OECD – BEPS Action Plan 7: Discussion Draft on preventing artificial avoidance of permanent establishment status

14 November 2014

Background

The Organisation for Economic Co-operation and Development (OECD) launched an Action Plan on Base Erosion and Profit Shifting (BEPS) in July 2013. OECD had identified 15 specific actions considered necessary to prevent BEPS and in that direction, on 31 October 2014, the OECD has released a Discussion Draft on Action 7 for preventing artificial avoidance of Permanent Establishment (PE) status. Action 7 calls for the development of changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS through the use of commissionnaire arrangements and the specific activity exemptions. The Focus Group on the Artificial Avoidance of PE Status, which was set up in order to carry out the work on Action 7, discussed various aspects of the PE definition that could give rise to BEPS concerns. This Discussion Draft discusses the strategies identified by the Focus Group and includes the options that it examined.

Commissionnaire arrangement

The Discussion Draft defines a commissionnaire arrangement as an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise which is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without having a PE to which such sales may be attributed for tax purposes. Since the person that concludes the sales does not own the products that it sells, it cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission).

The Focus Group has discussed various alternative formulations of Article 5(5) and 5(6) of the OECD Model Tax Convention that would reflect the policy without allowing the types of avoidance strategies that have taken place under the current wording of the Article. The following are four alternative proposals that the Group is currently considering (Option A-D).

In current situation, under Article 5(5) of the OECD Model Tax Convention, a person acting on behalf of a foreign enterprise having ‘authority to conclude contract in the name of the enterprise’ forms a PE of the foreign enterprise.

1 http://www.oecd.orgctp/treaties/discussion-draft-action-7-prevent-artificial-avoidance-pe-status.htm
Option A suggests to replace the words ‘conclude contracts’ by ‘engages with specific persons in a way that results in the conclusion of contracts’ to strengthen the requirement of ‘independence’. This option also suggests to cover situations where conclusion of contract are in the name of enterprise or 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 for the provision of services by that enterprise.

This Option addresses situations where contracts are not formally concluded by the intermediary who is acting on behalf of the enterprise but where that intermediary’s interactions with specific persons result in the conclusion of contracts. This would include not only cases where the contract is concluded by the intermediary but also cases where the intermediary habitually interacts with identifiable persons in a way that directly results in the conclusion of contracts.

Option B is similar to Option A except it suggests to replace the words ‘conclude contracts’ by ‘concludes contracts, or negotiates the material elements of contracts’. It addresses situations where contracts are not formally concluded by the intermediary who is acting on behalf of the enterprise by introducing the alternative test of an intermediary who concludes contracts or who negotiates the material elements of contracts.

Option C suggests to replace the phrase ‘contracts in the name of the enterprise’ by ‘contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise’ and to replace ‘conclude contracts’ by ‘engages with specific persons in a way that results in the conclusion of contracts’.

This option is similar to Option A except that it addresses the difficulties arising from the phrase ‘contracts in the name of’ by replacing that phrase by ‘contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of’.

The ‘specific activity exemptions’ is a list of exceptions included in Article 5(4) of the OECD Model Tax Convention, according to which a PE is not deemed to exist where a place of business is used solely for activities that are listed in such article.

Option E suggests to amend Article 5(4) so that all its subparagraphs i.e. activities listed therein are subject to a ‘preparatory or auxiliary’ condition.

The word ‘delivery’ in Article 5(4)

If option E (under which activities listed in Article 5(4)(a) to (d) would be subject to the condition of being of a ‘preparatory or auxiliary’ character) is not adopted, it would be possible to address BEPS concerns specifically related to Article 5(4)(a), (b) and (d) through the following three options:

The first option would address concerns arising from the reference to ‘delivery’ in Article 5(4)(a) and 5(4)(b). The Discussion Draft provides that it is difficult to justify the application of these exceptions


3 According to these subparagraphs, the term ‘permanent establishment’ is 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.

© 2014 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.
where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online (the said exception would only apply, however, as long as these goods are owned by the enterprise). The word ‘delivery’ is absent from the corresponding provisions of the United Nations (UN) Model Convention. However, some countries regard the omission of the expression in the UN Model Convention as an important point of departure from the OECD Model Convention, believing that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country.

Further adding an overall condition of ‘preparatory or auxiliary’ to Article 5(4) (as proposed under option E) would address any perceived problem with the word ‘delivery’ so that the word ‘delivery’ could be kept.

However, if option E is not adopted, Option F suggests to remove the term ‘delivery’ from Article 5(4)(a) and (b).

The exception for purchasing goods or merchandise or collecting information

Another change that could be made if option E was not adopted relates to Article 5(4)(d), according to which the term PE is deemed not to include the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise.

Assuming that there is no need to have a special rule for ‘mere purchase’ as regards the attribution of profits, the question arises as to what would otherwise justify a specific exception to the PE threshold for purchasing activities.

The Focus Group concluded that adding an overall condition of ‘preparatory or auxiliary’ to Article 5(4) (as proposed under option E) would address any perceived problem with the exception related to purchasing activities so that this exception could be kept in subparagraphs 5(4)(d). If, however, option E is not adopted, another option i.e. Option G suggest to remove the reference to purchasing activities from 5(4)(d).

The Option G would retain the current exception applicable to collecting information for the enterprise. Concerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises.

A broader alternative to option G is Option H which would address such concerns which suggests to delete the whole Article 5(4)(d).

Fragmentation of activities between related parties

Paragraph 27.1 of the OECD Commentary on Article 5 currently deals with the application of Article 5(4)(f) in the case of what has been referred to as the ‘fragmentation of activities’. It provides that Article 5(4)(f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of Article 5(4)(a) to (e) provided that they are separated from each other locally and organizationally. In such a case each place of business has to be viewed separately and in isolation for deciding whether a PE exists. Places of business are not ‘separated organisationally’ where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another, etc.

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.

Logic of the last sentence i.e. 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 should not be restricted to cases where the same company maintains different places of business in a country but should be extended to cases where these places of business belong to related parties.

The Option I suggest to change preamble of Article 5(4) as ‘Notwithstanding the preceding provisions of this Article and subject to paragraph 4, the term ‘permanent establishment’ shall be deemed not to include:……..’. The new Article 5(4.1) would deny the application of the exceptions of Article 5(4) where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or by associated enterprises at different locations. For the rule to apply, a group of associated enterprises must have at least one fixed place of business that satisfies the PE threshold in a Contracting State.

---

4 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
a) that place or other place constitutes a permanent establishment for the enterprise or the associated enterprise under the provisions of this Article, and
b) the business activities carried on by the 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, 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.
Alternatively, the Discussion Draft suggests Option J. This option is similar to option I except for the fact that it also applies where none of the places to which it refers constitutes a PE but the combination of the activities at the same place or at different places go beyond what is preparatory or auxiliary.

Splitting-up of contracts

The splitting-up of contracts in order to avoid the exception in Article 5(3) is discussed in paragraph 18 of the OECD Commentary on Article 5. It provides that the twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

The splitting-up of contracts in order to avoid the existence of a PE is also a concern with the application of service-PE provisions, such as the alternative provision found in paragraph 42.23 of the Commentary on Article 5 and in Article 5(3)(b) of the UN Model. Paragraph 42.45 of the OECD Commentary on Article 5 addresses this issue and includes an alternative anti-abuse provision that may be included in treaties that include a service-PE provision. As indicated in that paragraph, legislative or judicial anti-avoidance rules may apply to prevent such abuses. Some States, however, may prefer to deal with them by including a specific provision in the Article.

The Focus Group concluded that BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by Article 5(3) could be addressed either by the general anti-abuse rule (i.e. the ‘Principal Purposes Test’ rule) proposed as a result of the work on Action 6 or by a more ‘automatic’ rule that would take account of any activities performed by associated enterprises.

The Option K

The Option K follows the ‘automatic’ approach put forward in paragraph 42.45 of the Commentary on Article 5.

In order to avoid the splitting-up of contracts using enterprises of different States, the provision applies regardless of where the associated enterprise is resident.

One difficulty with this approach is that it applies, for instance, to an enterprise of State A that sends specialists for only a few days to a construction site in State B where most of the work is done by a local subsidiary. A possible solution to that problem would be to add a minimum period of presence (e.g. 30 days in any twelve month period) that an enterprise would need to satisfy for the rule to apply to that enterprise. Another solution would be to add an exception such as ‘... unless it is established that obtaining the benefit of paragraph 3 is not one of the principal purposes for carrying on these activities through different enterprises’.

The opening words of Option K ‘For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded’ emphasise the limited scope of the rule, which does not affect the attribution of profits.

Alternatively, the Discussion Draft provides option L. Option L suggests that no specific rule for the splitting-up of contracts would be added to Article 5 but this issue would be dealt with through the addition of an example in the Commentary on the principal purposes test rule proposed in the report on Action 6. This solution would only address cases where the splitting-up of contracts is tax-motivated, thereby excluding situations where there are legitimate business purposes for the involvement of associated enterprises in the same project.

Insurance

Paragraph 39 of the OECD Commentary on Article 5 suggests that insurance companies may do large-scale business in a State without having a PE in that State. According to the definition of the term PE an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business or if it carries on business through a person.

Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a PE in the other State if they collect premiums in that other State through an agent established there, other than an agent who already constitutes a PE or insure risks situated in that territory through such an agent.

---

1 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

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,

2 If a service-PE provision is included in the treaty, the rule would need to be adapted in order to also apply to that provision.

© 2014 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Article 5(6) of the UN Model provides that an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a PE 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.

Some countries, however, favour extending the provision to allow taxation even where there is representation by such an independent agent. They take this approach because of the nature of the insurance business, the fact that the risks are situated within the country claiming tax jurisdiction, and the ease with which persons could, on a part-time basis, represent insurance companies on the basis of an “independent status”, making it difficult to distinguish between dependent and independent insurance agents. On the other hand, some other countries see no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. They also point to the difficulty of ascertaining the total amount of business done when the insurance is handled by several independent agents within the same country.

The Focus Group concluded that the two alternative approaches could be adopted in order to deal with BEPS concerns related to the artificial avoidance of the PE threshold in relation to insurance activities. Option M provides that an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a PE 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.

This provision is found in many treaties with some variations. It can be seen as merely extending the scope of the agency-PE rule by providing that the collection of premiums and the insurance of risks through a person other than an agent of independent status results in a PE even if insurance contracts are not concluded by that person.

Alternatively, Option N suggests no specific rule for insurance enterprises would be added to Article 5 and the issue of insurance enterprises would be dealt with through the more general changes proposed to Article 5(5) and 5(6) [Option A to D].

**Profit attribution to PEs and interaction with Action Points on Transfer Pricing**

BEPS concerns around the PE rules (outside the digital economy issues) relate primarily to situations where one member of the Multinational Enterprises (MNE) group is shielded from tax by the technical operation of the PE rules and is allocated a large share of the relevant group income (e.g. by virtue of assuming or being allocated business risk, of holding valuable assets, etc.).

Whilst there are a number of different ways of approaching these issues, they cannot be addressed successfully without coordination between the work on the PE status mandated by Action 7 and some other Actions.

This is why the wording of Action 7 emphasises that the question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE. Whilst that preliminary work has identified a few areas where additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a PE if the proposals included in this note were adopted. It was acknowledged, however, that the work on other parts of the BEPS Action Plan, in particular Action 9 (Risks and capital), might involve a reconsideration of some aspects of the existing rules and guidance.

**Our comments**

This is a first draft of OECD on Action 7 for preventing artificial avoidance of PE status. This Discussion Draft has given various options to prevent artificial avoidance of PE Status. These options are mainly related with commissionnaire arrangements, preparatory or auxiliary activities, splitting-up of contracts, PE in case of insurance business and fragmentation of activities between related parties. These options suggest solutions to issues faced by various countries in relation to profit shifting by the multinational enterprises by use of Article 5 dealing with PE.