OECD releases discussion draft on preventing artificial avoidance of PE status under BEPS Action 7

Executive summary

On 31 October 2014, the Organisation for Economic Co-operation and Development (OECD) released a Discussion Draft in connection with Action 7 on the artificial avoidance of permanent establishment (PE) status under its Action Plan on Base Erosion and Profit Shifting (BEPS). The document titled *BEPS Action 7: Preventing the Artificial Avoidance of PE Status* (the Discussion Draft or the Draft) contains fourteen proposed options for addressing arrangements entered into by taxpayers that raise OECD concerns about potential artificial avoidance of PE status. The options generally would lower the PE threshold and tighten the exceptions to PE status set forth in Article 5 of the OECD Model Tax Convention and the related Commentary. In particular, these options address the PE standard related to *commissionnaire* and similar arrangements, modify the preparatory and auxiliary exception to PE status, and address the PE threshold for insurance.

Detailed discussion

The 31 October 2014 Discussion Draft under Action 7 focuses on the OECD’s concerns about the potential for companies to enter into arrangements that would, in their view, artificially avoid the occurrence of PEs and sets forth alternative options for addressing these concerns under Article 5 of the OECD Model Tax Convention. The Discussion Draft notes that the views and options included therein do not represent the consensus views of the OECD’s Committee on Fiscal Affairs or its subsidiary bodies but is intended to provide stakeholders with an opportunity to comment on the proposals before the OECD issues its final recommendations under Action 7 by September 2015. Written comments should be submitted to the OECD on or before 9 January 2015. The OECD has indicated its intention to have a public consultation on the Draft and the comments received on 21 January 2015.
The options discussed in the Discussion Draft are summarized below.

**Commissionnaire arrangements and similar strategies**
The Draft states the view that changes are required to the wording of the dependent and independent agent provisions in paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention in order to address what are considered BEPS strategies involving commissionnaire structures and similar arrangements. The Draft describes a commissionnaire arrangement as an arrangement through which a person sells products in a given country in its own name but on behalf of a foreign enterprise that is the owner of such products. The current wording of Article 5(5) of the OECD Model Tax Convention requires a person acting on behalf of a foreign enterprise to have the “authority to conclude contracts in the name of the enterprise” in order to be considered a PE for the enterprise. The interpretation of this phrase has been the subject of litigation in certain countries in recent years where several courts have decided that because a commissionnaire does not legally bind the foreign enterprise, the commissionnaire did not conclude contracts in the name of the enterprise.

In general, the Draft expresses the view that where an intermediary carries out activities in a country that are intended to result in the regular provision of goods or services by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business.

In this regard, the Draft includes four alternative options (Options A-D) for amending the wording of paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention that are currently being considered by the OECD.

Consistent with the current requirement under Article 5(5), all four options require that a person must act in a country on behalf of the foreign enterprise and undertake certain activities for that enterprise. Each option would, however, modify the independence requirement in Article 5(6) to provide that where a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of paragraph 6 with respect to these enterprises. According to the Draft, the concept of “associated enterprises” used in this new paragraph 6 language is intended to mirror the concept used for the purposes of Article 9 of the OECD Model Tax Convention. Thus, an enterprise would be deemed to be associated with another enterprise if it participates directly or indirectly in the management, control or capital of the other enterprise or if the same persons participate directly or indirectly in the management, control or capital of the two enterprises.

Under Options A and B, a permanent establishment may be deemed to exist in certain circumstances where an intermediary is involved in the conclusion of contracts that results in the provision of property or services by the foreign enterprise. Importantly, the difference between Options A and B relates to the specifics of the involvement of the intermediary in the contract: Option A requires the habitual engagement with specific persons that results in the conclusion of contracts in the name of the enterprise or for the provision of property or services by the enterprise, whereas Option B requires either habitual conclusion of contracts, or the negotiation of material elements of contracts, in the name of the enterprise or for the provision of property or services by the foreign enterprise.

Options C and D focus on the legal relationship between the intermediary and the foreign enterprise and modify the language and objective of the provision to apply to contracts that are “on the account and risk of the enterprise” (rather than contracts “in the name of the enterprise” or for the provision of property or services by the enterprise, as under Options A and B). Option C describes the activity of the intermediary by reference to the habitual engagement with persons that results in the conclusion of contracts that are on the account and risk of the enterprise, whereas Option D describes the activity as either habitual conclusion of contracts, or the negotiation of material elements of contracts, that are on the account and risk of the enterprise. In contrast to Options A and C which would require that the activities of the intermediary result
in the conclusion of a contract in order for a PE to be deemed to exist, under Options B and D, a PE may be deemed to exist when the person habitually concludes contracts or negotiates material elements of a contract.

**Specific activity exemptions**
The Discussion Draft examines various aspects of Article 5(4) that may be considered as potentially giving rise to the artificial avoidance of the PE threshold. Section B of the Discussion Draft sets forth four options that would modify Article 5(4) of the OECD Model Tax Convention relating to the exceptions from PE status for preparatory or auxiliary activities.

The first issue considered in the Discussion Draft is whether all the categories of activities specified in paragraph 4 should be subject to an explicit condition that the activities referenced therein must be of a "preparatory or auxiliary" nature in order for the exception to PE status under Article 5(4) to be applicable. The OECD October 2011 and 2012 discussion drafts on the clarification of the PE definition suggested a change to the Commentary on Article 5 that would have clarified that Article 5(4) applies automatically where one of the activities listed in this paragraph is the only activity carried on at a fixed place of business. However, the Discussion Draft states that some delegates questioned whether such interpretation reflected what they considered to be the original purpose of Article 5(4) (i.e., to cover preparatory or auxiliary activities only).

The Discussion Draft includes a first approach (Option E), as well as three alternative approaches to be considered if Option E is not adopted. Under Option E, Article 5(4) would be amended to make all of the activities listed therein subject to the condition of being preparatory or auxiliary. Stated differently, the activities set forth under Article 5(4) would only be excluded from PE status if such activities are auxiliary or preparatory in nature. In the event that Option E is not adopted, the Discussion Draft proposes three other targeted options, as follows:

- **Remove the reference to “delivery” in Article 5(4)a and (b)**
  The Discussion Draft expresses a concern about the word “delivery,” which is included in Article 5(4)(a) and (b). The Discussion Draft refers to the United Nations Model Treaty, which does not include “delivery” in the exceptions to PE status. The Draft explains that some regard the United Nation Model Treaty’s omission of the word “delivery” as an important departure from the OECD Model Tax Convention, reflecting the view that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of income in the host country. The Discussion Draft notes that adding an overall condition of “preparatory or auxiliary” as suggested in Option E would address any perceived problem with the word “delivery”; however, as an alternative, Option F would delete the word “delivery” (i.e., to exclude delivery activities from the PE exception under Article 5(4) of the OECD Model Tax Convention). Under this option, for example, enterprises resident in State A using facilities in State B for the delivery of goods or merchandise that they own would create a PE in State B. The Discussion Draft notes, however, that the Commentary to the United Nations Model Treaty points out that if delivery activities are treated as giving rise to a PE, issues may arise in connection with the attribution of income to such a PE, which could cause prolonged litigation and result in the inconsistent application of treaties.

- **Delete the exception for purchasing**
  With respect to the purchasing exception under subparagraph d) of Article 5(4), the Discussion Draft reviews the changes that were made to Article 7 of the OECD Model Tax Convention under the Authorized OECD Approach (AOA), which resulted in the elimination of a provision relating to the attribution of profits and purchasing activities. In light of those changes, the Discussion Draft questions whether the purchasing exception under Article 5(4) may continue to be justified. The Discussion Draft suggests that by adding the preparatory or auxiliary condition to all activities listed in Article 5(4) as described in Option E, issues with respect to the purchasing activity exception would be resolved. However, in the event the Option E approach is not adopted, the Discussion Draft suggests Option G that would eliminate the reference to purchasing activities in Article 5(4)(d).
Alternatively, the Discussion Draft proposes Option H that would delete subparagraph (d) of Article 5(4) altogether. In this regard, the Draft states that subparagraph (d) also includes an exception for the collection of information and that there are concerns about the potential for enterprises to try to extend the scope of this exception beyond its intended focus on the collection of information for the enterprise itself.

**Fragmentation of activities between related parties**

Paragraph 27.1 of the OECD Commentary clarifies that an enterprise cannot fragment a cohesive operating business into smaller operations in order to argue that each is merely engaged in preparatory or auxiliary activity. The Discussion Draft expresses the view that the anti-fragmentation rule should take into account not only the activities carried on by the same enterprise at different places but also complementary activities carried on by associated enterprises in different places or at the same place. The Draft sets forth two options in this area. Option I would limit the application 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 this Option I rule to apply, a group of associated enterprises must have at least one fixed place of business that satisfies the PE threshold in a country. Alternatively, the Discussion Draft sets forth Option J, under which a PE could arise even if none of the places of business in a country constitute a PE so long as 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 Discussion Draft reiterates a concern raised in the Commentary to Article 5 of the OECD Model Tax Convention involving situations whereby enterprises divide up contracts in order to avoid a PE. For example, in the context of Article 5(3), contracts could be divided up into several parts, each covering a period less than 12 months and each attributed to a different associated company. The Discussion Draft also points out a similar concern with respect to the application of the service-PE provision described in the Commentary to Article 5.

The Discussion Draft proposes two options to address BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by Article 5(3) of the OECD Model Tax Convention. First, Option K would require aggregating the time spent by associated enterprises at the same building site or construction or installation project in certain cases to determine whether the 12-month threshold is met. Alternatively, the Discussion Draft proposes Option L that would address concerns related to the splitting up of contracts by the inclusion of a general anti-abuse rule (i.e., the “Principal Purpose Test”) proposed as a result of the work on Action 6. The Discussion Draft notes that relying on a general anti-abuse rule addresses 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**

The Discussion Draft references the concern raised in the Commentary to Article 5 of the OECD Model Tax Convention that an insurance company may conduct a significant volume of business in a country without having a permanent establishment in that country. This Commentary further notes that some countries have included provisions in their treaties to address these concerns, but that the decision to include such a provision depends on countries’ factual and legal situations and that therefore it was not viewed as advisable to include such a provision in the OECD Model.

The Discussion Draft also refers to the Commentary to Article 5 of the United Nations Model Treaty relating to insurance companies, which states that because of the nature of the insurance business, insurance companies can conduct business in a country through dependent agents that lack the authority to conclude contracts or through independent agents. The United Nations Model Treaty Commentary also discusses other issues, such as difficulties in determining whether an agent is “independent” or determining the total amount of business when the insurance is handled by several independent agents within the same country.
The Discussion Draft mentions that there are a few examples of insurance-specific PE provisions in some existing bilateral treaties. The Discussion Draft includes two options to modify the PE threshold with respect to insurance. Option M, which is similar to provision included in Article 5(6) of the United Nations Model Treaty, would extend the scope of the agency-PE rule in Article 5(5) by providing that, except in regard to reinsurance, the collection of premiums and the insurance of risks through a person other than an agent of independent status would result in a PE, even if insurance contracts are not concluded by that person. Option N would deal with issues related to insurance through the more general changes proposed with respect to Article 5(5) and (6) discussed above (i.e., Options A through D).

The Discussion Draft acknowledges that it is difficult to determine where profits that represent the remuneration of risk should be taxed. The Draft observes that modifications to the PE threshold would not address cases where the remuneration of risk is shifted through the payment of insurance or reinsurance premiums to an associated enterprise that performs no functions in a country. The Draft states that such issues may be addressed more appropriately through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted through transfer pricing or other special measures, including addressing the deductibility of insurance or re-insurance premiums paid to related parties.

The Discussion Draft specifically invites comments on “the question of whether reinsurance raises specific concerns related to the avoidance of the permanent establishment threshold.”

### Profit attribution to PEs and transfer pricing

The Discussion Draft states 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), and Action 9 (transfer pricing for risks and capital). The Discussion Draft reiterates that the question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE. However, the Draft notes that the OECD 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 options described in the Draft were adopted. The Discussion Draft notes that the work on other parts of the BEPS Action Plan, especially Action 9 (transfer pricing for risks and capital), might involve a reconsideration of some aspects of the existing rules and guidance related to attribution of profits.

### Implications

The Discussion Draft is the first draft of the output to be produced under Action 7 of the OECD BEPS project. The options described in the Discussion Draft, addressing commissionaire arrangements, modifying the preparatory or auxiliary exception, and addressing PE threshold for insurance, if implemented, would significantly modify the current PE thresholds under Article 5 of the OECD Model Tax Convention, thereby potentially creating a taxable presence for companies where none exists today. For example, the taxation of supply chain, distribution functions, and insurance transactions may be impacted under any of these alternative options. The OECD also is expected to address attribution of profit to PEs through the transfer pricing action items, with discussion drafts for these items expected to be released in mid-December 2014.

Companies should evaluate how the proposed options may impact them, stay informed about developments in the OECD and in the countries where they operate or invest, and consider participating in the dialogue regarding the BEPS project and the underlying international tax policy issues.

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**Endnote**

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