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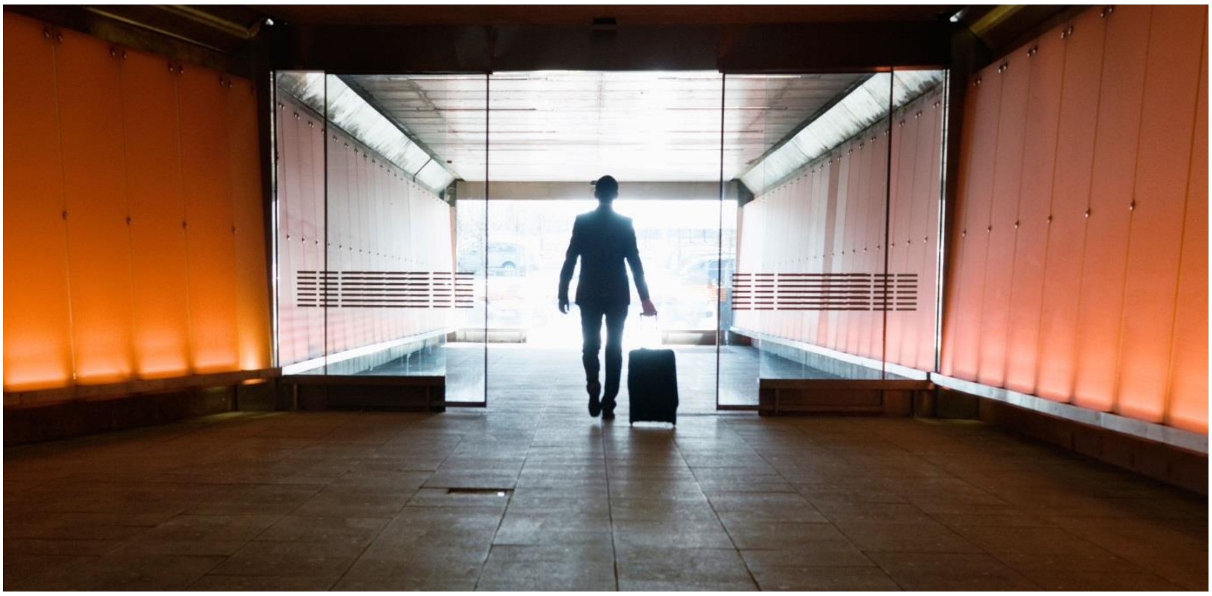
Tax insights
Preventing the Artificial Avoidance of PE Status



Snapshot

On 5 October 2015, ahead of the G20 Finance Ministers' meeting on 8 October, the OECD Secretariat published thirteen papers and an Explanatory Statement outlining consensus Actions under the Base Erosion and Profit Shifting ('BEPS') Project. 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 OECD Model Tax Treaty and transfer pricing guidelines.

As part of the 2015 output, the OECD Secretariat issued a final report in relation to preventing the artificial avoidance of permanent establishment status (Action 7), which introduces changes to the OECD Model Treaty and the Commentary. 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 permanent establishment in Article 5 of the OECD Model Treaty.

This Action is of particular interest in Australia at present in light of the Government's intention to legislate the Multinational anti-avoidance law (MAAL) from 1 January 2016.

Australian perspective

The key Australian issue in respect of Action 7 is how the OECD outcomes interact with the proposals under the MAAL which was introduced as a Bill into Parliament in September 2015, to be effective from 1 January 2016.

A key focus of Action 7 is to address the artificial avoidance of permanent establishment status. The MAAL also targets a similar issue. The Explanatory Memorandum states that the MAAL "will ensure that multinational entities cannot use complex, contrived and artificial schemes to escape paying Australian tax. It targets those multinational entities that:

- avoid a taxable presence by undertaking significant work in Australia in direct connection to Australian sales but booking their revenue offshore; and
- have a principal purpose of avoiding tax in Australia or reducing their foreign tax liability".

The MAAL can only have operation where, under the relevant test, the foreign entity does not have a permanent establishment in Australia. Thus, if under the current law or under the BEPS proposals (as appropriate), the foreign entity has a permanent establishment in Australia, the MAAL has no operation.

Affected businesses are thus left juggling three different standards: existing permanent establishment rules, BEPS proposed but yet to be implemented permanent establishment rules and the uncertainties of the MAAL rules, which if operative, will create a notional permanent establishment. The usual BEPS challenges of navigating from the old global standard to a new global standard are amplified by the MAAL standard – creating complexity for affected taxpayers.

The Government and the Australian Taxation Office (ATO) has made it clear that the anticipated outcome of the MAAL is behavioural change by taxpayers.
The Commissioner of Taxation stated on 7 October 2015 that ""we're very happy to work with companies, to get the outcome that sits behind this legislation and that outcome is to ensure that the profits generated from sales, where the economic activity that causes those sales to occur, the profit is left here in Australia if that economic activity [giving] rise to that profit did occur here in Australia". Further, the Commissioner stated that the ATO will be "entering discussions with around 80 multinational enterprises who will be potentially affected by [the MAAL]".

In an outbound context, a wider scope of permanent establishment could result in Australian groups being exposed to foreign tax under the new permanent establishment standard. Assuming consistent interpretation, such income should qualify for exemption from an Australian domestic law perspective, which will have potential implications on effective tax rate, franking credits and deductions for financing costs.

On Article 5 more generally, some of the BEPS proposals are already reflected in Australia's more recent treaty practice. For example:

- The proposals narrow the preparatory or auxiliary exceptions in Article 5(4). The OECD recommendation is consistent with some of Australia's existing tax treaties (eg, with New Zealand, South Africa, Finland)
- The proposals also include changes to prevent the splitting up of construction contracts to fall under the treaty prescribed time periods. The Australia / New Zealand treaty (amongst others) already has a similar provision that aggregates time periods where activities are carried out by associated enterprises

Artificial avoidance of permanent establishment status

The report starts from the position 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 permanent establishment 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 agency arrangements.

The critical change is the scope of the agency PE, often referred to as the "contract concluding" PE. The current OECD Model deems a PE where a person **has, and habitually exercises, an authority to conclude contracts in the name of the foreign enterprise.**

The new Action 7 standard refers to a person who

- **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**

The new standard still covers the case where a person concludes contracts in the name of the foreign enterprise, but has been **significantly widened** by the inclusion of a person who habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the foreign enterprise. This test replaces 'negotiates material elements of contracts' which was included in the previous discussion draft.

Next, there is also a narrowing of 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 vote and value of a company's shares (directly or indirectly more than 50%) or by way of de facto control.

The further change in Article 5(5) is that the role of the agent can create a PE for a foreign enterprise in cases where the contracts are in the name of the agent (ie, not in the name of the foreign enterprise), but the contract with the agent is for:

- the transfer of the ownership of property owned by that foreign enterprise, or that the foreign enterprise has the right to use; or
- the granting of the right to use property owned by that foreign enterprise, or that the foreign enterprise has the right to use; or
- the provision of services by that enterprise

This is particularly relevant to commissionnaires and other forms of undisclosed agency arrangements.

OECD Commentary

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'. 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 foreign enterprise are delivered and where the foreign enterprise routinely approves these transactions'.

The Commentary clarifies the following important aspects:

- the test 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); and
- where an agency permanent establishment is created, it is not the case

that the entire profits will be attributed to the permanent establishment (usual principles for business profits will apply).

Specific activity exemptions

Changes to the Model Treaty will mean that all of the exceptions from creating a fixed place of business permanent establishment for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information, refer Article 5(4)) will only apply where the activity or activities in question is/are **preparatory or auxiliary**, and that is to be determined in relation to the business as a whole. This is to reflect modern ways of doing business, where such activities (previously regarded as preparatory or auxiliary) may now represent a key part of a business' value chain (particularly relevant for supply chains involving digital sales).

The Commentary also includes **an alternative** for countries who 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 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 storing of goods in a bonded warehouse during the custom clearance process would be considered as preparatory and auxiliary.

Fragmentation of activites

The Model Treaty will include a far-reaching **anti-fragmentation rule** that covers situations where activities in a country are 'fragmented' between separate places or across group companies in order to meet the exceptions for activities that are (if considered in isolation) preparatory or auxiliary. Broadly, the proposal prevents the exceptions from applying where there is

- an existing permanent establishment in the local country; or
- 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 in order to circumvent the specific 12-month time period for creating permanent establishments 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 permanent establishment threshold for insurance businesses** in the Model 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 and Permanent Establishments

Further guidance will be issued in respect of the attribution of profits to permanent establishments. 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 permanent establishments, additional guidance is necessary on how the rules will apply to new permanent establishments 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 permanent establishment threshold in tax treaties.

Implications for business

The final report makes wide-reaching changes to the existing threshold for creating a permanent establishment to tax the profits of a foreign company resident. Groups may find that in the future some profits are to be primarily taxed in a different country than is the case under the current rules. The report introduces changes that are intended 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 sales take place.

The existence or otherwise of an agency permanent establishment 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 focusses 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 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 permanent establishment of their principals (although the simultaneous holding of stock locally by a principal is likely to create a permanent establishment 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 goods-in-country 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 non-resident entity. 'At the disposal' is a concept discussed in the Commentary, but does not form part of the Model Treaty wording. Even if the premises are 'at the disposal', then exceptions may be available if limited to **preparatory or auxiliary activities**. 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 may not apply. Companies will need to review their supply chain arrangements on sales and procurement.

Because of the potential impact on commercial arrangements, these changes remain a key area of concern for all businesses. 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 (eg, in relation to business travel by sales people), what is preparatory or auxiliary in the context of the particular 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 permanent establishment threshold is the boundary that allocates primary taxing rights over profits to one country or another, there remains concern that the new definitions will lead, in the transition, 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 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 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 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.

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 permanent establishments (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 permanent establishments, 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 Treaty and treaties in which those provisions are included.

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 permanent establishment threshold are likely from 2017 through the multilateral instrument, unless countries choose to use bilateral protocols to implement change more quickly.

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- The Final BEPS Reports (Part 1: Transfer Pricing), 28 October 2015
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For further details and to register for the webcasts, please go to; http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

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