Tax insights
BEPS Action 7: Preventing the artificial avoidance of PE status

Snapshot

- On 31 October 2014, the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (BEPS), released a Discussion Draft on Action 7 in relation to preventing the artificial avoidance of permanent establishment (PE) status.
- Action 7 is focused on the need to update the OECD tax treaty definition of PE (article 5 in the OECD model treaty) to prevent abuses of the threshold allocating taxing rights for trading activities to different jurisdictions.
- The Discussion Draft provides preliminary but substantive proposals for public analysis and comment.
- The aim of the proposals is to remove the ability of some businesses to escape material taxation in a sales country by contractual arrangements, or so-called "fragmentation."
- Provisions similar to a number of the proposals are already found in some of Australia's tax treaties.
- Comments are invited by 9 January 2015 and, in particular, the OECD is interested in examples of unintended effects.

On 31 October 2014, the OECD, as part of its work on the Action Plan to address BEPS, released a Discussion Draft on Action 7 in relation to preventing the artificial avoidance of PE status. This Action is focused on the need to update the OECD tax treaty definition of PE (article 5 in the OECD model treaty) to prevent abuses of the threshold allocating taxing rights for trading activities to different jurisdictions. As part of this work, the OECD is considering the modernisation of the PE threshold in relation to digital cross-border business, in line with the work on Action 1.

As with other Discussion Drafts on BEPS Actions, the proposals do not represent a consensus view from the G20/OECD governments involved, but are designed to provide preliminary but substantive proposals for public analysis and comment.

Deloitte comments and next steps for business

The work on taxable presence is a key facet of the BEPS project, and one that has potentially far-reaching consequences for both businesses and governments. The aim of the proposals is to remove the ability of some businesses to escape material taxation in a sales country by contractual arrangements, or so-called "fragmentation." Many multinational businesses will need to undertake considerable work in determining whether a PE exists, even in the absence of structures that involve *commissionnaires* or other arrangements designed to limit PEs. In some cases, there will be additional PEs in countries with a corresponding increase in compliance costs. It is likely that there will be more audits by tax authorities seeking to understand the circumstances of a multinational's operations and what this means for potential PEs within their borders.

The PE issue is primarily one of the boundary between different governments and the allocation of taxing rights between countries in relation to trading activities. There is an onus on OECD and G20 governments to make this boundary as clear as possible for businesses and tax authorities to apply successfully, efficiently and appropriately. Concepts such as "engages with specific persons in a way that results in the conclusions of contracts" would benefit from tighter definition. Alongside additional compliance costs, the risk for business is that tax authority challenges for additional tax will lead to more disputes placing more pressure on dispute resolution, or potentially double taxation. For example, where the principal purposes test is proposed as a solution to abuse involving splitting up of contracts, it is essential that there is adequate protection for taxpayers via access to mutual agreement procedures.

Similarly, issues around the attribution of losses to PEs may need to be addressed.

Businesses should consider their structures and supply chains now, and work out how the proposed changes may affect their tax and compliance positions, including whether any double taxation can be relieved through exemption or credit methods. Participation in the OECD's consultation process will help the OECD understand the consequences of the proposals in scenarios not envisaged by the Focus Group working on this Action.

Insurance companies will be justified in thinking that the specific proposal being considered in relation to insurance PEs is a potential re-drawing of the taxing boundary between source and residence countries. It is odd that this appears in the BEPS work given the OECD's stated aims.

Businesses should consider their structures and supply chains now, and work out how the proposed changes may affect their tax and compliance positions.

The Discussion Draft comments that preliminary work suggests that limited changes will be required in relation to transfer pricing and attribution of profits to PEs. We do not agree.

Given the need to ensure a balance between the costs of additional compliance and the amount of tax to be raised in the PE countries it seems essential that the consequences are fully considered. In addition, the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments that sets out the OECD's approach is focused almost entirely on the financial services industry. Parts II-IV deal with specific financial services situations, and Part I, which applies generally, contains many financial services examples. Additional guidance for non-financial services sectors will be essential to ensure a consistent approach by different businesses and different governments.

Proposals for amendments to article 5

Artificial avoidance of PE status through commissionnaire arrangements and similar strategies: The OECD proposes changes to the current rules on dependent and independent agents, which set out when an intermediary creates a PE of a non-resident company. The changes are intended to limit the currently favourable treatment of *commissionnaire* and similar arrangements (as well as potentially limited risk distributors through changes to specific exemptions, below). Activities performed by an intermediary in a sales country that are intended to result in the regular conclusion of contracts by a foreign entity will in future create an agency PE (taxable presence) of the foreign entity. The exception for independent agents remains, but the Discussion Draft proposes tightening the rule to make it clear this will not apply to an agent acting only for a group of companies. The Discussion Draft puts forward four alternative (but similar) proposals to amend the agency PE provisions (paragraph 5 of article 5 of the model treaty). The alternatives are:

A. Proposals to add a reference to contracts for the provision of property or services by the foreign entity where the intermediary "engages with specific persons in a way that results in the conclusions of contracts."

B. Proposals to add a reference to contracts for the provision of property or services by the foreign entity where the intermediary "concludes contracts, or negotiates the material elements of contracts."

C. Proposals to focus on contracts which, by virtue of the legal relationship between the agent and the foreign enterprise "are on the account and risk of the enterprise" where the intermediary "engages with specific persons in a way that results in the conclusion of contracts."

D. Proposals to focus on contracts which, by virtue of the legal relationship between the agent and the foreign enterprise, "are on the account and risk of the enterprise" where the intermediary "concludes contracts, or negotiates the material elements of contracts."

It is difficult to see how in practice the concepts in proposals A and C, in particular, can be determined consistently. In addition, the OECD proposes to strengthen the requirements (paragraph 6 of article 5 of the model treaty) for an agent to be considered "independent" such that it does not create a PE of a foreign entity. The exemption would only apply where the agent is acting on behalf of "various persons" and specifically clarifies that acting "exclusively or almost exclusively on behalf of one enterprise or associated enterprises" will not be sufficient to be considered an independent agent.

Artificial avoidance of PE status through the specific activity exemptions: The OECD proposes changes to the list of exceptions for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, and purchasing) under which a fixed place of business is treated as not creating a PE (paragraph 4 of article 5). This is a proposal to modernise the exemptions for activities, such as warehousing, that would have been considered preparatory or auxiliary when the model tax treaty provisions were originally negotiated. Modern ways of doing business and, in particular, internet sales have made warehousing in the form of sophisticated logistics centres a core part of some businesses' value chains; it is clear that many governments think the current exemption is far too wide. The Discussion Draft discusses possible alternative amendments—a "catch all" approach that will require analysis of businesses' value

chains or a series of more targeted amendments that will remove altogether the application of exemptions for some activities:

E. A catch-all requirement that for the exemption to apply, each specific activity (or the combination of activities) must be of a "preparatory or auxiliary character."

F. An alternative proposal if E is not adopted would be to remove "delivery" from the specific activity exemptions.

G. A further proposal if E is not adopted would be to remove "purchasing goods or merchandising" from being a specific activity for exemption.

H. An alternative to proposal G if proposal E is not adopted would be to remove "purchasing goods or merchandising" and "collecting information" from being specific activities for exemption.

Provisions similar to proposal E have already been adopted by Australia in a number of tax treaties, such as with New Zealand, South Africa and Finland. The explanatory memorandum accompanying the 2010 New Zealand treaty acknowledged that the requirement that all the specified activities be of a "preparatory or auxiliary character" was intended "to prevent the situation where enterprises structure their business so that most of their activities fall within the exceptions with a view to avoiding taxation in that country".

Provisions similar to proposal F can be found in a number of Australia's tax treaties including those with Argentina, India, Indonesia, Norway, Russia and Singapore. The Indian and Indonesian treaties also have a specific paragraph deeming a dependent agent's maintenance of a stock of goods or merchandise from which they make regular deliveries on behalf of an enterprise of the other Contracting State to give rise to a PE. The Russian tax treaty contains a similar paragraph except there is no requirement that such deliveries be "regular".

As a variation on the complete removal of the term "delivery", Australia's tax treaties with Turkey and South Africa provide specific exclusions for the use of facilities or maintenance of stock solely for only the "irregular delivery" of goods or merchandise. In the Sri Lankan treaty a similar exclusion applies only in relation to the "occasional delivery" of goods or merchandise.

Fragmentation: In addition, the OECD is concerned with situations where activities are "fragmented" into separate PEs of an enterprise or separate PEs of related parties, to permit the argument that each particular PE meets the requirements for activities to be preparatory or auxiliary (paragraph (f)). Two alternative proposals are put forward here:

I. Under this proposal, none of the specific activity exemptions (paragraph 4 of article 5) will apply where "the same enterprise or an associated enterprise" carries on activities, one of the enterprises has a PE (under the provisions of the rest of article 5) and the business activities constitute "complementary functions that are part of a cohesive business operation."

The OECD is concerned with situations where activities are "fragmented" between related parties to meet the requirements for activities to be preparatory or auxiliary.

J. Under this proposal, the specific activity exemptions will not apply as with proposal I and also where the "overall activity resulting from the combination of the activities… is not of a preparatory or auxiliary character" where the activities constitute "complementary functions that are part of a cohesive business operation." Under this option, there is no need for one or other enterprise to have

a PE under the rest of the provisions of article 5.

Splitting up of construction contracts: The OECD is considering proposals to deal with the splitting up of contracts between related parties in relation to the specific 12-month time period for creating permanent establishments for building sites, construction or installation projects (paragraph 3 of article 5) (and also non-OECD model services PE articles for countries that have adopted them). The proposals put forward are as follows:

K. For purposes of determining the 12-month period, activities carried on by associated enterprises will be added to the period of time of an enterprise's activities on site.

L. As an alternative to the specific rule proposed in K, the principal purposes test proposed in relation to preventing treaty abuse under Action 6 of the BEPS Action Plan could be used to address splitting up of contracts. An example would be added to the Commentary on article 5 of the model treaty to illustrate this.

Variations of proposal K have already been adopted by Australia as a means of counteracting contract splitting for the purposes of the application of the PE rules, for example in Australia's tax treaties with Chile, Finland, France, Japan, New Zealand, Norway, South Africa and the United Kingdom. Under these treaties the duration of the relevant activities is determined by aggregating the periods during which activities are carried on in a Contracting State by associated enterprises provided that the activities of the enterprise in that State "are connected with" or "substantially the same as" the activities carried on in that State by its associate. For these purposes the period during which two or more associated enterprises are carrying on concurrent activities is counted only once.

Insurance: The Discussion Draft considers specifically a concern that has been raised that insurance companies may do large-scale business in a country without having a PE. The OECD is considering two alternative approaches here and asks for input on whether re-insurance raises specific concerns related to the avoidance of PE status. The approaches are:

M. A specific PE threshold, similar to that found in the UN model, for insurance companies, "if it collects premiums in the territory … or insures risks situated therein." Re-insurance is excluded from this.

N. Under this proposal, there would be no specific treaty provision for insurance companies, and any issues would be dealt with through the proposed changes to PEs in respect of sales in options A-D, which apply equally to insurance as to other industries.

Profit attribution to PEs and interaction with action points on transfer pricing

This section recognises the need to coordinate the work on thresholds for PEs with the BEPS work on transfer pricing (particularly on interest deductions and other financial payments, intangibles and risks and capital) and the allocation of profits to PEs under existing principles. The Discussion Draft comments that the preliminary work by the OECD to date has not identified substantial changes that would need to be made in relation to the attribution of profits to a PE (although some additions and /or clarifications would be useful). The OECD acknowledges, however, that work on other areas, in particular risks and capital, might involve a reconsideration of some aspects of the existing rules.

Timetable

Comments are invited by 9 January 2015 and, in particular, the OECD is interested in examples of unintended effects. A public consultation meeting will be held at the OECD in Paris on 21 January 2015, for which registration opens on 15 November 2014. The meeting also will be broadcast over the internet.

Given that changes to the definition of taxable presence will require amendments to tax treaties, it may take some time for the final rules to take effect globally. Changes could be made through a multilateral convention, but we also should expect countries to use bilateral protocols to implement quicker change.

Contacts

For more information, please contact

Vik Khanna
Partner
+61 (3) 9671 6666
vkhanna@deloitte.com.au

Peter Madden
Partner
+61 (2) 9322 7449
pmadden@deloitte.com.au

David Watkins
Partner
+61 (2) 9322 7251
dwatkins@deloitte.com.au

Fiona Craig
Partner
+61 (2) 9322 7770
ficraig@deloitte.com.au

Mark Hadassin
Partner
+61 (2) 9322 5807
mhadassin@deloitte.com.au

Claudio Cimetta
Partner
+61 (3) 9671 7601
ccimetta@deloitte.com.au

For further information, visit our website at www.deloitte.com