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

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On May 15, 2015, the Committee on Fiscal Affairs (CFA) of the Organization for Economic Cooperation and Development (OECD) released a new discussion draft of Action 7, *Preventing the Artificial Avoidance of PE Status* (the 2015 Draft). The 2015 Draft chooses among the multiple-choice options of the original discussion draft of Action 7 (the 2014 Draft) and supersedes the 2014 Draft, but still "does not, at this stage, represent the consensus views of the CFA or its subsidiary bodies." Comment is requested on the 2015 Draft, although no further public consultation meeting on it will be held.

The provisions affected and the options chosen are:

¶ of Article 5 of OECD Model	Topic	**Option Chosen**	**Description**
5, 6	Agency permanent establishments (PEs) in general	B	An agency PE requires conclusion of contracts *or* negotiation of material contract elements, where the contract is in the name of the principal *or* is for property or services of the principal.
5, 6	Agency PEs for insurance	N	No treaty provision.
4	Specific activity exemptions in general	E	No change to the enumerated exceptions, but all are contingent on preparatory or auxiliary character of the overall activity of the fixed place of business.
4	Anti-fragmentation rule for specific activity	J	To constitute a PE in a State, a fixed place in a State need not constitute a PE by itself *if* the "cohesive business operation" carried on by "complementary

	exemptions		functions" of connected parties in the State is not of a preparatory or auxiliary character.
3	Splitting-up of contracts for PE exceptions based on fixed time periods	L	No treaty provision.

In each case, the option is expanded upon via proposed Commentary language, and in some cases is slightly modified. Nothing is provided on the way in which profits should be attributed to agency PEs, or other PEs, that are newly deemed to exist by virtue of the proposed new provisions. The purpose of this alert is to provide a brief summary of the options chosen in the 2015 Draft.

I. Agency PEs

To the brief explanation of option B in the 2014 Draft, the 2015 Draft adds detail in the form of proposed Commentary on Article 5(5) and (6). The 2015 Draft also modifies proposed Article 5(6).

A. Proposed Changes to Article 5(5) and (6)

Today, paragraphs 5 and 6 of Article 5 (the "agency PE" rules) of the OECD Model Tax Convention (the OECD Model) 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*, 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.
>
> 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.

1. Article 5(5)

The 2015 Draft would replace the words "*exercises, in a Contracting State an authority to conclude contracts"* in paragraph 5 with the words "concludes contracts, *or negotiates the material elements* of contracts."

The choice of option B means that "engaging with specific persons in a way that results in the conclusion of contracts" (the language used in options A and C) was rejected as an activity that gives rise to agency-PE status.

The 2015 Draft further would replace the words “contracts in the name of the enterprise” with—

> contracts that are *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.*”

The choice of option B means that the conclusion or negotiation of “contracts which, by virtue of the legal relationship between the agent and the principal, are on the account and risk of” the principal (the language used in options C and D), was rejected as a way to define the scope of contracts the conclusion or negotiation of which could give rise to agency-PE status.

2. Article 5(6)

Like all the 2014 options, the 2015 Draft would revise Article 5(5) so that a PE could arise based on the activities of an “independent” agent (as well as a “dependent” agent), *unless* the independent agent is described in the first sentence of revised Article 5(6). All of the 2014 options would deny the current-law benefits of independent agency if the agent (1) is not “acting on behalf of various persons,” or (2) “acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises.” The 2015 Draft, by contrast, excludes an otherwise independent agent from favorable treatment under Article 5(6) only if it “acts exclusively or almost exclusively on behalf of one or more enterprises to which it is *connected*” (emphasis added). The 2015 Draft defines “connected person” based on 50-percent-or-greater common ownership (by vote and value) or “if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.”

B. Proposed changes to the Commentary on Article 5(5) and (6)

1. Proposed Commentary on Article 5(5)

Unlike the 2014 Draft, the 2015 Draft contains proposed new Commentary language on agency PEs. It would add 12 new paragraphs to the Commentary on Article 5 (new ¶¶ 32.1 to 32.12). The proposed revised Commentary would provide, among other things, that:

- a contract may be considered “concluded” in a particular State (e.g., an offer may be accepted in a State) even if it is not “signed” in that State (¶32.4);

- it is sufficient for a contract to be considered as concluded in a particular State if the key provisions of a contractual relationship have been determined in such State, even if the contract is subject to further approval or review outside the state (¶32.5);

- the “material elements” of a contract may vary, but typically include “the determination of the parties” and “the price, nature and quantity of the goods or services to which the contract applies” (¶32.5);

- the object and purpose of paragraph 5 is "to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise" (¶32.6);

- the phrase "concludes contracts or negotiates the material elements of contracts" applies to a person that "acts as a sales force of the enterprise and, in doing so, makes or accepts contractual offers even if standard contracts are used for that purpose" (¶32.6).

Proposed ¶32.6 of the Commentary provides the following example to illustrate the application of Article 5(5):

> RCO, a company resident of State R, distributes various products and services worldwide through its websites. SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO's employees promote RCO's products and services and are responsible for large accounts in State S; these employees' remuneration is partially based on the revenues derived by RCO from the holders of these accounts. When one of these account holders agrees to purchase a given quantity of goods or services promoted by an employee of SCO, the employee indicates the price that will be payable, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO's contracts, including the fixed price structure used by RCO, which the employee is not authorised to modify. When concluding that contract online, the account holder is offered a choice of payment options. In this example, SCO's employees are negotiating the material elements of the contracts that are concluded with RCO. The fact that SCO's 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 of the contracts is limited to convincing the account holder to accept these standard terms.

2. Proposed Commentary on Article 5(6)

The 2015 Draft proposes to remove existing ¶37 from the Commentary on Article 5(6). Paragraph 37 provides that a person will come within the scope of Article 5(6) only if "he is independent of the enterprise both legally and economically."

The proposed Commentary also provides:

- It is not the case that Art 5(6) "will apply automatically where a person acts for one or more enterprises to which that person is not connected. . . . Independent status is *less likely* if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are connected to each other) over the lifetime of that person's business or over a long period of time. Where, however, a person is acting exclusively for one enterprise, to which it is not connected, for a short period of time (e.g. at the beginning of that person's business operations), it is possible that paragraph 6 could apply. All the facts and circumstances would need to be taken into account to determine whether the person's activities constitute the carrying on of a business as an independent

agent" (¶38.6, emphasis added).

- "Where, for example, the sales that an agent concludes for enterprises to which it is not connected represent less than 10 per cent of all the sales that it concludes as an agent acting for other enterprises, that agent should be viewed as acting 'exclusively or almost exclusively' on behalf of connected enterprises" (¶38.7).

- The concept of a "person connected to an enterprise" is distinct from the concept of "associated enterprises" which is used for the purposes of Article 9; "although the two concepts overlap to a certain extent, they are not intended to be equivalent" (¶38.8).

II. Specific Activity Exemptions

The 2015 Draft would impose a "preparatory or auxiliary" condition on *any* use of Article 5(4), and would adopt the broader of the two "anti-fragmentation" proposals from the 2014 Draft.

A. Proposed "preparatory or auxiliary" condition for application of 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 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;
>
> *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 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*;
>
> *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*.

The 2015 Draft eliminates the italicized passages set forth above and makes a proviso like the one found in subparagraph *f)* a condition of *any* application of paragraph 4. The proviso reads 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."

B. Proposed change to Commentary on Article 5(4)

The 2015 Draft proposes adding an example to ¶22 of the Commentary in which an enterprise resident in one country, and which sells online to customers in the other country, maintains "a very large warehouse" in the second country in which a "significant" number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in the second country. The proposed Commentary states that Article 5(4) should not prevent these activities from being a PE in the country where the warehouse is located because, "being an essential part of the enterprise's sale/distribution business, [they] do not have a preparatory or auxiliary character."

Another example in the proposed Commentary indicates that after adding the "preparatory or auxiliary" proviso to Article 5(4), the place-of-purchase exception of Article 5(4)(*d)* "typically will not apply in the case of a fixed place of business used for the purchase of goods or merchandise" to prevent it from being a PE "*where the overall activity of the enterprise consists in selling these goods*" (¶22.5).

Proposed ¶22.4 of the Commentary adds an example of a stock of goods belonging to an enterprise resident in one country that is maintained by a toll manufacturer in the other country for purposes of processing by that toll manufacturer. This will not constitute a PE of the nonresident enterprise under any paragraph of Article 5, unless the enterprise is allowed unlimited access to a separate part of the facilities of the toll manufacturer for the purpose of inspecting and maintaining the goods stored therein. If such unlimited access is allowed, then Article 5(4)(*c) will* be relevant, and *an analysis must be done* as to whether or not the maintenance of that stock of goods by the resident enterprise constitutes a preparatory of auxiliary activity of the nonresident enterprise. No conclusion is reached in the proposed Commentary on this point).

A more unambiguously favorable example in the proposed Commentary under Article 5(4)(*d)* provides that where an investment fund sets up an office in a State solely to collect information on possible investment opportunities in the State, "the collecting of information will be a preparatory activity" and the office will therefore be deemed not to be a PE (¶22.6).

C. Anti-fragmentation rule

The 2015 Draft adds a new restriction (proposed Article 5(4.1)) on claiming the benefits of Article 5(4):

> 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 a connected enterprise carries on business activities at the same place or at another place in the same Contracting State and
>
> *a)* that place or other place constitutes a permanent establishment for the enterprise or the connected enterprise under the provisions of this Article, or
>
> *b)* the overall activity resulting from the combination of the activities

carried on by the two enterprises at the same place, or by the same enterprise or connected enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or connected enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

This is the less favorable of the two 2014 options, and is illustrated in proposed Commentary language. One of the examples set forth in the proposed Commentary (see ¶30.3, Example B) provides as facts:

> RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse.

The example concludes that Article 5(4.1) "prevents the application of the exceptions of paragraph 4 to the warehouse." It will not be necessary, therefore, to determine whether Article 5(4)(*a)* applies to the warehouse. "The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions that are part of a cohesive business operation (i.e. storing goods in one place and selling these goods through another place)."

III. Splitting-up of Contracts

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.[1]

[1]Similarly (in terms of setting a fixed time period that separates PEs from non-PEs), ¶42.23 of 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
>
> *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

The Commentary on Article 5 discusses abuses that have arisen in order to avoid crossing the 12-month threshold. The abuse involves dividing "contracts up into several parts, each covering a period less than 12 months and attributed to a different company which was, however, owned by the same group."[2]

The 2015 Draft adopts the option of adding no language to Article 5, but relying instead on the general anti-abuse rule (the Principal Purpose Test or PPT rule) proposed as part of Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*), and adding an example to the Commentary on that rule.

The proposed Commentary describes 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).

In addition the 2015 Draft proposes that the Commentary set forth a treaty provision to be used in treaties that do not include the PPT rule or as an alternative provision to be used by countries concerned with the splitting-up-of-contracts issue. The alternative provision is based on the option in the 2014 Draft to insert language on this point directly into the OECD Model, with the following modifications:

- replace the concept of "associated enterprises" with the concept of "connected enterprises" (based on the definition of "person connected to an enterprise" proposed for the purpose of Article 5(6));

- add a minimum time threshold (30 days) under which the provision could not apply;

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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. *See,* e.g., Article V(9) of the U.S.-Canada Treaty as amended by the protocol signed in 2007.

[2]Paragraph 42.45 of the Commentary sets forth an additional treaty provision which 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.

- restrict the application of the rule to cases where the enterprises perform “connected activity.”

Factors to be considered in the determination of whether activities are connected would include especially:

- whether the contracts covering the different activities were concluded with the same person or related persons;
- whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;
- whether the activities would have been covered by a single contract absent tax planning considerations;
- whether the nature of the work involved under the different contracts is the same or similar;
- whether the same employees are performing the activities under the different contracts.

IV. Conclusion

Comments on the 2015 Draft are due by June 12, 2015 and will be made available to the public. The work on Action 7 is scheduled to be completed by September 2015. Only after that time will follow-up work on the attribution-of-profits issues related to Action 7 be carried out. The plan seems to be to provide the necessary attribution-of-profits guidance before the end of 2016 (the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7).
