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BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

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 status. This Action is focused on the need to update the OECD tax treaty definition of permanent establishment ('PE') (Article 5 in the OECD model treaty) in order 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 Business Next Steps

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 permanent establishment exists, even in the absence of structures that involve *commissionaires* 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 issue of permanent establishment is primarily one of the boundaries 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 permanent establishments 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.

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.

Singapore perspective

In a Singapore context, as Singapore is a popular choice to host a regional headquarter / hub location in Asia Pacific, these developments are likely to be of particular relevance if implemented. Where groups have restructured their business models such that functions, assets and risks including intellectual property are centralised in Singapore and are outside the source country, the local PE risk may be heightened. Going forward, these groups may face increased PE challenges in other jurisdictions where they operate.

Presently, from a domestic perspective, the IRAS generally adopts the position that no further profit is attributable to a dependent agent in Singapore of a foreign enterprise as long as the dependent agent is remunerated on an arm’s length basis. There is currently no indication that Singapore will change this position in light of this discussion draft.

With the exception of very early double tax agreements (DTAs), Singapore has substantially adopted OECD Model provisions in her DTAs. As such, any revisions to Article 5 of the OECD MTC, including accompanying guidance and commentary, are likely to be persuasive in the interpretation of Singapore's treaties.

Proposals for Amendments to Article 5 of the OECD Model Treaty

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 permanent establishment 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 of the model treaty). 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 key 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.

In addition, the OECD is concerned with situations where activities are 'fragmented' between related parties in order to meet the requirements for activities to be preparatory or auxiliary. Two alternative proposals are put forward here:

I. Under this proposal the specific activity exemptions will not 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**'.
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 of the model treaty) (and also non-OECD model services PE articles for countries that have adopted them). The proposals put forward are as follows:

K. For the 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.

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 permanent establishment (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 will also be broadcast over the internet.

Given that changes to the definition of taxable presence will require amendments to double 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 should also expect countries to use bilateral protocols to implement quicker change.

Find out more

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