OECD holds public consultation on BEPS Action 7 on permanent establishment

Executive summary

On 21 January 2015, the Organisation for Economic Co-operation and Development (OECD) held a public consultation in connection with the Base Erosion and Profit Shifting (BEPS) project that was focused on Action 7 on preventing the artificial avoidance of permanent establishment (PE) status. The consultation was an opportunity for stakeholders to engage directly with the OECD Secretariat and the country delegates who are responsible for the work on this Action.

Detailed discussion

On 31 October 2014, the OECD issued a discussion draft on Action 7 on preventing the artificial avoidance of PE status (the Discussion Draft). The Discussion Draft sets forth 14 proposed options (Options A through N) for modifying the PE rules in Article 5 of the OECD Model Tax Convention which generally would lower the threshold for finding a PE and eliminate exemptions from PE status. The OECD received over 800 pages of comments on the Discussion Draft, which are posted on its website.

The 21 January 2015 consultation was a dialogue among stakeholders, country tax officials, and the OECD Secretariat on key issues and concerns raised in the comments. The consultation was hosted by OECD Working Party 1, which has responsibility for the OECD’s work on tax treaty matters. This working group also has responsibility for other BEPS Actions, including the work on preventing treaty abuse (Action 6) and on improving dispute resolution (Action 14), which were the subject of public consultations during the same week.

Delegates from 19 countries participated in the consultation. Also participating were business representatives from around the world, including EY representatives, and representatives of non-governmental organizations (NGOs). The session was live-streamed by the OECD and a recording will be available on the OECD website.
Opening remarks and general comments

The consultation began with opening remarks from the UK delegate who chairs the working group, who stressed that the options described in the Discussion Draft do not represent the consensus views of the participating countries. He indicated that the working group will meet in March and will issue a revised draft in the spring that will contain firmer proposals. The Chilean delegate who chairs the Action 7 focus group further noted that the Discussion Draft reflects more divergence in views than a typical OECD discussion draft. She stressed the importance of the work being undertaken and stated that maintaining the status quo in this area is not possible.

Business commentators expressed the view that the current PE rules have worked well for the past 50 years, providing a level of certainty and stability that facilitates cross-border trade and investment. Three main observations were made. First, any rule which would make it easier to establish the presence of a PE would almost certainly increase the substantive and administrative costs for cross-border transactions. Second, if the PE rules are to be changed, it is crucial that the new rules are clear and well understood as the rules that they replace. Any ambiguity in new PE rules would inevitably create disputes between countries and increase the risk of double taxation. It was also noted that this would be exacerbated if substantial progress is not made on the work on dispute resolution under Action 14. Third, concerns were expressed that the proposed options implicate the balance between source and residence country taxing rights which is not part of the BEPS project; any revisiting of this balance should be discussed directly rather than through the proxy of the PE rules.

Business commentators also noted that changes to the PE threshold in Article 5 would impact other articles in the OECD Model Tax Convention and would have implications beyond corporate income tax, including impact on valued added tax (VAT).

Commissionnaire and similar arrangements (Options A through D)

The Discussion Draft includes four options (Options A-D) that would modify Articles 5(5) and 5(6) of the OECD model tax convention to address the PE standard related to commissionaire and similar arrangements.

In general, commentators expressed concern about how Options A-D might apply because of the general and subjective nature of the language used in the proposals and the lack of defined terms. Options A and C would extend the inquiry beyond an agent’s direct conclusion of contracts to the agent’s “engagement with specific persons in a way that results in the conclusion of contracts.” These options were criticized as potentially broad enough to be viewed as implicating virtually any distribution relationship.

Although some of the terms used in Options B and D are undefined (for example, the reference to “material elements of contracts”), some commentators saw Option B as something that might potentially be workable if further revised and clarified. Another commentator thought that Option D, which describes the activity as habitual conclusion of contracts, or the negotiation of material elements of contracts, that are on the account and risk of the enterprise, might be an option that should be considered because of the reference to the legal relationship between the parties.

Rather than proposing Options A-D, some commentators suggested that the OECD should define “commissionaire” so that any new test might be more objective. There was also a suggestion to define commissionaire by reference to civil law codes. In response to this suggestion, the OECD Secretariat asked how this approach would work in common law jurisdictions that do not have such a concept. With respect to these options, commentators further asked what was meant by the reference to “similar arrangements.”

Several commentators highlighted the need for the working group to continue its study of these options in the context of profit attribution. In particular, practitioners shared experiences of countries asserting PE status only to ultimately conclude that there was little or no profit attributable to such PE. Given the consequences of finding a PE (including the administrative costs, return filing obligations, and
potential civil and criminal penalties for failure to file), participants stressed the need to evaluate profit attribution in the context of the new proposed rules. The US delegate invited more comments about the attribution of profits issue, indicating that this is something that the working group had tried to take into account in the options included in the Discussion Draft.

Many of the commentators further criticized the element of Options A-D that would amend Article 5(6) to narrow the definition of independent agent.

An NGO representative stated that there was widespread concern that multinational enterprises could fragment their activities and avoid PE status, which in turn would mean a competitive advantage when compared with smaller enterprises. On this basis, the representative viewed Options A-D as justified. Any suggestion that there should be different PE standards for large and small business was rejected by many other participants, who stated that it did not make sense to draw such distinctions and that the goal ought to be to produce clear, precise rules for companies of all sizes.

**Specific activity exemptions (Options E through H)**
The Discussion Draft includes several options (Options E-H) that would amend the exemption for “preparatory or auxiliary” activities in Article 5(4) of the OECD Model Tax Convention. Commentators widely expressed the view that any of the options proposed would extend PE status to situations where BEPS is not a concern and taxable presence is not warranted. This could create great uncertainty for business and increase compliance and controversy costs. Commentators also expressed the need for more clarity, including better examples, on how these options would apply.

Some commentators expressed a preference for option E, which would amend Article 5(4) so that all the activities listed in that paragraph would be subject to a “preparatory or auxiliary” condition. However, it was indicated that more clarity on the meaning of such term would be needed.

Many commentators expressed their opposition to the option that would eliminate “delivery” from the activities listed in Article 5(4).

Concerns were also expressed by commenters regarding the difficulties in valuing and determining profit attribution with respect to the activities that would create a PE under the proposed restrictions of the Article 5(4) exemptions, in particular profit attribution for activities related to delivery, warehousing and collection of information.

**Fragmentation of activities (Options I and J)**
The Discussion Draft includes two options (Options I and J) that would address concerns about the potential for contracts to be split up to avoid the 12-month threshold for certain PEs under Article 5(3). Commentators expressed the view that these options do not meet the principles of simplicity, certainty, and foreseeability, which are critically important in the PE context. Concern was expressed about the automatic approach of Option K. Commentators indicated that finding a PE should require that a determination be made that the division of the contract was artificial. Some expressed a preference for Option L which would involve addressing any issues in this area through application of the general anti-abuse rule (the so-called principal purpose test) that is proposed in connection with Action 6 (addressing treaty abuse).
Special rule for insurance (Options M and N)
The Discussion Draft includes two options (Options M and N) related to whether or not the OECD Model Tax Convention should be amended to add a special rule for insurance businesses under which collection of premiums or insurance of risks in a country through any person other than an independent agent would create a deemed PE. Commentators objected to the Option M deemed PE proposal, expressing concern about the singling out of the insurance industry. They noted that agents do not make decisions on whether to accept risk or manage it, which are the key functions in an insurance business. Commentators further noted that today the PE standard for tax purposes is quite similar to the applicable regulatory standard and that keeping this alignment is important. The presence of premium taxes was also referenced. Country delegates expressed different views on Option M. The German delegate noted the limited role of an insurance agent and favored continued application of traditional PE principles. The Indian delegate expressed the view that risk assessment happens in the local country. The Chilean delegate noted that free trade agreements can limit countries’ ability to impose premium taxes. The OECD Secretariat expressed interest in how the regulatory construct for insurance businesses implicates the PE question.

Attribution of profits issues
The final section of the consultation focused on the attribution of profits implications of the PE options and these issues also were raised by commentators throughout the day. Two specific questions with respect to profit attribution were raised. First, if the definition of a PE were to be changed, what amount of profit would be attributable to the new PE? Second, would the amount of extra profit justify the burdens associated with the finding of a PE?

Commentators stated that the current rules on profit attribution, the Authorized OECD Approach (AOA) included in Article 7 of the OECD Model Tax Convention, require further clarification, specifically with regard to attribution of profits to a dependent agent PE. Commentators also suggested that some of the perceived BEPS issues could be dealt with through the sound application of transfer pricing principles, rather than the proposed changes to the PE standard. Commentators indicated that any decision to lower the PE standard should not be made without considering the attribution of profits implications, the extra compliance burden on businesses, and the potential controversy that could arise.

Commentators also stressed that there should be no force of attraction of profits. This is particularly relevant for multinationals with different business units. The fact that one unit could be found to have a PE should not lead to the conclusion that profits of other business units that have somewhat similar units could be allocated to such PE.

Concluding comments
The OECD Secretariat concluded the consultation by highlighting three broad messages. First, the need for clear rules was noted. Second, the questions of whether the options would create PEs for marginal activities and whether that would be appropriate will be considered. Third, the relevance of profit attribution in the policy proposals regarding the PE standard will be considered.

In terms of next steps, the working group will meet in March to further consider the Discussion Draft and the comments received. It is intended that a revised draft will be issued in the spring and that stakeholders will have an opportunity to submit written comments.

Implications
The discussion at the consultation underscored the significant impact that the proposed changes to the PE standard would have on global businesses. Moreover, countries already are focusing on PE issues, even in advance of any changes in treaty rules related to PE. Thus, it is important for companies to keep informed of developments in this area in the OECD and in the countries in which they operate, to assess the implications of these developments for their business models, and to consider actively engaging with policymakers in this international tax debate.

Endnote
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