Deloitte.

10 June 2015
2015/16

Tax insights
Permanent Establishments: BEPS Action 7 and Australian measures

Snapshot

On 15 May 2015 the OECD, as part of the Base Erosion and Profit Shifting ('BEPS') project, released a revised Discussion Draft on Action 7 ('the Discussion Draft') in relation to preventing the artificial avoidance of permanent establishment ('PE') status. The Discussion Draft sets out recommended changes to the OECD model tax treaty based on feedback and consultation on the previous draft and aims to lower the threshold used to determine whether a PE exists.

Shortly before this OECD release, as part of the 12 May 2015 Federal Budget, the Australian Government announced the introduction of a new multinational anti-avoidance law ('MAAL') aimed specifically at structures that are designed to avoid the existence of a PE. We have separately addressed the MAAL below.

The OECD Discussion Draft and the MAAL are directed at tackling a similar issue – however the approaches which have been adopted are very different. The MAAL is to have effect from 1 January 2016 and will therefore apply in advance

of any future treaty changes which seek to incorporate the OECD's recommendations on Action 7 (and Action 6 on treaty abuse).

Australia's move to take unilateral action on this issue, in advance of the BEPS project, runs contrary to the notion of a cohesive and coordinated approach to international tax reform being championed by the BEPS project. The MAAL may also have far-reaching impacts on the manner in which multinationals conducting business in Australia choose to structure their operations. In addition, multinationals face further uncertainty as to whether Australia will in due course adopt the OECD recommendations on Actions 6 and 7 and how such measures would interact with the MAAL.

Introduction

On 15 May 2015, the OECD released a revised Discussion Draft on Action 7 in relation to preventing the artificial avoidance of PE status. This work is focussed on updating the definition of PE 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 modernisation of the PE threshold in relation to digital cross-border businesses, as part of the work on the digital economy (Action 1).

The Discussion Draft identifies specific proposals from the alternatives put forward in an earlier discussion draft (issued on 31 October 2014) and also includes associated commentary.

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 substantive proposals for public analysis and comment.

Article 5 proposals

The Discussion Draft sets out recommended changes to the OECD model tax treaty, with a focus on particular business structures which are causing concern from a BEPS perspective.

Commissionnaire 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, the Discussion Draft proposes changes to the rules on dependent and independent agents, intended to address commissionnaire and similar arrangements by:

- extending the agency PE rules (paragraph 5, Article 5 of the model tax treaty) to include not only a person who habitually concludes contracts but also a person who habitually negotiates the material elements of contracts;
- amending the agency PE rules to extend beyond 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; and
- strengthening the requirements (paragraph 6, Article 5 of the model tax treaty) for an agent to be considered 'independent', such that an entity will not be independent where the agent acts 'exclusively or almost exclusively for one or more enterprises to which it is connected'.

The draft updated commentary on Article 5 of the model tax treaty includes a number of examples to assist with new and uncertain concepts such as "negotiating material elements of the contracts". For example, this would include where a person acts as the sales force for the 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. It 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). 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 distributor arrangements will be addressed

through the work on the transfer pricing of risks and capital (Action 9 of the BEPS Action Plan).

Specific activity exemptions

The OECD proposes to modernise the PE exemptions for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) included in paragraph 4, Article 5 of the model tax treaty by ensuring that each of these specific exemptions only apply where the activity (or activities) in question is preparatory or auxiliary in relation to the business as a whole. This is to reflect modern ways of conducting business, 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 the model tax treaty including further guidance on the meaning of 'preparatory or auxiliary'. It notes, "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 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.

Fragmentation

The Discussion Draft proposes (in a new paragraph 4.1 to Article 5 of the model tax treaty and updated commentary) the creation of PEs where activities in a country are 'fragmented' between one or more 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" (which includes activities of locally resident entities) provided that the activities constitute "complementary functions that are part of a cohesive business operation".

Splitting up of 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 (paragraph 3 of Article 5 of the model tax treaty). The recommendations are set out in the proposed updated 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 (where treaties do not include the principal purposes test) 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

The Discussion Draft proposes no specific PE threshold for insurance businesses in the model tax treaty. Instead, insurance businesses will be treated as for those in any other industry and the general changes proposed to the PE threshold will apply equally to them (unless specific variations from the model tax treaty are negotiated in bilateral agreements between specific countries).

Profit attribution to PEs

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 work on transfer pricing, in particular, intangibles, risk and capital will also need to be taken into account. The OECD has agreed to undertake follow-up work on 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 negotiation of the multilateral instrument that will implement changes to the PE threshold in tax treaties.

Deloitte perspective

The OECD is pressing ahead with changes to the threshold for PE in order to prevent the artificial avoidance of PEs where a company, or group, has significant activity in a local country. 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.

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:

- whether material elements of contracts are being negotiated;
- 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 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.

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.

The G20/OECD will provide further guidance, with appropriate time for analysis, on the principles for attributing profit to permanent establishments by December 2016. This remains a key area to determine what additional profits may be attributed to a wider scope of PE.

Timetable

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 8 October 2015.

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

Australian MAAL

Broadly, **there are seven factors to consider in assessing whether the MAAL may apply to a particular arrangement.**

1. Group with a global turnover greater than AUD 1 billion
2. Supply by non-resident to Australian unrelated customers and related income is booked by non-resident
3. Such income is not attributable to a PE in Australia
4. Activity (e.g. people activity) in Australia by dependent entity
5. "Designed to avoid "a PE
6. Principal purpose to obtain an Australian / foreign tax advantage
7. No tax / low tax entity anywhere in the group, subject to a carveout where:
    a) The activities are not directly or indirectly connected to the relevant supply
    b) There is substantial economic activity

By incorporating the MAAL into Australia's general anti-avoidance provisions, these measures should override the outcomes which would otherwise arise under Australia's bilateral tax treaties. Where the provisions apply, the non-resident would be deemed to have a PE in Australia, to which profits could be attributed. In addition, Australian interest or royalty withholding tax could apply to payments by a non-resident which are attributable to a deemed PE. In this regard, it remains unclear whether reduced rates of withholding tax under bilateral treaties may apply to affected payments.

A detailed discussion of the MAAL can be found in our previous Tax insights (12 May 2015).

Interaction of Action 7 with MAAL

The Action 7 recommendations are intended to reduce the threshold at which a PE is determined to exist. The MAAL can only apply where the supply to Australian customers is not related to an existing PE in Australia. As such, should Australia adopt the Action 7 recommendations, we would expect this to substantially limit the application of the MAAL, as many existing structures are likely to give rise to a PE, bringing them within the scope of Australia's taxing rights, under the OECD proposals.

However, given the differing timeframes for implementation of the MAAL and the Action 7 recommendations, taxpayers may need to consider both the short-term impact of the MAAL, and the longer-term changes proposed by the OECD. This could prove both complex and costly for taxpayers affected in this way

Contacts

For more information, please contact

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

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

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

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

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

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's approximately 195,000 professionals are committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms. Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2014 Deloitte Tax Services Pty Ltd.