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Global Tax Alert

OECD releases revised discussion draft on preventing artificial avoidance of PE status under BEPS Action 7

Executive summary

On 15 May 2015, the Organisation for Economic Cooperation and Development (OECD) released a revised discussion draft in connection with Action 7 on the artificial avoidance of permanent establishment (PE) status under its Action Plan on Base Erosion and Profit Shifting (BEPS). The document entitled *BEPS Action 7: Preventing Artificial Avoidance of PE Status* (the Revised Discussion Draft or Revised Draft) substantially refines the initial discussion draft on Action 7, which was released by the OECD on 31 October 2014 (the Initial Discussion Draft or Initial Draft). See EY Global Tax Alert, *OECD releases discussion draft on preventing artificial avoidance of PE status under BEPS Action 7*, dated 4 November 2014. The Initial Discussion Draft sought comments on 14 proposed options for modifying the definition of PE under Article 5 of the OECD Model Tax Convention on Income and on Capital (the Model Convention), which generally would lower the PE threshold and tighten the exceptions to PE status.

The OECD received extensive comments on the Initial Discussion Draft and held a public consultation. With this input and following further discussion within the OECD group responsible for the work on Action 7, the OECD prepared the Revised Discussion Draft. Unlike the Initial Draft, which contained several alternative proposals for modifying Article 5 to address particular focus areas, the Revised Draft contains a specific proposal to modify Paragraphs (4), (5) and (6) of Article 5 to address each focus area. In addition, the Revised Draft contains proposed amendments to the existing commentary accompanying the Model Convention (the existing commentary, the Model Commentary and amendments, the Proposed Commentary).

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As in the Initial Draft, the Revised Discussion Draft states that it does not represent the consensus view of the OECD's Committee on Fiscal Affairs or its subsidiary bodies and seeks comments on its proposals. Comments on the Revised Draft are to be submitted by 12 June 2015. The OECD has indicated that it does not intend to hold a public consultation on the Revised Draft.

Detailed discussion

Background

Article 5 of the Model Convention describes the circumstances in which a person will be treated as having a PE within a country. The Initial Discussion Draft included 14 options to modify Article 5 to address the OECD's concerns about the potential for companies to enter into arrangements that would, in its view, artificially avoid the occurrence of PEs. The Revised Discussion Draft narrows and refines those options based on the comments received and further consideration by the OECD and provides Proposed Commentary on the proposed changes to Article 5.

The options discussed in the Revised Discussion Draft are summarized below.

Commissionnaire arrangements and similar strategies

The Initial Discussion Draft contained four options (Options A through D) related to Articles 5(5) and 5(6) that were intended to address *commissionnaire* arrangements and similar strategies. In general, these options were designed to create a PE for a foreign enterprise in a country when an intermediary of that foreign enterprise carries out activities in such country that are intended to result in the regular provision of goods or services by the foreign enterprise.

The Revised Discussion Draft proposes Option B with some refinement, noting that this option was preferred by a majority of commentators who expressed a preference among the four options. The Revised Draft refers to this option as Proposal 1.

Proposal 1 generally provides that, under Article 5(5), an enterprise will be deemed to have a PE in a country where a person is acting in that country on behalf of the enterprise, and, in doing so, such person habitually concludes or "negotiates the material elements" of certain contracts identified by Proposal 1. The identified contracts are those contracts that are: (a) in the name of the enterprise, (b) for the transfer of, or right to use, property that the enterprise owns or has the right to use, or (c) for the provision of services by the enterprise. The activities described in Proposal 1, however, will not create a PE for the applicable enterprise if: (a) those activities are limited to the "preparatory or auxiliary" activities described in Article 5(4) (as modified by Proposal 2, discussed below), or (b) the activities are carried on by certain independent agents under Article 5(6) (as modified by Proposal 1, also discussed below).

The Revised Discussion Draft also specifically notes the concern expressed by commentators that the concept of an "associated enterprise" contained within the independent agent exception under Article 5(6) as proposed to be modified by the Initial Discussion Draft was too broad. For purposes of the independent agent exception, the Revised Draft, therefore, replaces the term "associated enterprise" with the narrower concept of "connected to," which, as described below. is specifically defined in Proposal 1.

Regarding the independent agent exception under Proposal 1, a person acting in a country on behalf of an enterprise of another country will not cause the enterprise to have a PE in the first country if that person carries on a business in the first country "as an independent agent and acts for the enterprise in the ordinary course of that business." Proposal 1 also provides, however, that when a "person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected," that person cannot be considered an independent agent under Article 5(6) with respect to the applicable enterprise. For this purpose, Proposal 1 generally provides that a person is "connected to" an enterprise if: (a) the person owns at least 50% of the beneficial interests of the enterprise or vice versa (or, in the case of a company, at least 50% of the aggregate vote and value of the company's shares or beneficial equity), (b) a third person owns at least 50% of the beneficial interests of both the person and the enterprise (or, in the case of a company, at least 50% of the aggregate vote and value of the company's shares or

beneficial equity), or (c) based on all the facts and circumstances, either the person or enterprise controls the other or both are under the common control of a third person.

The Revised Discussion Draft also includes Proposed Commentary on Article 5 to provide guidance on several significant issues around Proposal 1, including the following key points. First, Paragraph 32.8 of the Proposed Commentary provides additional guidance on when a PE would be created under Article 5(5), explaining that a typical case covered by the Article occurs when contracts are concluded by an agent, partner or employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and its clients. Paragraph 32.8 of the Proposed Commentary also notes, however, that Article 5(5) may apply when the contracts entered do not legally bind the enterprise to third parties with which those contracts are concluded, but are contracts for the transfer of, or right to use, property that is owned by the enterprise or that the enterprise has the right to use, or for the provision of services by the enterprise. For instance, Paragraph 32.8 states that Proposal 1 would apply to *commissionnaire* structures in which the *commissionnaire* does not enter into contracts with third parties that legally bind the enterprise but the enterprise's property is nevertheless transferred to those third parties. Therefore, a crucial condition in assessing Paragraph (b) and (c) of Article 5(5) is whether the person acting on behalf of the enterprise has concluded or negotiated the material elements of a contract that will be performed by the enterprise rather than the person. The Proposed Commentary would make clear that this result would apply even when the *commissionnaire* does not disclose the identity of the enterprise to any third parties.

Second, in contrast to *commissionnaire*-type arrangements, Paragraph 32.12 of the Proposed Commentary would clarify that Article 5(5) is not intended to apply when a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises. In those cases, the person is not acting on behalf of another enterprise and the contracts are not the type described under Article 5(5). Therefore, a distributor, including a so-called low risk distributor, would not cause the enterprise selling property to the distributor to have a PE in the distributor's country of operation as long as the transfer of title to property sold by the distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold). This is the case even when the enterprise and the distributor are "associated" with one another.

Third, Paragraphs 32.5 and 32.6 of the Proposed Commentary provide some explanation of the meaning of the phrase "negotiates the material elements" of a contract. On this point, the Proposed Commentary states that the fact that the key ingredients of a contractual relationship have been determined in a given country is sufficient to treat the contract as if it had been formally concluded in that country. The Proposed Commentary states that this phrase is intended to address when contracts are being negotiated by a person in a given country but are subject to formal conclusion outside of that country (i.e., final approval or review). The Revised Discussion Draft also notes that the meaning of "material elements" may vary depending on the nature of the contract, but would normally include the determination of the parties between which the contract will be concluded, as well as the price, nature and quantity of the goods or services to which the contract applies. The Proposed Commentary goes on to provide an example in which employees of an enterprise's wholly-owned foreign subsidiary service large accounts and promote the enterprise's products in that foreign country. When an account holder agrees to purchase goods or services promoted by those employees, the employees indicate

the price and that a contract must be concluded online. As a result, the account holders complete their orders online directly with the enterprise using a standard form contract. The example concludes that, in such a case, the employees of the subsidiary are negotiating the material elements of the contracts that are concluded by the enterprise and the fact that those employees cannot vary the terms of the contracts does not mean that there is no negotiation, but rather means that the negotiation of the material elements is limited to convincing the account holders to accept these standard terms.

Fourth, the Proposed Commentary under Paragraph 33.1 would clarify that, regardless of whether a person is concluding contacts or negotiating the material elements of a contract on behalf of an enterprise, the person must "habitually" perform those acts in order to establish a PE for the enterprise. Thus, the transitory conclusion or negotiation of material elements of a contract by a person on behalf of an enterprise will not create a PE for the enterprise. The Proposed Commentary provides that it is not possible to prescribe a precise frequency test to determine whether the "habitually" standard is met. Nonetheless, factors similar to those used for Article 5(6) would be relevant in making such a determination.

Fifth, as previously noted, Proposal 1 would limit the scope of the independent agent exception under Article 5(6) so that a person cannot be an independent agent when it "acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected." This represents a change from the Initial Discussion Draft, which provided a similar limitation on a person acting on behalf of "associated enterprises" rather than "connected" enterprises. The change to "connected" responds to commentators' requests for a more definite standard. Regarding this "connected" standard, Paragraph 38.11 of the Proposed Commentary in Proposal 1 would provide that the fact that an enterprise and its subsidiary are connected does not affect the operation of Article 5(7), which generally provides that the mere fact that a parent enterprise controls its subsidiary will not cause the parent to have a PE in the subsidiary's country of residence. That is, Articles 5(5) and 5(6) must still be applied to a parent-subsidiary relationship to determine if the subsidiary's activities on behalf of its parent give rise to a PE for its parent. Additionally, Proposed Commentary is included with respect to other modifications to the independent agent exception under Article 5(6) included as part of Proposal 1. In particular, the Proposed Commentary under Paragraph 38.6 would provide guidance on what it means for a person to act "almost exclusively" for connected enterprises. In this regard, Paragraph 38.7 of the Proposed Commentary indicates that a person will be treated as acting "almost exclusively" on behalf of connected enterprises if that person has no significant business activities apart from those conducted for the connected enterprises. An example illustrating this concept concludes that a sales agent acts "almost exclusively" for connected enterprises when less than 10% of the agent's sales are for non-connected enterprises.

Finally and more generally, regarding status as an independent agent, Paragraph 37 notes that it may be difficult to determine whether an individual is serving the enterprise as an employee or as an independent agent and indicates that the Model Commentary contained under Article 15, addressing income from employment, will be relevant in making this determination.

Specific activity exemptions

The Initial Discussion Draft addressed Article 5(4) of the Model Convention, which specifically exempts certain activities from creating a PE status, and provided four alternative options for modifying these exemptions (Options E through H). In general, these options were intended to prevent what the OECD viewed as the artificial avoidance of a PE through the application of the Article 5(4) exemptions.

Proposal 2 of the Revised Discussion Draft adopts Option E for modifying Article 5(4). Option E would subject all of the specific activity exemptions in Article 5(4) to a "preparatory or auxiliary" condition. Although the Revised Draft indicates that each of the

options were subject to strong objection from commentators, it states that commentators were viewed as generally favoring Option E over the other relevant options. With respect to Option E, however, the Revised Draft notes that several commentators expressed concern that this option would create additional uncertainty and sought greater clarification regarding the meaning of "preparatory or auxiliary." In this regard, the Revised Draft provides additional guidance regarding the meaning of "preparatory or auxiliary" as part of the Proposed Commentary under Paragraph 21.

As with Proposal 1, the Proposed Commentary reflects several important changes to the Model Commentary under Article 5(4). The Proposed Commentary under Paragraph 21.2 would clarify that an activity has a preparatory character if it is carried on in contemplation of the "essential and significant part of the activities of the enterprise as a whole." That Proposed Commentary would also explain that an activity has an auxiliary character if it is an activity that supports, but is not part of, the "essential and significant part of the activities of the enterprise as a whole." The Proposed Commentary provides that Article 5(4) would not apply if a fixed place of business used for the supply of information not only gave out information, but also furnished plans, etc. specially developed for the purposes of the individual customer. Moreover, the Proposed Commentary provides that a fixed place of business that has the function of managing an enterprise, or part of an enterprise, cannot be regarded as doing preparatory or auxiliary activities.

Paragraph 21.2 of the Proposed Commentary also explains that a determination of whether an activity is preparatory or auxiliary must be made in light of the role of those activities within the business of the enterprise as a whole. Paragraph 22 of the Proposed Commentary presents an example of an enterprise engaged in a sales and distribution business. The enterprise maintains a large warehouse in a foreign country with a significant number of employees for the main purpose of storing and delivering in that foreign country goods of the enterprise that were sold by the enterprise online to customers in that foreign country. Although Article 5(4)(a) would provide that the preparatory or auxiliary use of facilities for the storage, display or delivery of goods would not give rise to a PE, the example concludes that the activities the enterprise performs at the large warehouse are essential to its sales and distribution business and therefore cannot be considered preparatory or auxiliary.

In addition, Paragraph 22.5 of the Proposed Commentary illustrates how the proposed change to Article 5(4) would apply to subparagraph (d), which generally covers the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information. The Proposed Commentary notes the exception under Article 5(4)(d) would not apply to a fixed place of business used for the purchase of goods when the overall activity of the enterprise consists of selling these goods.

Furthermore, amendments in Paragraph 21.3 of the Proposed Commentary would explain that the PE status exemptions under Article 5(4) apply only to those activities in which an enterprise engages on its own behalf. Therefore, a PE may arise when an enterprise engages in the type of activities listed in Article 5(4) on behalf of another.

Paragraphs 22.3 and 22.4 of the Proposed Commentary would further clarify certain limitations on the scope of Article 5. For instance, the Proposed Commentary notes that an enterprise will not have a PE when goods belonging to that enterprise are maintained by another person in facilities operated by that other person and the facilities are not at the disposal of the enterprise. Furthermore, the mere presence of goods or merchandise belonging to an enterprise does not mean that the fixed place of business where these goods or merchandise are stored is at the disposal of that enterprise.

Fragmentation of activities between connected parties

The Initial Discussion Draft also addressed concerns about the potential for avoidance of PE status through the fragmentation of activities among related parties. In this regard, the Initial Draft contained

two options (Options I and J) for adding a new "anti-fragmentation rule" to Article 5.

In the Revised Discussion Draft, the OECD acknowledges some concerns of commentators related to Options I and J, including the uncertainty of their application, their failure to respect separate-entity principles, the possibility that the options would result in a multitude of new PEs (thereby increasing the risk of double taxation), the failure to recognize that separate subsidiaries are used for many legal, regulatory, and commercial reasons, and the fact that these options could effectively lead to a force-of-attraction principle or unitary taxation. However, the Revised Draft expresses the view that it is essential to have an anti-fragmentation rule in Article 5 to address BEPS concerns. Specifically, the Revised Draft notes that this rule is necessary to prevent the application of the preparatory or auxiliary exemption found in Article 5(4) when a cohesive business operation is divided into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

Proposal 3 in the Revised Discussion Draft specifically adopts Option J (new Paragraph 4.1 of Article 5), which provides that the preparatory or auxiliary exemptions under Article 5(4) shall not apply to a place of business maintained by an enterprise in a country if the "enterprise or a connected enterprise" carries on business activities at the same place or another place in the same country and either: (a) the place or other place constitutes a PE, or (b) the overall activity by the two enterprises at the same place or by the same enterprise or connected enterprises at the two places is not preparatory or auxiliary. The aggregation rule under new Paragraph 4.1 would only apply if the business activities carried on by the two enterprises constitute "complementary functions that are part of a cohesive business operation."

The Proposed Commentary under Paragraphs 30.1 to 30.3 would provide additional guidance on the anti-fragmentation rule, including two examples illustrating the operation of Proposal 3. The first example involves a banking enterprise with several branches in a foreign country that each constitutes a PE. The bank also has a separate office in that foreign country that it uses to verify information provided by customers on their loan applications made to those branches. The example concludes that the separate office constitutes a PE in the foreign country because the banking enterprise has a PE at another place within the country that is part of the same cohesive business. The second example involves a parent company that manufactures and sells appliances. The parent company has a wholly owned subsidiary that operates a store that sells the parent's appliances in a foreign country, and the store constitutes a PE in that country. In addition, the parent owns a small warehouse in the foreign country that stores a few large items and is used by the subsidiary to supply its customers. The example concludes that the parent company cannot avail itself of the exemptions under Article 5(4) because its subsidiary, a connected enterprise, has a PE in the foreign country and the parent's warehouse and the subsidiary's store are part of a cohesive business.

Splitting-up of contracts

The Initial Discussion Draft also addressed concerns about related enterprises artificially splitting-up contracts into several parts, each covering a period of less than 12 months and attributed to a different company owned by the same group. To address such a situation, the Initial Draft proposed two options (Options K and L).

The Revised Discussion Draft notes that commentators objected to both Options K and L, but that the majority favored Option L. Option L would rely on a general "Principal Purpose Test" (PPT) as described in the September 2014 report under BEPS Action 6 (preventing treaty abuse). Option K, in contrast, would provide an objective rule that would aggregate the time during which "associated enterprises" carried on activities for a particular project in determining whether they exceeded Article 5(3)'s 12-month threshold. Some commentators noted that Option K would disregard the separate company principle, would be difficult to administer and could inadvertently apply to legitimate business operations. The Revised Draft concludes that Option L should generally be used to address the splitting-up of contracts but that Option K should be included in the Proposed Commentary as

a provision that could be used in certain cases, such as when a treaty would not include a PPT provision or as an alternative provision to be used by countries concerned with the splitting-up of contracts.

As a result, Proposal 4, which addresses the issue of artificial splitting-up of contracts, does not propose to alter the text of the Model Convention but instead proposes changes to the Model Commentary. Regarding Option L, the Proposed Commentary would add an example related to the PPT illustrating when it would be considered appropriate to aggregate the time that two related companies worked on a construction project when it is reasonable to conclude that one of the principal purposes of dividing the contract is to obtain a benefit under Article 5(3).

As noted earlier, the Proposed Commentary would also include Option K as an optional provision. In doing so, however, Proposal 4 makes several important amendments to the Initial Discussion Draft's version of Option K. Specifically, instead of using the term "associated enterprise" to identify persons potentially subject to the aggregation rule, Proposal 4 uses a "connected to" test. Proposal 4 also adds a *de minimis* exception, under which activities carried on during periods of less than 30 days would not be aggregated with other periods of activity. Finally, Proposal 4 restricts the aggregation rule to when the enterprises perform "connected activities." Accordingly, the modified version of Option K included in Proposal 4 generally provides that, if an enterprise of one country carries on the activities described under Article 5(3) in a second country for a period of less than 12 months and one or more enterprises connected to the first enterprise perform "connected activities" at the same site or project for a period exceeding 30 days, the periods of activity of the connected enterprises would be aggregated for the purpose of applying Article 5(3).

Insurance

The Initial Discussion Draft also addressed the treatment of insurance companies under Article 5 of the Model Convention. In this regard, the Initial Draft contained two Options: Option M, which generally would cause an insurance company to have a PE in a country if it collected premiums or insured risk within such country, and Option N, under which PE issues related to insurance would be addressed through the more general changes proposed for Articles 5(5) and (6), discussed earlier.

Concerning these options, the Revised Discussion Draft explains that a vast majority of the comments received in writing and at the public consultation took the view that no special rule should apply to insurance companies. Commentators objected to Option M on the grounds that insurance premiums were often already subject to special taxes, that the option would create a misalignment with the regulatory framework for insurers, that the collection of premiums alone should not create a taxable nexus, and that, although little or no profit should be attributed to the activities described under Option M, there would be a risk of countries attempting to inappropriately attribute significant profits to PEs that would be created under Option M. The OECD concluded that Option N was the better approach and therefore the Revised Draft does not propose any special rules for insurance companies under Article 5. The Revised Draft notes that concerns related to when a large network of exclusive agents may be used to sell insurance for a foreign insurer should be addressed through the more general changes proposed to Articles 5(5) and 5(6) discussed above.

Profit attribution to PEs and transfer pricing

The final issue addressed by the Revised Discussion Draft is the appropriate rules for determining the profits attributable to a PE and the interaction between Action 7 and other transfer pricing-related Actions. The Initial Discussion Draft stated that the PE concerns that are the focus of Action 7 could not be adequately addressed without coordination with other Actions. Consistent with this view, the Revised Discussion Draft concludes that the work on the attribution of profits to a PE cannot be realistically undertaken before the work on Action 7 and Actions 8-10 has been completed. In addition, the Revised Draft notes that the OECD received numerous comments expressing concern regarding the lack of guidance on the proper attribution of profits to a PE. The Revised Draft states

that, for these reasons, the OECD will continue to work on the issue of attribution of profits to PEs after September 2015, with a goal of providing guidance before the end of 2016, which the Revised Draft notes is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7.

Implications

The Revised Discussion Draft narrows the alternative options for modifying the PE rules in Article 5 that were included in the Initial Discussion Draft and sets forth specific proposals that would modify Paragraphs 4, 5 and 6 of Article 5, together with Proposed Commentary on those proposals. These include amending the agent and independent agent rules under Articles 5(5) and 5(6), adding a preparatory or auxiliary condition to each of the activities listed in Article 5(4), and creating a new anti-fragmentation rule under Article 5(4.1). The Proposed Commentary contained in the Revised Draft provides additional explanation regarding the proposed Article 5 modifications.

Stakeholders are likely to continue to have concerns regarding the proposals, including the uncertainty of aspects of the proposed rules and the potential for a business to have more PEs under the proposed lower thresholds. New PEs would mean additional tax filing obligations and increased potential for controversy. Moreover, the issue of profit attribution to these new PEs is an important matter for stakeholders, and it now appears that work in this area will be done concurrently with the negotiation of the multilateral instrument under Action 15 that could implement the PE changes that are recommended under Action 7.

Although the proposals are subject to public comment and further work by the OECD, they reflect concepts that are likely to be part of the recommendations that will be contained in the final report under Action 7 to be issued later this year. Companies should evaluate how the proposals may affect them, stay informed about developments in the OECD and in the countries where they operate or invest, and consider participating in the dialogue regarding the BEPS project and the underlying international tax policy issues.

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