Permanent establishments

Recent trends and developments
<table>
<thead>
<tr>
<th>Moderator</th>
<th>Panel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tom Philibert</td>
<td>Albena Todorova</td>
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<tr>
<td>Partner</td>
<td>Catherine Mbogo</td>
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<td>EY Senegal</td>
<td>East Region Tax Leader</td>
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<td>EY Kenya</td>
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<td>Akinbiyi Abudu</td>
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<td>Director</td>
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<td>EY South Africa</td>
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<td>EY Nigeria</td>
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</tbody>
</table>
Agenda

► Action 7 overview
► Revised permanent establishment proposals
► Profit attribution
► Updates from across the African continent
► What should you do next?
Article 7
“Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”

Article 5(1)
“… the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

Article 5(3)
“A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.”

Article 5(4)
Exemption for specific activities (e.g., storage, display or delivery of goods) and activities that are preparatory or auxiliary in nature.

Article 5(5)
“Where a person, other than an independent agent, has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, the enterprise is deemed to have a permanent establishment in that State.”
Organization for economic cooperation and development (OECD) concern about potential for companies to engage in Base erosion and profit shifting (BEPS) activity by entering into “arrangements that artificially avoid the occurrence of Permanent Establishments (PE’s).”

Aim of Action 7

“Develop changes to the PE definition to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and specific activity exemptions. Work on these issues will also address related profit attribution issues.”

Coordination required with work on:

- Action 4 (interest deduction)
- Action 8 (intangibles) and
- Action 9 (risk and capital)

Consider profit attribution when changing PE definition.
Stage 1: Drafting, discussion, consultation and publishing final deliverable with changes to Article 5 of the OECD Model Treaty and Commentary

- Discussion draft 31 Oct 2014
- Public consultation Jan 2015
- Revised discussion draft May 2015
- Expected final deliverable Sept 2015*

* Attribution of profits: work will continue and guidance is expected to be issued before the end of 2016.

Stage 2: Adoption by countries in one of the following ways

<table>
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<th>Changes adopted through a treaty</th>
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<td>Bilaterally</td>
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<tr>
<td>Multilaterally</td>
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When does it come into force?

- Depends on the length of time to negotiate the bilateral agreement and subsequent domestic law procedures to ratify the treaty so that it enters into force in each country.

- Depends on the length of time to negotiate the multilateral instrument and subsequent domestic law procedures to ratify the treaty so that it enters into force in each country (note Action 15).
## Action 7 overview

**Overview of revised discussion draft**

<table>
<thead>
<tr>
<th>Areas of focus</th>
<th>Significant changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Commissionaire (and similar arrangements)</td>
<td>Expansion of Art. 5(5) by lowering the threshold for finding PE and tightening independence criteria in Art. 5(6)</td>
</tr>
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<td>2. Specific activity exemptions</td>
<td>Narrowing scope of PE exemptions in Art. 5(4)</td>
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<td>3. Fragmentation of activities</td>
<td>Anti-fragmentation provision whereby preparatory or auxiliary exemptions would not apply to a place of business maintained by the enterprise or a connected enterprise in specific circumstances</td>
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<td>4. Splitting up of contracts (projects where activities are carried out by several connected entities)</td>
<td>Application of general anti-abuse rules or, alternatively, aggregation of time spent on connected activities (to be included in the commentary)</td>
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<td>5. Insurance</td>
<td>Addressed through more general changes proposed to Art. 5(5) and Art. 5(6)</td>
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Revised permanent establishment proposals
Commissionaire and similar arrangements
Commissionaire is a commercial structure in civil law jurisdictions:
- Commissionaire acts in “its own name,” but on behalf of the principal

What is the OECD’s stated concern?
- Example in the Revised Discussion Draft illustrates a case involving a business restructuring:
  - Prior to the restructuring, products were sold in State Y by a company resident in State Y and a member of the same multinational group as the principal
  - Lack of a PE means that profits from sales in State Y are taxed where the principal is resident (i.e., State X), whereas the commissionaire is taxed on the difference between the commission fee received and its expenses in State Y
- The Revised Discussion Draft proposes to modify Article 5(5) and Article 5(6), effectively lowering the PE threshold
Changes to Art. 5(5) will lower the threshold for creating a PE by expanding the scope as follows:

**Art. 5(5)**

Person acting on behalf of an enterprise habitually concludes contracts, or negotiates the material elements of contracts that are

**BEFORE**
Actual conclusion of contracts required to create a PE

**AFTER**
Enterprise deemed to have a PE when a person acting on behalf of the enterprise habitually concludes contracts or negotiates material elements of contracts
Proposed commentary elaborates on the meaning of the phrase “concludes contracts:”

- Contracts may be concluded without any active negotiation of the terms where standard terms of a contract are accepted
- Contracts may be concluded in a state even if signed outside that state

Proposed commentary elaborates on the meaning of the phrase “negotiates material elements of contracts:”

- Aimed at situations where contracts are essentially negotiated in a given state but are subject to formal conclusion, or possibly further approval, outside that state
  - For example: Solicitation and receipt of orders that are sent directly to a warehouse from which goods are delivered and where the enterprise routinely approves these transactions
- May treat the contract as concluded in a state if the key ingredients of the contract have been determined in that state
  - “Material elements” may vary but would include price, nature and quantity of the goods and services
Article 5(5) also applies to contracts that create obligations that will effectively be performed by the foreign enterprise rather than the person contractually obliged to do so:

For example, contracts concluded by a commissionaire in its own name whereby, because of the arrangement between the foreign enterprise and commissionaire, the foreign enterprise would directly transfer to the third-party ownership or the use of property that it owns or has the right to use.

In contrast, when a person concludes contracts on its own behalf and, in order to perform under the contract, obtains goods or services from another enterprise, that person is not acting on behalf of that enterprise nor selling property that is owned by the enterprise:

For example, low-risk distributor that sells to customers products that it buys from other enterprises.
Modify the independence requirement in Art. 5(6)

Delete explicit examples of agents of independent status: ‘broker and general commission agent’

Art. 5(5) activities do not give rise to a PE if carried out by an independent agent acting in the ordinary course of its business.

A person that acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected shall not be considered independent.

All facts and circumstances would need to be considered to determine whether a person is independent when acting on behalf of one or more unrelated enterprises.

**BEFORE**

Depending on the facts and circumstances, an agent acting on behalf of a related enterprise could be considered as an independent agent.

**AFTER**

A person acting exclusively or almost exclusively on behalf of one or more enterprises to which it is connected* shall not be considered independent.

*In general, a person is “connected” to an enterprise if it possesses at least 50% of the beneficial interests in the other or if a company has at least 50% of the aggregate vote and value of shares of the other company or the beneficial equity interests. De facto control is also considered.
The proposed commentary clarifies that Article 5(6) requires that the person must be carrying on a business as an independent agent and be acting in the ordinary course of that business.

Where a person's activities on behalf of the enterprises to which it is not connected do not represent a significant part of that person's business, that person would not qualify as an independent agent:

- For example, where the sales that an agent concludes for enterprises to which it is not connected represent less than 10% 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.

Interaction with Article 5(7):

- It is possible that a subsidiary will act on behalf of its parent company in such a way that the parent will be deemed to have a permanent establishment under paragraph 5:
  - For example, a subsidiary acting exclusively or almost exclusively for its parent would be unable to benefit from the “independent agent” exception of Article 5(6).
  - Parent-subsidiary relationship, however, does not imply that such relationship is sufficient by itself to conclude that Article 5(5) applies; necessary to evaluate the activities undertaken.
**Before**
If authority to conclude contracts is not habitually exercised: no PE risk

**After**
The mere convincing of potential buyers to accept standard terms of a contract without any active negotiation of the contract terms could be considered to come within the phrase “concluding contracts,” thus creating a potential PE risk.

Also, a contract may be considered to be concluded in a state even if it is signed outside that state.

**Before**
Contracts concluded with third party on behalf of the principal but in the name of the agent (such as commissionaire arrangements): no PE risk*

**After**
Commissionaire arrangements could give rise to a PE for the principal.

* In most civil law countries
Revised permanent establishment proposals
Specific activity exemptions and activity fragmentation
Art. 5(4) of the OECD Model Tax Convention allows an entity from State X to undertake specific exempted preparatory or auxiliary activities in State Y without creating a PE in State Y.

Why? This is because preparatory or auxiliary activities were generally considered non-value adding activities, and therefore little profit would be allocated thereto.

What is the OECD’s concern?

- Specific activity exemptions will be open to BEPS abuse.
- Activities performed in State Y may in fact be value added for the taxpayer’s business – for example:
  - Delivery of goods
  - Purchasing of goods or collecting information
  - Fragmentation of business activities
- Profits that should be taxed in State Y are instead taxed in State X where the taxpayer resident.
Modification to make all activities in Article 5(4) subject to preparatory or auxiliary condition.

What is preparatory or auxiliary?
- Depends on the relative importance of the activity when compared with the business of the enterprise as a whole.
- Expanded anti-fragmentation rule to apply to activities of preparatory or auxiliary character in reference to connected enterprises.
Merely storing a stock of goods belonging to R Co at S Co’s facilities for processing by S Co would not result in a PE for R Co.

If, however, S Co’s facilities are at the disposal of R Co, a PE could be considered to exist under Art. 5(1).

Consider whether Art. 5(4) applies:

Subject to the new anti-fragmentation provision in Art 5(4.1), if R Co is a distributor of products manufactured by other enterprises, the maintenance of a stock of goods for processing by S Co would not form an essential and significant part of R Co’s activity; therefore, the preparatory or auxiliary exemption would apply.
Merely storing a stock of goods at an independent logistics provider would not give rise to a PE for R Co.

If, however, 3PL’s warehouse is at the disposal of R Co, a PE could be considered to exist under Art. 5(1).

Consider whether Art. 5(4) applies:

Subject to the new anti-fragmentation provision in Art 5(4.1), the maintenance of a stock of R Co’s goods by 3PL will not create a PE if it can be shown that this activity is preparatory or auxiliary in character.
The anti-fragmentation provision covers situations where the combined activities of connected persons at the same place or different places in the same country exceed what is considered to be preparatory or auxiliary.

The anti-fragmentation provision applies when activities carried on by 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.
Using the same example in slide 20 but assuming now that:

- R Co and S Co are connected enterprises.
- The place used to maintain its stock of goods for processing is at R Co’s disposal.
- Then subject to the new anti-fragmentation provision in Art 5(4.1), R Co may now have a PE because:
  - R Co and S Co are connected enterprises.
  - The place used by R Co at S Co’s facilities is a PE of R Co because this place is at the disposal of R Co.
  - R Co and S Co’s business activities at the same place are likely to be seen as complementary functions that are part of a cohesive business operation (i.e., storing goods in one place for processing by another).
For example, the facts below would create a PE under new Article 5(4.1) because:

- S Co and R Co are connected enterprises
  - S Co's store is a PE of S Co in State S.
  - The business activities carried on by R Co at its warehouse and by S Co at its store constitute complementary functions that are part of a cohesive business operation (i.e., the storing of goods in one place and the selling of these goods through another place).
### Revised permanent establishment proposals

**Recap of potential impact**

<table>
<thead>
<tr>
<th><strong>Before</strong></th>
<th><strong>After</strong></th>
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<tr>
<td>Warehouse facilities used for storage or delivery of goods: no PE risk</td>
<td>Warehouse facilities used for storage or delivery of goods would be exempted only if the activity of the fixed place of business is of a preparatory or auxiliary character; otherwise, there is a PE risk.</td>
</tr>
<tr>
<td>A purchasing office solely performing purchasing functions: no PE risk</td>
<td>A purchasing office merely performing purchasing functions would constitute a PE where that purchasing function forms an essential and significant part of the enterprise’s overall activity.</td>
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<tr>
<td>Existing anti-fragmentation rule covers only activities undertaken by one enterprise in several locations</td>
<td>A PE may exist if the enterprise or a connected enterprise carries on business activities at the same location, or different locations in the same country, and such activities constitute <strong>complementary functions</strong> that are <strong>part of a cohesive business operation</strong> and, <strong>when combined</strong>, exceed what is preparatory or auxiliary.</td>
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Africa Tax Conference™ 2015
Revised permanent establishment proposals
Contract splitting
Art. 5(3) of the OECD Model Tax Convention provides that a building site or construction or installation project is a PE only if it lasts more than 12 months.

What is the OECD’s concern?

12-month rule is open to BEPS abuse

How? Contracts for construction-type activities can be split up so that they are:
  - Carried out under separate contracts that are allocated to different associated enterprises
  - Over a period of less than 12 months, such that no PE is created.

Profits relating to these construction activities that should be taxed in the source state are instead taxed where the various associated enterprises are tax resident.
Revised permanent establishment proposals
Contract splitting

Two options proposed:

- Include an example to the general anti-abuse ‘principal purpose test’ proposed under Action 6 project
-Aggregate time spent by connected activities at the same project to calculate the 12-month period when each enterprise performs such activities for more than 30 days

**BEFORE**

Construction-type activities carried out under separate contracts by different companies do not create PEs as long as each contract does not exceed 12-month threshold

**After**

Under a general anti-abuse rule, a PE may be deemed to exist if contracts are concluded with a principle purpose of claiming an exemption under Art. 5(3).

Under the alternative proposal, it would be necessary to evaluate the activities carried on by one or more connected enterprises at the same building site, construction or installation project to determine whether they are connected activities that should be aggregated.
According to the example provided on how the principal purpose test would apply, the scenario below would create a PE because:

- Submitted successful bid for construction project
- Project duration 22 months

The principal purpose for the conclusion of the separate contract with Sub Co was for R Co and Sub Co each to obtain the benefit of the 12-month rule in Art. 5(3).

Granting the benefit of that rule is contrary to the object and purpose of Art. 5(3) as the time limitation of this paragraph would be meaningless.

Therefore, time under both contracts should be aggregated.
Revised permanent establishment proposals

Insurance
Scenario:
- Insurance company in State X sells insurance in State Y through Agent Y.
- Agent Y has no authority to conclude contracts for insurance company but collects premiums from the insured on behalf of insurance company.

What is the OECD’s concern?
- Lack of taxable PE nexus means that profits from insurance sales in State Y are taxed in state X where insurance company is resident, while Agent Y is taxed on the difference between the commission fee received and its expenses, e.g., local insurance premium taxes paid in State Y.

Rely on changes proposed to Article 5(5)/(6)
The October 2014 discussion draft stated that BEPS concerns around the PE rules cannot be addressed successfully without coordination between the work on Action 7 and the work on:

- Action 4 (limit base erosion via interest deductions and other financial payments)
- Action 8 (transfer pricing for intangibles)
- Action 9 (transfer pricing for risks and capital)

There was reaction to the October 2014 discussion draft:

- A large number of comments received on the October 2014 discussion draft focused on the attribution of profits to a PE and urged that further work on Article 7 should not proceed without more information on how much additional profits would be captured by lowering the PE threshold.
- Many commentators noted that Article 5 was difficult to apply and the options proposed in the discussion draft would create risks of double taxation, increasing cross-border disputes.
Profit attribution
Profit attribution to PEs and transfer pricing (continued)

The revised discussion draft:
- Indicates that the existing rules of Article 7 would be appropriate for determining the profits of any new PE arising under the proposed options
- It also notes that it was previously acknowledged that there was a need for additional guidance on how Article 7 rules would apply to PEs
- However, the revised draft does not contain any detailed comments or guidance on profit attribution and transfer pricing

The work that is still needed:
- The OECD says work on the attribution of profits to a PE will be continued after September 2015 but cannot be realistically undertaken before work on Action 7 and Actions 8 - 10 have been completed.
- The goal is to provide the necessary guidance before the end of 2016.
Updates from across the African continent
What should you do next?
What should you do next?
If a PE exists, you could face the following issues

1. Potential reporting and transactional mapping errors
2. Accounting, billing and reporting processes may need adjusting
3. Enterprise Resource Planning (ERP) systems may need reconfiguring
4. Incorrect pricing and compensation results in actual cost to business

1. Potential criminal offense (in some countries) for failure to report or register PE
2. Reputational risk arising from media coverage

1. Obligation to register the PE for taxes
2. Obligation to file tax returns (e.g., income tax, Value Added Tax (VAT) and wage tax)
3. Under declaration and payment of income tax and VAT
4. Risk of double taxation
5. (Mis)allocation of profits to PE
6. Potential withholding tax
7. Retroactive VAT or transfer pricing income adjustments
8. Additional interest and penalties
**What should you do next?**

**How to be Action 7 ready**

<table>
<thead>
<tr>
<th>Assess</th>
<th>Do a “sustainability check” of your existing operating model for PE risk:</th>
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<tbody>
<tr>
<td></td>
<td>► Coordinate your approach: consider direct tax, indirect tax, transfer pricing and human capital implications</td>
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<tr>
<td>Quantify</td>
<td>Consider the material impact by quantifying costs of the following risks:</td>
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<tr>
<td></td>
<td>► Direct tax</td>
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<td>► Indirect tax</td>
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<td>► Reputational</td>
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<td>► Regulatory</td>
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<td>► Operational</td>
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<td>► Compliance</td>
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<tr>
<td>Weigh</td>
<td>Consider available options and perform feasibility analyses</td>
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<tr>
<td>Decide</td>
<td>Depending on outcome of feasibility analyses:</td>
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<td>-----------------</td>
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<tr>
<td></td>
<td>► Reinforce existing structure - creation of PE does not automatically mean there will be additional profit that is taxable</td>
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<td>► Change the structure</td>
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<tr>
<th>Manage and Monitor</th>
<th>Prepare guidelines for the business and regularly monitor compliance with these guidelines:</th>
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<tbody>
<tr>
<td></td>
<td>► Review of functional activities</td>
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<td></td>
<td>► Review transfer pricing for these activities</td>
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<td></td>
<td>► Review international travel and relocation of personnel (including numbers of employees, duration of temporary assignments, and other aspects of expatriate assignments)</td>
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<td>► Oversight by internal audit</td>
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</tbody>
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