1", Bulletin for International Taxation, January 2013, p. 13; the commercial agreements entered into by the commissionaire with the customers were enforceable against, and binding on, the commissionaire only; not the principal.
- 8) This is because no additional employees or assets can be allocated to such a "new generation" PE. Accordingly, the profit allocation can only be based on the remuneration for the risks assumed. However, considering that expenses related to the risk should also be attributed to the PE, such PE should only realize a low net profit.
- 9) The application of Article 5 (4) of the OECD Model further requires that no activities other than those listed in Article 5 (4) subparagraphs a) to d) are carried on at such fixed place of business; see Oliver R. Hoor, "The OECD Model Tax Convention – A comprehensive technical analysis", Legitech, Luxembourg 2015, p. 108.
- 10) According to the Authorized OECD Approach, the OECD Transfer Pricing Guidelines (regarding the application of the arm's length principle) should apply "by analogy" to internal dealings between a head office and a PE (and other parts of the same enterprise).