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OECD Releases Discussion Draft on BEPS Action 7 – Preventing Artificial Avoidance of PE Status

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In its first release of a paper under the G20/OECD Base Erosion and Profit Shifting (BEPS) Project following release of the seven "deliverables" in September 2014, the OECD on October 31 released a public discussion draft of Action 7, *Preventing the Artificial Avoidance of PE Status* (the Draft). Action 7 will ultimately change Article 5 of the OECD Model Tax Convention (which defines "permanent establishment" (PE)), with the goal of combatting base erosion and profit shifting that might be achieved through, for example, the use of commissionaire arrangements and the specific activity exemptions provided in Article 5(4).[1]

The Draft does not reflect any consensus among the 44 countries participating in the BEPS Project. Instead, it offers 13 options for changes to the text of, or Commentary on, the following provisions of Article 5:

- Paragraphs 5 and 6, the "agency PE" provisions (alternative options A through D, and options M and N)
- Paragraph 4, the "specific activity exemptions" (alternative options E through J)
- Paragraph 3, the 12-month rule (alternative options K and L)

The purpose of this alert is to provide a brief summary of the options put forth in the Draft. These options, if adopted, could significantly limit the treaty protection that taxpayers receive in the course of doing business across borders.

[1] References herein to "Article" and "paragraph" are, unless otherwise specified, to articles and paragraphs of the OECD Model Tax Convention.

I. Agency PEs

A. Paragraphs 1, 2, 5, and 6 of the OECD Model Convention

Article 5(1) generally provides that the term PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on, and Article 5(2) provides that the term includes especially a place of management, a branch, an office, a factory, or a workshop, and a mine, oil or gas well, quarry or any other place for extraction of natural resources.

Paragraphs 5 and 6 of Article 5 (the "agency PE" rules) provide as follows:

> 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has, and habitually *exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise [italics added]*, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.
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> 6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

B. Options for changes to Article 5(5)

The Draft would revise Article 5(5) so that it applies to agents of both "dependent" *and* "independent" status (unless the latter are also described in revised Article 5(6)) and provides four options (options A through D) to replace the words "*exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise*" in paragraph 5. Each of these four options would broaden the scope of agent activities that could give rise to a PE of the enterprise on whose behalf the agent undertakes its activities. The options reflect two different ways of revising the words "*exercises, in a Contracting State an authority to conclude contracts,"* and two different ways of revising the words *"contracts in the name of the enterprise.*" These two possibilities for revising each half of the phrase "*exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise*" can be combined four different ways, thus resulting in the four options referred to above.

With respect to the words "*exercises, in a Contracting State an authority to conclude contracts,"* the Draft proposes replacement either with:

- "engages with specific persons in a way *that results in* the conclusion of contracts" (options A and C; italics added) or

- "concludes contracts, *or negotiates the material elements* of contracts" (options B and D; italics added)

Thus, under either of these approaches, it would no longer be necessary for the agent to conclude contracts for the enterprise in order for the enterprise to have an "agency PE" in the country in which the agent undertakes its activities as agent.

With respect to the words *"contracts in the name of the enterprise*" in paragraph 5, the Draft proposes replacement either with—

- "contracts *a*) in the name of the enterprise, *or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise*" (options A and B; italics added), or

- "contracts *which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise*" (options C and D; italics added).

In either case, the definition of PE would no longer require that the contract negotiated or concluded by, or resulting from the activities of, the agent be *in the name of* the enterprise.

C. Option for changes to Article 5(6)

Each of options A through D would revise Article 5(6) so that it carves certain activities of certain independent agents out of the PE-creating effects of revised Article 5(5). The carve-out would apply where the agent "carries on business in" the treaty country where the enterprise does not reside "as an independent agent acting on behalf of *various* persons" and acts for the enterprise in the ordinary course of that business (italics added). The revised language goes on to specify that where a person acts "exclusively or almost exclusively on behalf of *one enterprise or associated enterprises,* that person shall not be considered to be an independent agent" with respect to these enterprises (italics added). Thus, paragraph 6 if revised as proposed would make it clear that an agent with only one principal (or principals from only one group of associated enterprises) cannot avail itself of the "independent agent" exception from activities that create a PE for its principal.

D. Option for additional agency PE provision (U.N. Model Article 5(6))

The Draft poses the option (option M) of adding a new agency PE paragraph to the OECD Model Convention, solely for *dependent* agents through which insurance enterprises of one treaty country collect premiums or insure risks in the other treaty country (other than with respect to reinsurance). This language is borrowed from the United Nations Model Double Taxation Convention Between Developed and Developing Countries (the U.N. Model). The provision reads as follows:

> Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 6 applies.

The Draft also offers the option (option N) of leaving this language out of the OECD Model and treating the issue as having been adequately addressed by the other options for revising the agency PE provisions of the OECD Model.

II. Specific Activity Exemptions

A. Article 5(4)

Paragraph 4 of Article 5 provides as follows:

> 4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
>
> *a)* the use of facilities solely for the purpose of storage, display *or delivery [italics added]* of goods or merchandise belonging to the enterprise;
>
> *b)* the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display *or delivery [italics added]*;
>
> *c)* the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
>
> *d)* the maintenance of a fixed place of business *solely for the purpose of purchasing goods or merchandise [italics added]* or of collecting information, for the enterprise;
>
> *e)* the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity *of a preparatory or auxiliary character [italics added]*;
>
> *f)* the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that *the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character [italics added]*.

B. Option on preparatory and auxiliary character

Only subparagraphs *e*) and *f*) require that the activities be “of a preparatory or auxiliary character.” Option E would eliminate the italicized passages from those subparagraphs and make a proviso like the one found in subparagraph *f)* a condition of *any* application of paragraph 4. The proviso would read as follows:

> provided that such activity or, in the case of subparagraph *f)*, the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

C. Option on use of facilities or maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of delivery of such goods

The Draft indicates that if option E is not adopted, another option (option F) would be to delete the words "delivery" from subparagraphs *a*) and *b*). The Draft provides an example in which an enterprise maintains a large warehouse at which it employs a large number of employees who deliver goods stored at the warehouse; these goods are sold over the internet. The Draft states that this activity should rise to the level of a PE in the country where the warehouse is located, even though under the current subparagraph *a)* of paragraph 4, this type of activity would be exempted from the definition of a PE.

D. Options on maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information for the enterprise

The "purchasing activities" language in subparagraph *d*) appears to be a vestige of the way in which profits were attributed to PEs before the adoption of the Authorized OECD Approach (AOA). Thus, if option E is not adopted, another option (option G) would be to remove that language from Article 5(4)*d)*. An alternative (option H) would be to remove the entire subparagraph *d)*. This would address the concern that some enterprises attempt to extend the scope of the exception for "collecting information *for the enterprise*" by "disguising what is in reality the collection of information *for other enterprises* by repackaging the information collected into reports prepared for these enterprises."

E. Options on fragmentation of activities between related parties

Paragraph 27.1 of the OECD's Commentary on Article 5 (which addresses paragraph 4 *f*)) states that an enterprise "cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity." The Draft offers two options for applying this principle more broadly to fragmentation among separate associated enterprises.

Both options would add a new restriction (proposed Article 5(4.1)) to Article 5(4). Under both options, the new restriction would read, in part, as follows:

> 4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or an associated enterprise carries on business activities at the same place or at another place in the same Contracting State and
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> * * *
>
> the business activities carried on by the two enterprises at the same place, or by the same enterprise or associated enterprises at

> the two places, constitute complementary functions that are part of a cohesive business operation.

Under both options an additional condition would have to be met in order to make Article 5(4) inapplicable to an enterprise.

The difference between the two options (options I and J) are as follows:

Under option I, proposed paragraph 4.1 would make Article 5(4) inapplicable to an enterprise if and only if it were also the case that "that place or other place constitutes a permanent establishment for the enterprise or the associated enterprise under the provisions of this Article."

Option J is more stringent. Under option J, proposed paragraph 4.1 would make Article 5(4) inapplicable to an enterprise if all conditions set forth in option I are met. But in addition, proposed paragraph 4.1 would *also* make Article 5(4) inapplicable to an enterprise, even if it were *not* the case that "that place or other place constitutes a permanent establishment for the enterprise or the associated enterprise under the provisions of this Article," if in addition to meeting the "complementary functions that are part of a cohesive business operation" test quoted above, "*the overall activity [italics added]* resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or associated enterprises at the two places, *is not of a preparatory or auxiliary character [italics added].*"

Thus, option J would be similar to option I except that it would also deny Article 5(4) benefits where none of the places to which it refers constitutes a PE in itself, but *the combination* of the activities at those places goes beyond what is preparatory and auxiliary.

III. Splitting-up of contracts

A. Article 5(3), service-PE provisions, and the Commentary

Paragraph 3 of Article 5 provides as follows:

> A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

Paragraph 42.23 the Commentary on Article 5 sets forth a service-PE provision which would create a PE where none is created under the OECD Model Convention provisions. This provision reads as follows:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
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> *a)* through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or

b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.[2]

Paragraphs 18 and 42.45 of the Commentary on Article 5 discuss abuses that have arisen in order to avoid crossing the 12-month and 183-day thresholds under treaty language based on these Model provisions. The abuse involves dividing "contracts up into several parts, each covering a period less than 12 months [or 183 days, as the case may be] and attributed to a different company which was, however, owned by the same group." Paragraph 42.45 of the Commentary sets forth an additional treaty provision states may wish to adopt that would deal with this problem in the service-PE context:

For the purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are present and performing such services in that State, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals. For the purpose of the preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States.

B. Options on split-up contracts

The Draft offers two options to prevent enterprises from splitting up contracts to avoid a PE.

The first option (option K) is to add language to Article 5. The additional language would read as follows:

[2] See Article V(9) of the U.S.-Canada Treaty as amended by the protocol signed in 2007.

> For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded,
>
> *a)* where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during periods of time that do not last more than twelve months, and
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> *b)* activities are carried on at the same building site or construction or installation project during different periods of time by one or more enterprises associated with the first-mentioned enterprise, these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.

Option K indicates that if a service-PE provision is included in the treaty, the rule set forth above would need to be adapted in order to apply to that provision as well. Option K also notes that it might be appropriate to have exceptions for cases where it is established that obtaining the benefit of the 12-month rule is not one of the principal purposes for carrying on activities through different enterprises.

Option L would add no language to Article 5, but would rely instead on the general anti-abuse rule proposed as part of Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), and add an example to the Commentary on that rule. The example, set forth as part of option L, is a case in which multiple contracts are entered into by a customer in one treaty country with two separate associated enterprises resident in the other treaty country and, absent other facts and circumstances showing otherwise, it would be reasonable to conclude the one of the principal purposes for the conclusion of the separate contracts is so that each of the associated enterprises can obtain the benefits of Article 5(3) contrary to the object and purpose of Article 5(3).

Conclusion

Comments on the Draft are due by January 9, 2015 and will be made available to the public. The OECD is “particularly interested to learn about specific examples of unintended effects that might result from the options,” as well as examples of “possible avoidance that could result from each option.”

Those who submit comments can speak in defense of their comments at a public consultation meeting on January 21, 2015, in Paris. The public consultation meeting will be open to the public and accessible live over the internet.

The work on Action 7 is scheduled to be completed by September 2015.