

BEPS Action 7: The Attempt to Artificially Create a Taxable Nexus

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FEATURED PERSPECTIVE

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The OECD issued a discussion draft on BEPS action 7 (prevent the artificial avoidance of the permanent establishment status) in October 2014. The draft, which proposes changing the definition of PE in the OECD model treaty to broaden its scope, may have a major impact on global business models and the allocation of taxing rights over business profits.

On October 31, 2014, the OECD released a discussion draft regarding action 7 of the base erosion and profit-shifting action plan (prevent the artificial avoidance of the permanent establishment status) for public consultation. More than 800 pages of public comments have been provided by multinationals, business associations, and other interested parties on the discussion draft that includes proposals for changes to the definition of PE found in the OECD model tax treaty with a view to broaden its scope. The proposals in the discussion draft may have a major impact on global business models and the allocation of taxing rights over business profits.

The main purpose of the PE concept under the OECD model is to determine whether a contracting state has the right to tax the profits of an enterprise that is resident in the other contracting state. According to article 7 of the OECD model, a contracting state cannot tax business profits of an enterprise resident in the other contracting state unless it carries on its business through a PE located in its territory.

There are two types of PEs contemplated by article 5 of the OECD model. The first type is an establishment that is part of the same enterprise and under common ownership and control such as a place of management, an office, and so forth.¹ The second type is an agent who is legally separate from the enterprise but is nevertheless dependent on the enterprise to the point of forming a PE.²

The history of article 7 of the OECD model and the related definition of PE provided in article 5 of the OECD model dates back to the work of the League of Nations in the 1920s.³ From the beginning, the term “permanent establishment” has been at the heart of the discussion on the attribution of taxation rights in tax treaties.⁴ However, there has always been a general tendency to narrow the scope of the PE concept that

¹Articles 5(1)-(4) of the OECD model.

²Articles 5(5) and (6) of the OECD model.

³See Raffaele Russo, “Chapter 2: Historical Development of Article 7 of the OECD Model” in: *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings*, IBFD, 2005, p. 5.

⁴See Hans Pijl, “Agency Permanent Establishments: In the Name of and the Relationship Between Article 5(5) and (6) — Part 1,” *Bull. Int'l Tax'n* (Jan. 2013), p. 3.

can be easily explained with the balanced import and export activities of OECD member countries.⁵

The BEPS action plan calls for developing changes to the PE concept in the OECD model in order to prevent perceived abuses of that threshold. While the main focus of the discussion draft is on commissionaire-type structures, it also considers the PE definition more broadly. This article provides a critical overview of the proposals made in the discussion draft and considers their potential negative impact on cross-border trade and investment.

I. The Role of the PE Concept

The PE concept is important for the allocation of taxing rights over business profits realized by enterprises in a cross-border context. As a rule, a contracting state may tax the profits of an enterprise that is resident in the other contracting state only if it carries on its business through a PE located in its territory.⁶ An overwhelming majority of income derived from cross-border transactions falls into this category.⁷

When dividends, interest, and royalties are paid to an enterprise resident in the other contracting state, articles 10, 11, and 12 of the OECD model (dealing with dividends, interest, and royalties, respectively) restrict the taxing rights of the source state only when the income is not attributable to a PE located in the source state.⁸ In contrast, when such income is derived through a PE in the other contracting state, the host state of the PE has an unlimited primary taxing right.⁹ Moreover, article 11(5) of the OECD model entails a source-deeming rule according to which interest is deemed to arise in the host state of the PE if the indebtedness is connected with the PE and the related interest is borne by the PE.

The PE definition is also relevant in determining which contracting state may tax capital gains under article 13 of the OECD model. Here, article 13(2) of the OECD model allocates an unlimited primary taxing right over capital gains realized upon disposal of movable property forming part of the business property of a PE to the host state of that PE. Article 22(2) of the OECD model uses a similar standard for determin-

ing the right of a PE's host state to impose a capital tax on the movable property of an enterprise of the other contracting state.

When "other income" is realized by an enterprise of a contracting state through a PE located in the other contracting state (for example, dividends, interest, or royalties derived from a third state), article 21(2) of the OECD model provides for the application of article 7 of the OECD model. Hence, the host state of the PE has an unlimited primary right to tax such income. Article 21(2) of the OECD model is consistent with the rules laid down in article 13(2) of the OECD model (capital gains) and article 22(2) of the OECD model (capital) that also deal with taxing rights over "movable property" of a PE.

The concept of PE is further relevant when determining whether a host state may tax an individual employee resident in the other contracting state on his employment income. This is because article 15(2)(c) of the OECD model stipulates that such a taxing right exists regarding remuneration borne by a PE that the employer has in the host state. Evidently, this provision entails serious implications for both the employer and the employee.

The existence of a PE can result in nondiscrimination obligations of the host state of the PE. In this regard, article 24(3) of the OECD model provides that PEs of enterprises of a contracting state should be subject to taxation not less favorable than the taxation of enterprises of the other state carrying on the same activities. Thus, this provision calls for a comparison of the taxation of a PE and that of an enterprise of the host state in the same circumstances.¹⁰

II. Commissionaire Arrangements

A. Overview

Under commissionaire arrangements,¹¹ the distributing entity (the commissionaire) concludes sales contracts with the final customers in its own name but relies on the commissionaire agreement with the principal entity to fulfill its obligations toward the final customer.¹² Although the principal remains generally undisclosed, the commissionaire does not, at any stage, take legal title to the inventory. Instead, goods are delivered directly from the principal entity to the customer. Therefore, the principal entity may, for practical reasons, need to maintain a stock of goods in the state where the commissionaire is located.¹³

⁵*Id.* at p. 12.

⁶See article 5(1) of the commentary on the OECD model; see Oliver R. Hoor, *The OECD Model Tax Convention — A Comprehensive Technical Analysis*, Legitech, 2015, p. 103.

⁷Income from cross-border sales of goods and services falls into the scope of article 7 of the OECD model regardless of whether it is realized through a PE.

⁸Articles 10(2) (dividends), 11(2) (interest), and 12(1) (royalties) of the OECD model.

⁹Article 7(2) in connection with, respectively, articles 10(4) (dividends), 11(5) (interest), and 12(3) (royalties) of the OECD model.

¹⁰See Hoor, *supra* note 6, at 223.

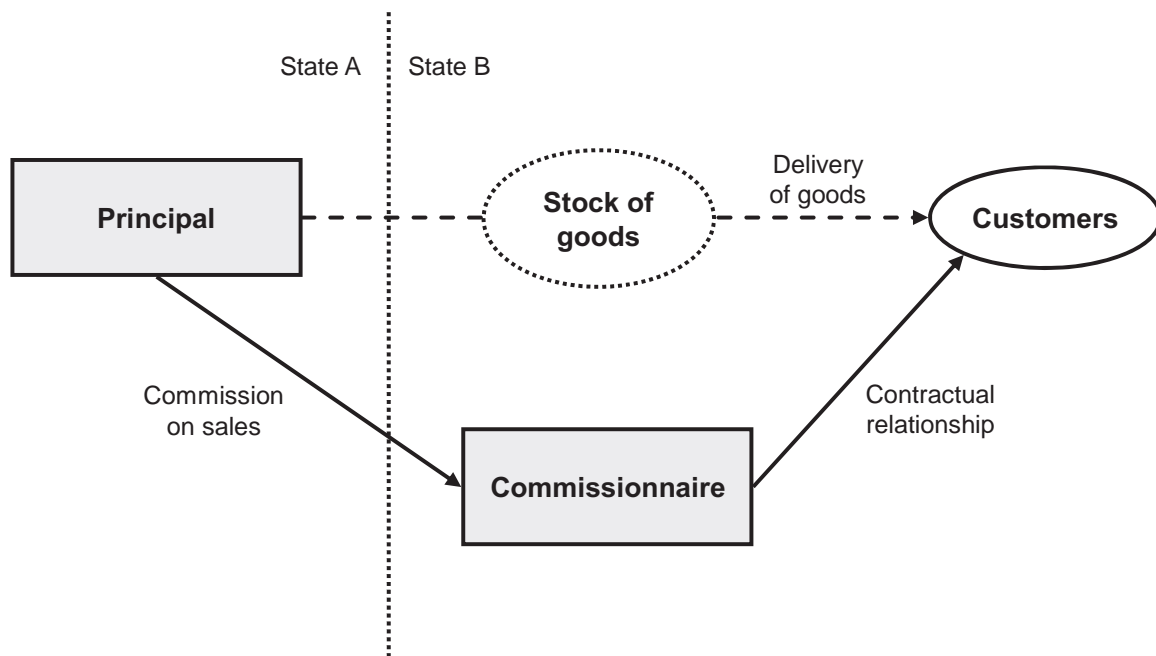
¹¹A commissionaire agreement is a form of contractual arrangement that exists under civil law.

¹²The sales contracts entered into by the commissionaire are for the benefit of the principal entity, but do not legally bind it.

¹³See Joel Cooper and Shee Boon Law, "Business Restructuring and Permanent Establishments," *Int'l Transfer Pricing J.* (July/

(Footnote continued on next page.)

Commissionnaire Distributor Model



According to article 5(4)(a) of the OECD model, the warehouse does not constitute a PE of the principal in State B. Likewise, the commissionnaire does not constitute a PE of the principal as the commissionnaire does not conclude contracts in the name of the principal but in its own name.

1. Example: Commissionnaire Arrangement

A principal resident in State A sells goods to customers resident in State B through a commissionnaire that is resident in State B. The goods are stored by the principal in a warehouse located in State B. The commissionnaire is remunerated with an arm's-length fee for the services rendered to the principal.

According to article 5(4)(a) of the OECD model, the warehouse does not constitute a PE of the principal in State B. Likewise, the commissionnaire does not constitute a PE of the principal since the commissionnaire does not conclude contracts in the name of the principal but in its own name.

There are legitimate commercial reasons for the implementation of commissionnaire structures such as legal reasons, limiting administrative burdens, risk protection, testing new markets, and so forth. As long as

the arm's-length principle is respected, such arrangements should not be considered to be abusive and, therefore, not give rise to BEPS concerns.

B. Dependent and Independent Agents

Articles 5(5) and (6) of the OECD model specify when activities carried on by an agent or another person acting on behalf of an enterprise create a PE of that enterprise. Under article 5(5) of the OECD model, a person — be it an individual or a company — is deemed to create a PE of the enterprise if that person has and habitually exercises authority “to conclude contracts in the name of the enterprise” even if the enterprise may not have a fixed place of business in that state (a so-called agency PE).¹⁴

¹⁴See articles 5(31) and (35) of the commentary on the OECD model; article 5(5) of the OECD model deems a PE to exist for activities on an enterprise that would not otherwise be attributed to a PE as defined under the basic rule provided in article 5(1) of the OECD model; see Hoor, *supra* note 6, at 109; a dependent agent does not need to be a resident of the source state or have a place of business therein. However, the business contracts in the state must be sufficient to create a taxable presence. Though this threshold is debatable, it remains that a transient presence generally does not suffice; see article 5(32) of the commentary on the OECD model.

Aug. 2010), p. 250; Jonathan Schwarz and Elina Castro, “Re-engineering Multinational Supply Chains,” *Bull. Int'l Tax'n* (May 2006), p. 188; the commissionnaire operates similar to a commission agent with the difference being that the principal is generally not disclosed; see Monique van Herksen, “Business Models,” (Chapter 2) in: *Transfer Pricing and Business Restructurings: Streamlining all the Way*, IBFD, Amsterdam 2009, p. 27.

The objective of article 5(5) of the OECD model is to ensure equal tax treatment of enterprises that perform activities in the source state via a separate legal person rather than an own fixed place of business. If the conditions of paragraph 5 are fulfilled, a person will be treated as a dependent agent, and the profits attributable to such agency PE will be dealt with in the same manner as those attributable to a fixed place of business under article 5(1) of the OECD model.¹⁵

If, however, the agent's activities are limited to those activities specified in article 5(4) of the OECD model, which would not constitute a PE if carried on by the enterprise through a fixed place of business, the person does not create a PE of the enterprise.¹⁶ Thus, contracts referred to in article 5(5) of the OECD model are those relating to the essential business operations of the enterprise, rather than ancillary activities.

Moreover, an enterprise is not deemed to have a PE in a contracting state if it carries on business in that state through an "independent" agent (for example, a broker or general commission agent) provided the agent is acting in the ordinary course of his business when acting on behalf of the enterprise (article 5(6) of the OECD model).¹⁷

Whether the agent is independent of the enterprise is a factual question and relies, among other things, on a review of contracts concluded between the agent and the enterprise.¹⁸ Among the questions to be considered is the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions or comprehensive control by the enterprise is not legally independent.¹⁹

¹⁵See articles 5(31) and (32) of the commentary on the OECD model; see Jacques Sasseville and Arvid Skaar, "Is There a Permanent Establishment?" *Cahiers de Droit Fiscal International*, Vol. 94a, 2009, p. 49.

¹⁶Article 5(4) of the OECD model takes precedence over article 5(5) of the OECD model; see Klaus Vogel and Moris Lehner, *Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen — Kommentar auf Grundlage der Musterabkommen*, 5th ed., C.H. Beck, Munich 2008, article 5, No. 123.

¹⁷Article 5(6) of the OECD model has been inserted in the OECD model for the sake of clarity and emphasis; see articles 5(36) and (37) of the commentary on the OECD model; see Sasseville and Skaar, *supra* note 15, at 32.

¹⁸Note that the term used for the position of the agent (for example, broker or general commission agent) is not conclusive but should be one of the factors considered when making a determination of independence. The content of the parties' contractual obligations and the practical implication of the contracts are ultimately decisive; see Detlef Piltz, "When Is There an Agency Permanent Establishment?" *Bull. Int'l Tax'n* (May 2004), IBFD, p. 200.

¹⁹Clearly, even in the case of an independent agent, the principal has the possibility to instruct and control the agent regarding the results of the work (for example, quality standards and sales volume); see Alessandro Caridi, "Proposed Changes of the

(Footnote continued in next column.)

Therefore, to pass the independence test, an agent should be able to demonstrate that he exercises control of his day-to-day activities.²⁰ Overall, the distinction between a dependent and an independent agent should be based on the aggregate facts relating to the relationship between the agent and the principal.²¹

One of the main criteria when assessing the agent's independence is whether he bears the business risk, that is, how the entrepreneurial risk is shared between the parties.²² Business risk refers primarily to the risk of loss. An independent agent typically bears the risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities performed is not economically independent within the meaning of article 5(6) of the OECD model.

C. Recent Commissionnaire Case Law

In recent years, the highest courts in several European countries had to decide whether a commissionnaire arrangement constitutes a PE of the principal. The French Supreme Administrative Court (in *Zimmer*²³), the Norwegian Supreme Court (in *Dell*²⁴), and the Italian Supreme Court (in *Boston Scientific*²⁵) have, in our view, correctly held that the normal operation of a civil law commissionnaire, that acts in his own name and who does not legally bind the principal, does not constitute a PE of the principal.²⁶

Since the contracts were "in the name of" the commissionnaire, the sales entities did not have and did not habitually exercise the authority to conclude contracts "in the name of" the principal. Therefore, a commissionnaire is not a dependent agent PE of the principal (article 5(5) of the OECD model). These decisions

OECD Commentary on Article 5: Part II — The Construction PE Notion, the Negative List and the Agency PE Notion," *Eur'n Tax'n J.* (Feb. 2003), IBFD, p. 45.

²⁰That the principal sets forth specific performance targets is rather irrelevant for the independence criterion.

²¹See Piltz, *supra* note 18, at 200.

²²The independent agent — rather than the enterprises represented — bears the entrepreneurial risk of his activities.

²³CE, nos. 304715, 308525, 10e et 9e s.-s., *Sté Zimmer limited* (Mar. 31, 2010).

²⁴*Dell Products v. Staten v/Skatt øst*, HR-2011-02245-A (Dec. 2, 2011).

²⁵Italian Supreme Court, Tax Section, no. 3769 (Mar. 9, 2012).

²⁶See Pijl, *supra* note 4, at 13; the commercial agreements entered into by the commissionnaire with the customers were enforceable against, and binding on, the commissionnaire only — not the principal.

confirm that treaty language should be interpreted according to its plain meaning rather than a substance-over-form approach.

While the Spanish Supreme Court followed the same reasoning in *Roche*,²⁷ it nevertheless held that the commissionaire creates a PE of the nonresident principal (for other reasons). However, note that the Spanish Supreme Court went far beyond the legal aspects in its arguments and reasoning, taking a broad and economically driven approach. We believe that this decision is exceptional and, in general, contemporary commissionaire arrangements that do not legally bind the principal should not constitute an agent PE of the principal.

D. Proposals in the Discussion Draft

The Focus Group on the Artificial Avoidance of PE Status considers that in many cases commissionaire structures and similar arrangements were put in place primarily to erode the taxable base of the state where sales took place. The position of the focus group is that when an intermediary exercises activities in a country that are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have sufficient taxable nexus in that country to be taxable unless the intermediary is performing these activities in the course of an independent business.

1. Independent Agent

The discussion draft proposes four alternative options that contain language that would significantly narrow the definition of an independent agent. The proposals in the discussion draft suggest to add to article 5(6) of the OECD model:

Where, however, 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.

Accordingly, there may be a different tax treatment of the same transactions when being entered into by associated enterprises as would be the case between unrelated enterprises. This suggests that there is a perception that being part of a group is a potential tax avoidance scheme.

The question is what would be the incentive to consider a PE in these circumstances. When an independent agent is remunerated at arm's length and presumably taxable in the country in which the sales are made, there is, all other things being equal, no additional tax revenue to gain from the creation of a PE of the principal. However, the existence of a PE would trigger significant administrative burdens for both the principal and the tax authorities that would be an impediment for international trade.

²⁷*Roche*, JUR\2012\41054 (Jan. 12, 2012).

2. Conclusion of Contracts

Alternatives A and C propose the replacement of the reference in article 5(5) of the OECD model to "conclude contracts" with the broader notion of "engages with specific persons in a way that results in the conclusion of contracts" according to which it would be sufficient for a PE to exist if the foreign principal is merely economically bound by the contracts concluded by the agent.

Such wording would go far beyond commissionaire arrangements and add significant uncertainty regarding the types of activities that may result in the conclusion of contracts. The proposed changes are particularly unclear as the discussion draft neither details nor provides any example of what is meant by a "similar arrangement."²⁸

We believe the arm's-length principle already ensures a fair allocation of profits between the principal and the agent, and a fair allocation of taxing rights between contracting states. When a PE would be found to exist, at most a minor amount of the overall profit of the principal can be attributed at arm's length to the PE. The principal would, however, have to bear a significant administrative burden when complying with the laws of that country and substantiating the arm's-length character of the profit attribution to the PE.

Alternatives B and D propose the replacement of the reference in article 5(5) of the OECD model to "conclude contracts" with "concludes contracts, or negotiates the material elements of contracts." According to the discussion draft, this proposal addresses situations in which contracts are not formally concluded by the intermediary who is acting on behalf of the enterprise.

Although this proposal is more targeted than the one provided in alternatives A and C, more guidance would be required on which parts of a contract may be classified as "material elements" and it should be clarified that the agent would need to have an active role in the negotiations for constituting a PE of the principal.

In addition to the proposed changes outlined above, alternatives A and B propose adding the phrase "contracts for the provision of property or services by the enterprise" to article 5(5) of the OECD model. Accordingly, all local support services may potentially constitute a PE regardless of the pricing of the support services. However, commissionaire arrangements are limited to the conclusion of contracts for the sale of goods. Therefore, this proposal goes far beyond commissionaire arrangements.

²⁸It is, for example, not clear whether under the proposal a sales agent that does not have the authority to conclude contracts but instead only has the authority to take orders with final approval by the principal would constitute a PE of the principal.

Alternatives C and D further address the perceived problem inherent in the wording of the existing dependent agent test relating to “contracts in the name of the enterprise” by replacing it with “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise.” Considering that countries may have different views about the types of legal relationships that are covered by such wording, these alternatives would add complexity, subjectivity, and legal uncertainty as to whether a PE is constituted.

It is interesting that different aspects of dependent and independent agents had already been considered in the 2011 discussion draft on the meaning of the term “permanent establishment” as defined in article 5 of the OECD model.²⁹ Here, the working group could not reach a common view about whether the phrase “to conclude contracts in the name of the enterprise” requires the enterprise to be legally bound vis-à-vis the third party (by reason of the contract concluded by the agent) or if it is sufficient that the foreign principal is economically bound by the contracts concluded by the person acting for it in order for a PE to exist (to the extent the other conditions of article 5(5) of the OECD model are met).³⁰

E. Summary

The proposed options would substantially lower the threshold that is required for a PE to be constituted and apply even when nonresident enterprises have only minimal activities in a country. As such, the proposals disregard the legitimate commercial reasons for businesses to use an agent when doing sales in another country. A fair allocation of taxing rights among contracting states is already achieved through the remuneration of the agent at arm’s length.

Even if a PE were found to exist in accordance with the proposals, it may be expected that in the large majority of cases only minor profits could be attributed to such PE even with the intention to shift more taxing rights to the source state. This is because no additional employees or assets can be allocated to such a “new generation” PE. Accordingly, the profit allocation can only be based on the remuneration for the risks assumed. However, considering that expenses related to the risk should also be attributed to the PE, such PE should only realize a low net profit.

It follows that commissionaire arrangements should often not raise any BEPS concerns as the country where sales are made may not expect additional taxing rights even if these proposals would be imple-

mented. All in all, it may be questioned whether the limited additional tax revenue that may reasonably be expected may justify the massive legal uncertainty and the significant administrative burden that would be the consequence of any of the proposed changes to the PE definition.

There must be a concern, however, that the creation of a new generation PE will be a prelude to reopening the profit attribution principles, even though, ostensibly, this should not be the case (see Section VI of this article).

III. Specific Activity Exemptions

A. Overview

Article 5(4) of the OECD model contains exceptions to the general rule provided under article 5(1) of the OECD model, listing a number of activities of a preparatory or auxiliary nature that may be carried out through a fixed place of business but that, nevertheless, do not create a PE. Even if the conditions of article 5(1) of the OECD model are met and the activity is carried on through a fixed place of business, no PE is constituted.³¹

The activities listed in article 5(4) of the OECD model share the common characteristic that the services performed are so remote from the actual realization of profits that it is difficult to allocate any profit to them. Therefore, article 5(4) of the OECD model is designed to prevent an enterprise of a contracting state from being taxed in the other contracting state.

B. Proposals in the Discussion Draft

The discussion draft provides for six alternative options with changes to article 5(4) of the OECD model that seek to limit the scope of the specific activity exemptions in order to tackle perceived abuses.

1. Specific Activity Exemptions

Alternative E suggests making all the activities currently listed in article 5(4) of the OECD model subject to the requirement of being of “preparatory and auxiliary” nature. Alternative E is the broadest of the six options and leaves the most room for subjective interpretations that would likely lead to disputes between taxpayers and tax authorities.

Alternative F proposes the removal of the word “delivery” from subparagraphs (a) and (b) of article 5(4) of the OECD model. Here, the discussion draft states that the exception for delivery is difficult to justify when an enterprise maintains a large warehouse in

²⁹The discussion draft was released by the OECD on October 12, 2011.

³⁰See Hoor, “Comments on the OECD Discussion Draft on the Meaning of ‘Permanent Establishment,’” *Tax Notes Int’l*, Jan. 16, 2012, p. 207.

³¹The application of article 5(4) of the OECD model further requires that no activities other than those listed in article 5(4)(a) to (d) are carried on at such fixed place of business; see Hoor, *supra* note 6, at 108.

which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online.

However, as acknowledged in the discussion draft, even if the delivery of goods is treated as giving rise to a PE, it may be that only a limited amount of income could be attributed to this activity. Notably, this option goes far beyond targeting only digital businesses — although this was the original motive to change article 5(4) of the OECD model.

Alternative G suggests deleting the exception for “purchasing” in subparagraph (d) of paragraph 4. The discussion draft states that when the provision was originally drafted there was a supposition that no or little profits could be attributed to purchasing activities. We believe this supposition is still valid and only a limited profit may be attributed at arm’s length to the purchasing function.

Alternative H suggests the deletion of subparagraph (d) of paragraph 4, which provides for an exception from the PE status in case of data collection. Like the other activities covered by article 5(4) of the OECD model, the collection of information is not a highly profitable activity. Therefore, it is questionable whether the additional administrative burden would be justified.

2. Fragmentation of Activities

Two options consider denying the application of the exceptions of article 5(4) of the OECD model when complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or associated enterprises at different locations. Both alternatives suggest adding a new paragraph 4.1 to article 5 of the OECD model.

Alternative I essentially amalgamates the operations of different related entities located within the same country when at least one of the entities has a PE and the other entity’s operations “constitute complementary functions that are part of a cohesive business operation.” Alternative J amalgamates the operations of related parties within the same country when the “overall activity resulting from the combination of the activities . . . is not of a preparatory or auxiliary character.” Accordingly, alternative J does not even require that any one of the related entities have a PE on its own.

Both options seem to be very broad and subjective and would result in a significant increase in the number of PEs. As such, these proposals would undermine legal certainty and cause a tremendous administrative burden for both taxpayers and tax authorities.

C. Summary

The discussion draft considers six alternatives that range from expressly stating that all activities listed in article 5(4) of the OECD model must be of “preparatory or auxiliary” nature to more targeted changes that would eliminate specific activities from the PE exemp-

tion (in particular, warehouses, purchasing offices, and offices used for gathering information).

In this respect, the 2011 discussion draft expressed a consensus that the wording of article 5(4)(a)-(d) of the OECD model does not support the view that the application of these subparagraphs was subject to the additional condition that the relevant activity was of a “preparatory or auxiliary nature.”³²

Also, both options regarding the fragmentation of activities between related parties challenge the separate enterprise approach and treat third-party transactions more favorably than arm’s-length transactions between related parties. All the proposed changes to article 5(4) of the OECD model would result in a significant increase of PEs, whereas only very limited profits could be attributed at arm’s length to such PEs.

IV. Splitting Up of Contracts

According to article 5(3) of the OECD model, building sites, constructions, and installation projects constitute a PE, provided that they last more than 12 months. Once the 12-month period is exceeded, a PE is deemed to exist (from the first day of activity) even if the general conditions laid down in article 5(1) of the OECD model are not met.

The 12-month test applies separately to each individual site or project; time spent on totally unconnected activities is, therefore, disregarded. However, a series of contracts or projects by a contractor that are interdependent both commercially and geographically are to be treated as a single project for the purposes of applying the 12-month threshold test.³³ According to paragraph 18 of the commentary on article 5 of the OECD model, the 12-month threshold has given rise to abuses and it has sometimes been found that enterprises divided their contracts up into several parts, each covering a period less than 12 months and attributed to a different company of the same group. To address the potential circumvention of the restrictions imposed by article 5(3) of the OECD model, the discussion draft considers two alternative options.

The first option is an “automatic” rule to be included in article 5 of the OECD model according to which periods of time spent by associated enterprises at a place that constitutes a building site or construction or installation project will be added for the (sole) purpose of the 12-month test. This option is fairly

³²Since article 5(4)(e) and (f) of the OECD model deals with other unspecified activities, it is a necessary requirement of the activities being of a preparatory or auxiliary nature. In contrast, the activities listed in article 5(4)(a)-(d) of the OECD model share that they have a preparatory or auxiliary character; see No. 74 of the 2011 discussion draft.

³³For example, the construction of a housing development would be considered as a single project, even if each house were constructed for a different purchaser.

similar to an alternative that can already be found in paragraph 42.45 of the commentary on article 5 of the OECD model and that may be included by contracting states in their bilateral tax treaties.

The second option would rely on the principal purposes test (PPT, a general antiabuse rule proposed in regard to BEPS action 6 relating to preventing treaty abuse) through the addition of an example in the commentary. This alternative would address only cases in which the splitting up of contracts is tax motivated and exclude situations when there are legitimate business purposes for the involvement of associated enterprises in the same project.

However, the PPT opens the door for tax administrations to disqualify taxpayers from treaty benefits when “one of” the main purposes of an arrangement or a transaction is considered to be a given treaty benefit. Obviously, this injects a subjective element into every aspect of determining whether treaty benefits are available and not much guidance is provided regarding when treaty benefits will be granted.

Furthermore, the PPT imposes a significant burden on the taxpayer (“establish that the granting of tax benefit would be in accordance with the object and purpose of provision in the convention”), whereas the onus on the tax administration is set low (“reasonable to conclude,” “one of the main purposes,” “directly or indirectly”). As such, the PPT would create significant uncertainty for taxpayers (and their advisers) because of the extremely unpredictable outcomes and cause serious concerns for bona fide businesses.

V. Insurance Companies

Insurance companies operating in a cross-border context may be taxed in another state if they either have a fixed place of business within the meaning of article 5(1) of the OECD model or carry on business through a dependent agent³⁴ in that state. In some cases, however, the agencies of foreign insurance companies do not meet any of the aforementioned requirements. Thus, profits arising from such business may not be taxed in the other state.³⁵

In this regard, the discussion draft provides for an option that would deal with the situation of dependent agents who sell insurance for a foreign insurer but do not formally conclude insurance contracts.³⁶ Alternatively, it is considered to rely on the changes proposed to articles 5(5) and (6) of the OECD model regarding

agency PEs. This aspect has already been considered in the 2011 discussion draft in which the working group agreed that no changes should be made to the commentary since only a few countries have included a special PE provision dealing with insurance agents in their tax treaties.³⁷

VI. Profit Attribution to PEs

According to the discussion draft, BEPS concerns regarding the PE rules relate primarily to situations when one member of a group clearly has a physical presence and tax nexus within a jurisdiction, whereas another member of the multinational enterprise group is shielded from tax in the absence of a PE, and the first-mentioned entity is allocated limited profits (because of limited functions and risks) while the foreign entity is allocated a large share of the income. However, this outcome is in line with the arm’s-length principle according to which associated enterprises should price controlled transactions as comparable transactions on the open market.

The discussion draft states that no substantial changes would be needed to the existing guidance concerning the attribution of profits to a PE. This statement is positive as the authorized OECD approach regarding the attribution of profits to a PE was adopted only on July 22, 2010, after a negotiation process of more than 10 years.³⁸

VII. Conclusion and Outlook

Whether a PE is found to exist is an important question and probably one of the most frequent tax treaty issues. The discussion draft sets out a number of proposals for changes to article 5 of the OECD model to significantly lower the PE threshold in a tax treaty context. Hence, the proposals seek to shift taxing rights to the source state rather than capturing untaxed profits that is the purported target of the BEPS action plan.

The proposals regarding commissionaire arrangements seem overbroad and would undermine the current rules on dependent agents. The vague language that is proposed to be added to article 5 is open to interpretation by local tax administrations and would result in legal uncertainty, long-lasting disputes, and double taxation. Similar uncertainty would occur if the “auxiliary and preparatory” requirement were to be added to article 5(4) of the OECD model.

The proposed changes to the PE concept may result in a PE being constituted in every country in which a

³⁴Article 5(5) of the OECD model.

³⁵See para. 39 of the commentary on article 5 of the OECD model.

³⁶According to this special provision, insurance companies would be deemed to have a PE in the other state if they either collect premiums in that other state or insure risks situated in the territory of the other state through an agent established therein.

³⁷See No. 135 of the 2011 discussion draft.

³⁸According to the authorized OECD approach, the OECD transfer pricing guidelines (regarding the application of the arm’s-length principle) should apply “by analogy” to internal dealings between a head office and a PE (and other parts of the same enterprise).

company is doing business. In the majority of these cases, only very limited profits will be attributed to the PE in accordance with the arm's-length principle. The administrative burden for both taxpayers and tax administrations will be disproportionate, especially when no or only little (additional) profits can be attributed to a PE. Moreover, a real risk exists that tax authorities could be tempted to deem a PE to exist even if the involvement of a foreign enterprise is very limited (for increasing tax revenue) or to attribute more profits to a PE than appropriate in accordance with the arm's-length standard.

Businesses need legal certainty about the threshold that gives rise to the constitution of a PE since the existence of a PE entails tax consequences and compliance obligations. As such, the proposed changes would be an impediment for international trade and investment without shifting significantly more taxing rights to the source state. We believe the OECD should carefully analyze the impact of the proposals on businesses and tax revenue before adopting any changes to the established PE definition. ♦