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Permanent Establishments

Todd Izzo, Cassie McCormick and Maggie Reilly of Deloitte Tax examine the more subjective permanent establishment standard embodied in recent OECD base erosion and profit shifting guidance, as well as implications for multinational groups. ''Businesses will need to react, and may need to alter their legal structure, information reporting systems, and warehouse and logistic arrangements to address these important changes,'' the authors write.

A More Subjective Permanent Establishment Standard

By Todd Izzo, Cassie McCormick and Maggie Reilly

The permanent establishment (PE) concept is foundational to the system of international taxation. By internal law in some countries, and by treaty where a treaty applies, it generally defines the level of presence in a country required to subject a nonresident to taxation in that country.

Typically, treaties provide that profits of an enterprise (i.e., a trade or business) of a resident of one contracting state aren't taxable by the other contracting state unless the enterprise has a PE in that other state, and if it does have such a PE, that the other state may tax only the profits that are attributable to the PE.

Todd Izzo is a partner, Cassie McCormick is a manager and Maggie Reilly is a senior consultant with Deloitte Tax LLP.

In response to concerns that the existing Organization for Economic Cooperation and Development's Model Tax Convention[1] definition of PE, upon which many treaties base their PE definitions, imposes too high a barrier on countries seeking to tax nonresidents, Action 7 of the OECD/Group of 20 Base Erosion and Profit Shifting (BEPS) Project recommends altering the OECD Model PE definition.

As discussed below, these changes include (but are not limited to):

- the modification of the existing agency PE rules (so as, among other things, to treat ''commissionaire'' structures as giving rise to PEs);
- cutting back on the existing PE exceptions for specific activities; and
- the introduction of a new anti-fragmentation rule.

These changes will lead to a more subjective application of the PE concept, which may introduce far greater uncertainty to the taxation of cross-border business activity. Businesses will need to react, and may need to alter their legal structures, information reporting systems, or warehouse and logistics arrangements to address these important changes.

[1] OECD (2014), Model Tax Convention on Income and on Capital, OECD Publishing, Paris (hereinafter, OECD Model).

Background

In comparison to Action 7, the OECD Model as last updated in 2014 defines PE using relatively objective standards. The main determinants of a PE, as defined in Article 5 of the OECD Model, are:

- a fixed place of business at the disposal of the enterprise; or
- a dependent agent that has and habitually exercises an authority to conclude contracts in the name of the enterprise.

Exceptions are provided for specified activities, and any other activity of a preparatory or auxiliary character.

An example of a fixed place of business is an office in the headquarters of S, a newly acquired subsidiary company of parent P, which an employee of P is allowed to use to ensure that S complies with its contractual obligations to P. According to the Commentary on Article 5 of the OECD Model, the office, if at the employee's disposal for a sufficiently long period of time, constitutes a fixed place of business of P.[2]

Even if an enterprise doesn't have a fixed place of business outside its country of residence, a PE may be imputed to the enterprise through actions outside its country of residence by its dependent agent (an ''agency PE'' or ''dependent agency PE'' (DAPE)). (The term ''dependent'' agent is shorthand for an agent that isn't ''of an independent status''—the latter being an agent who is independent of the enterprise both legally and economically, and who acts in the ordinary course of his or her business when acting on behalf of the enterprise.)

Under the OECD Model, activities that create an agency PE are limited to activities of a dependent agent that has and habitually exercises an authority to conclude contracts in the name of the enterprise; the Commentary states that this language applies equally to an agent who concludes contracts that are binding on the enterprise even if those contracts aren't actually in the name of the enterprise, and that lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent.

Article 5 of the OECD Model also specifically lists certain business activities that although carried on through a fixed place of business, aren't substantial enough to give rise to a PE. In most relevant part, these exceptions include the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery, or for the purpose of processing by another enterprise.

BEPS Action 7

The OECD on Oct. 5, 2015, published 13 final reports on the 15 ''actions'' of the BEPS Project. The final report on Action 7 recommends:

- expanding the definition of an agency PE;
- imposing a ''preparatory or auxiliary character'' requirement on every specified activity that the OECD Model excludes from PE treatment; and
- introducing an anti-fragmentation rule to further limit the scope of the preparatory or auxiliary activity exceptions.[3]

Options for Multinationals

Changes reflected in Action 7 of the OECD BEPS Report introduce a more subjective standard for determining whether a permanent establishment exists in a jurisdiction. Options for multinational groups facing this uncertainty include:

- altering legal arrangements to mitigate risk, such as shifting from toll manufacturing to contract manufacturing arrangements;
- limiting income attributable to a PE; and
- limiting activities of employees in order to mitigate risk of establishing a fixed place of business.

Broader Agency PE Rules

First, Action 7 broadens the agency PE rules by moving away from the objective requirement that a dependent agent will create a PE only if the agent is vested with the authority to conclude contracts. In its place, the new standard provides that a dependent agent constitutes a PE of the enterprise when the agent ''habitually plays a principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.''

For example, if a representative of a company solicits and receives orders, which the company approves and ships from its warehouse, the representative may be considered to have a principal role in leading to the conclusion of contracts even though the representative didn't actually enter into or negotiate the terms of the contract. If a distributor's employees play a principal role in directing customers to purchase products from its principal's website, leading to the conclusion of contracts, the distributor may be treated as an agent and consequently create a PE.

Specifically, if Company Z sells its products through a website and a wholly owned subsidiary located in a State X persuades customers in State X to buy Company Z's products, even though X's employees don't officially conclude the contracts, X's employees are playing a principal role in the contract negotiation, and even though the sale is executed through the website, a PE may be recognized.

[2] See also *Creole Prod. Servs. Inc. v. Stavanger Municipality* (Stavanger Co. Ct., 1981) (U.S. company found to have established a PE on a Norwegian drilling platform as their employees were permitted to use an office on the drilling platform).

[3] OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report, OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en (hereinafter Action 7). Action 7 also addresses the splitting up of contracts between group companies to circumvent the specific 12-month time period for creating PEs for building sites and construction or installation projects. A discussion of this Action 7 modification is outside the scope of this Article.

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A PE need not exist where a person merely promotes and markets goods or services of an enterprise in a way that doesn't directly result in the conclusion of contracts. If a pharmaceutical company's representatives promote the company's products to doctors who don't contract with the company, the representatives' activities need not be viewed as directly resulting in the conclusion of contracts even if they lead to an increase in prescriptions written for, and sales of, the products. The way in which persuasion or negotiation is defined for the purpose of an agent entering into a contact is an element of Action 7 that seems to be open to various forms of interpretation.

Importantly, these agency changes apply not only to selling agents, but also to purchasing agents, because under Action 7, not all purchasing activities are considered to be of a preparatory or auxiliary character. If an enterprise is engaged in the purchase of goods, and employs a dependent agent that plays a principal role leading to the conclusion of the purchasing contract, such agent may create a PE for the enterprise.

Commissionaire Creates PE

Second, the changes recommended by Action 7 are designed to end the ability to do business through commissionaire arrangements without creating PEs where the commissionaires are located. A commissionaire arrangement permits a person (i.e., the commissionaire) to contract to sell products in its own name, but on behalf of another party (i.e., the enterprise). The commissionaire acts on behalf of the enterprise, but doesn't create enforceable rights and obligations between the enterprise and the customer.

Prior to Action 7, this arrangement generally allowed an enterprise to sell products in certain countries outside its residence country without such activities giving rise to a PE outside its residence country.

Under its revised dependent agency rule, Action 7 effectively creates a PE for the enterprise under a commissionaire arrangement, since the commissionaire ''habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification'' by the enterprise.

Auxiliary, Preparatory Exemption Limited

Third, Action 7 limits the exemption from PE status for any specific activity or combination of activities to those activities that are of a preparatory or auxiliary character. In order to have a preparatory or auxiliary character, such activity can't be ''an essential and significant part of the activity of the enterprise as a whole.''[4] Generally, if the overall purpose of the fixed place of business is ''identical to the general purpose of the whole enterprise,'' then such activity won't be considered to have a preparatory or auxiliary character.[5]

For example, if an enterprise of State R maintains a very large warehouse in State S, in which a significant number of employees work for the main purpose of storing and delivering goods that the enterprise sells online to customers in State S, then such activities constitute an essential part of the enterprise's sale/distribution business and therefore don't have a preparatory or auxiliary character.[6]

Although this example provided in Action 7 is relatively clear, auxiliary and preparatory ''to the business as a whole'' can be a challenging concept to rely on with a high degree of comfort in a variety of taxpayer situations. For example, in the case of inventory held for sale to customers, the timely delivery and logistical management of finished products can form a critical function. Determining when these functions are preparatory or auxiliary to the business as a whole will present a challenge in many cases.

Importantly, the preparatory or auxiliary requirement doesn't modify the general fixed place of business aspect of the PE definition. If an enterprise's goods or merchandise are maintained by another person in facilities operated by the other party and the enterprise doesn't have the facilities at its disposal, then the place where the stock is maintained can't be a PE of the enterprise.[7]

Suppose, for example, that an independent third-party logistics company operates a warehouse in State S, and continuously stores there goods or merchandise belonging to an enterprise of State R. Generally, the warehouse doesn't constitute a fixed place of business of the enterprise of State R. However, if the logistics company grants the enterprise unlimited access to a specific part of the warehouse for the purpose of inspecting and maintaining its goods or merchandise stored there, then these activities could potentially constitute a PE of the enterprise, depending on whether or not they constitute a preparatory or auxiliary activity.[8]

Auxiliary and preparatory ''to the business as a whole'' can be a challenging concept to rely on with a high degree of comfort in a variety of taxpayer situations.

The same standard appears to apply in the context of inventory held at an unrelated toll manufacturer.[9]

By limiting the application of specified activities exceptions to instances where the activity doesn't form an integral part of the taxpayer's business, adoption of the Action 7 recommendations will force taxpayers to either apply this subjective test to every such activity, or to determine whether the place at which the activity occurs is at the taxpayer's disposal.[10] To avoid PE status under the Action 7 recommendations, supply chains may need to be redesigned to, for example, eliminate

[4] Commentary at ¶ 24; accord, Action 7 at 30.
[5] Action 7 at 30.
[6] Id. at 31.
[7] Id. at 32.
[8] Id.
[9] Id. at 32-33.
[10] For example, in addition to the Norwegian case discussed above, see Rev. Rul. 56-165, 1956-1 C.B. 849 (a Swiss resident established a U.S. PE through the presence of logging equipment in the U.S. for the purpose and expectation that orders would be obtained for such equipment) and contrast *Toronto Blue Jays Baseball Club v. Minister of Fin. (Ontario)*, 2005 D.T.C. 5360 (Ont. CA), where the court held that locker rooms and other facilities utilized by a Toronto team in non-Ontario venues weren't fixed places of business since the team lacked a sufficient exercise of control over the premises to establish a fixed place of business.

group members' fixed places of business outside their countries of residence.

Anti-Fragmentation Rule

Fourth, Action 7's new anti-fragmentation rule further limits the specific activity exceptions by reference to the activities of all closely related enterprises[11] carrying on activities in the same country, assuming that the activities ''constitute complementary functions that are part of a cohesive business operation.''

Requiring an assessment of the activity of related persons in determining PE status represents a fundamental change in how multinational groups typically have assessed PE risk.

For example, RCO, a resident of State R, manufactures and sells products. RCO wholly owns SCO, a resident of State S. SCO obtains products from RCO, which it sells in its store in State S. There is also a small warehouse in State S, which RCO owns and where RCO stores some products that are identical to those displayed in the store owned by SCO. When a customer buys a product from SCO, the SCO employees go to the warehouse owned by RCO and take possession of the product before delivering it to the customer (the ownership is only acquired by SCO from RCO when the product leaves the warehouse). The business activities carried on by RCO at its warehouse and by SCO at its store are complementary functions that are part of a cohesive business operation.[12]

Thus, the normal specific activity exceptions can't prevent the warehouse from being a PE of RCO in State S, even if RCO's warehouse activity is, by itself, preparatory or auxiliary. RCO's activities in State S and SCO's activities in State S need to be viewed in total.

Again, the new anti-fragmentation rule only makes the specific activity exceptions inapplicable, and doesn't modify the general fixed place of business requirement for existence of a PE. In the example above, the fact that the warehouse is owned by RCO establishes a fixed place of business in State S. If the warehouse were instead owned and operated by SCO as opposed to RCO, and RCO employees didn't have the warehouse facilities at their disposal, then RCO need not be treated as having a State S PE.

A member of a group of companies may find it difficult, however, to establish that the facilities of another member aren't at the disposal of the employees of the first member. Carefully designed internal group rules and regulations regarding access to facilities owned by a group member would be required, at a minimum, to establish that such facilities aren't at the disposal of employees of other group members.

Arguably, the same standard could also apply in the context of inventory held at a related toll manufacturer. Consider the example above where goods belonging to RCO, an enterprise in State R, is maintained by a toll manufacturer located in State S for the purposes of processing by that toll manufacturer, the fixed place of business isn't at the disposal of RCO and there is no PE where the goods are maintained.

On the other hand, if RCO is allowed unlimited access to inspect or oversee the conversion of the goods in a separate part of the facility, then these activities could potentially give RCO a fixed place of business in State S. If the toll manufacturer is closely related to RCO, this place can be a State S PE of RCO, even if it is otherwise of a preparatory or auxiliary character.

U.S. multinational groups may face some tension where they are claiming that RCO is viewed as the manufacturer of the goods for Subpart F purposes, where RCO employees would need to perform the manufacturing functions without having facilities at the toll manufacturer treated as at their disposal.[13]

Income Attributable Standard

If an enterprise of a contracting state is deemed to have a PE in the other contracting state, the latter may generally tax the enterprise's income deemed attributable to such PE. The OECD in July released for comment a discussion draft of additional guidance on the attribution of profits to PEs,[14] taking into account the changes to the PE definition made by Action 7.

Generally, income is attributable to a PE under transfer pricing standards. The discussion draft provides guidance through the form of examples on how the new OECD transfer pricing guidelines in Actions 8-10 impact the attribution of profits to a PE.

In order to determine the profits attributable to the DAPE, it is necessary to determine and deduct an arm's-length reward to the dependent agent for the services it provides to the enterprise.

The discussion draft focuses on two typical fact patterns that benefit from additional guidance on the attribution of profits:

[11] For purposes of the anti-fragmentation rules under Article 4, entities are considered closely related enterprises ''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 . . . for example where a person or enterprise . . . possessed directly or indirectly more than 50 per cent of the beneficial interests in the enterprise.'' See Action 7, Article 4, paragraph 30.3.

[12] Action 7 at 41 (''Example B'').

[13] See Treas. Reg. Section 1.954-3(a)(4)(iv), which provides for the substantial contribution test, pursuant to which related-party sales won't qualify as foreign base company sales income (and thus not give rise to Subpart F income) if the party selling the product substantially contributed to its manufacture. Treas. Reg. Section 1.954-3(a)(4)(iv)(b) lays out a list of factors that may be taken into account for purposes of determining whether a controlled foreign corporation satisfies the substantial contribution test, including (1) oversight and direction of the activities or process; (2) activities considered to be part of, but not satisfying, the physical manufacturing definition; (3) selection of materials or vendors, control of raw materials, work-in-process or finished goods; (4) management of manufacturing costs or capacities; (5) control of manufacturing related logistics; (6) quality control; and (7) developing (or directing use or development) of product design and design specifications.

[14] Public Discussion Draft, BEPS Action 7, Additional Guidance on the Attribution of Profits to Permanent Establishments, July 4, 2016.

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■ dependent agent PEs, including those created through commissionaire and similar arrangements; and

■ warehouses as fixed place of business PEs.

For example, where an enterprise has a PE in a host country due to the activities of a dependent agent (a DAPE), the host county generally has the right to tax two different persons, the dependent agent (typically, a resident of the host country) and the enterprise (a nonresident of the host country). In order to determine the profits attributable to the DAPE, it is necessary to determine and deduct an arm's-length reward to the dependent agent for the services it provides to the enterprise.[15]

In the warehousing example, two scenarios are discussed. If warehousing is the core business of the enterprise, then the profits of the PE should reflect the reward for the economic ownership of the asset as well as the routine functions performed at the warehouse.[16] If warehousing is simply an internal function of the business, the warehouse should be viewed as a cost center and therefore the PE shouldn't attract a portion of third-party revenues, but instead should be calculated as a return on the investment in such asset.

Conclusion

Overall, the changes recommended by the 2015 final report on Action 7 of the BEPS Project introduce a more subjective PE standard that in turn may provide more uncertainty and risk for companies with cross-border operations.

The changes to the rules around dependent agents move away from relatively clear guidance by reference to the authority to conclude contracts to a subjective test by reference to a principal role leading to the routine conclusion of contracts without material modification.

With respect to the ownership of inventory, the previously clear guidance that ownership of inventory held for sale or held for processing doesn't constitute a PE has been significantly altered. Groups must determine whether the inventory ownership activity forms an integral part of the taxpayer's business, taking into account the activities of all closely related enterprises under the new anti-fragmentation rule. These changes will lead to an increased reliance on the rules regarding what does or doesn't constitute a fixed place of business.

Faced with this PE uncertainty, multinational groups will be forced to consider several options. Groups could look to alter their legal arrangements to mitigate the risk that an enterprise in the group has PEs in nonresident countries.

For example, shifting from toll manufacturing to contract manufacturing arrangements would shift inventory ownership to the manufacturer and may limit the risk that the enterprise has a PE in the country where the manufacturer operates. This shift would likely involve operational changes and changes to accounting information systems.

Alternatively, a group could decide that an enterprise in the group must be treated as having PEs in nonresident countries, and then seek to manage the income attributable to the PEs. This approach will generally mean that the enterprise needs to file tax returns in the countries where the PEs are deemed to exist—an approach that may lead to increased audit activity and controversy.

Finally, a group could seek to monitor and limit the access of the enterprise's employees to facilities of group members in other countries, to mitigate the risk of establishing fixed places of the enterprise's business in countries outside the enterprise's residence country.

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[15] Id. at ¶ 18 (citing Article 7 of the OECD Model and Section D.5 of Part I of the 2010 OECD Report on Attribution of Profits to a PE).

[16] Id. at ¶ 93.