Analysis

Preventing the artificial avoidance of the permanent establishment status

Speed read

The amendments to the permanent establishment threshold as part of the BEPS project have potentially far reaching consequences for cross-border trading activities. The first changes amend the deemed 'agency permanent establishment' concept. The second set of changes focuses on fixed place of business permanent establishments. An increased compliance burden is expected, even in cases where no additional tax is levied. Cases will turn on their facts, but a number of concepts are open to interpretation and will cause uncertainty for international businesses. Further work on the attribution of profits to permanent establishments is expected (by 31 December 2016) and will be essential in determining the consequences of a newly created taxable presence.

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On 5 October 2015, the OECD Secretariat issued a final report on preventing artificial avoidance of permanent establishment (PE) status (Action 7 of the BEPS Action Plan). This considers the important boundary for allocating taxing rights for business (trading) activities to different jurisdictions. The report builds on proposals put forward in earlier discussion drafts and sets out changes to update the definition of PE in Article 5 of the OECD Model Tax Convention and its associated Commentary. The report was approved by the G20 finance ministers in Lima, Peru on 8 October, and will be put to the G20 leaders in Ankara, Turkey in November.

The changes agreed under the BEPS project amend the thresholds for both types of PE in the OECD Model Treaty:

- those where a non-resident has a fixed place of business in a country; and
- those where there is deemed to be a PE in the absence of a fixed place of business, where an agent or intermediary carries on activity in a country on behalf of a non-resident company.

The deemed agency PE concept

The first changes amend the deemed 'agency permanent establishment' concept. The rules are updated to include the activity of an intermediary that results in contracts 'for the transfer of, or the granting of the right to use, property, or the provision of services' by a non-resident, as well as contracts in the name of a non-resident. In applying this rule, the test is that the intermediary 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification' by the overseas company.

These changes are aimed, in particular, at addressing the tax status in local market countries of commissionnaires (a civil law concept where the agent – the commissionnaire – acts in its own name and does not bind the customer to the principal), along with other forms of undisclosed agent.

Commissionnaires and other agents that are selling the goods or services of an overseas company will, under the new rule, create a PE of the overseas company in the local market. In addition, the changes are designed so that an agency PE will exist where an overseas company's goods or services are being sold in a local market by a sales entity that is, in effect, doing all the work to secure the sales and establish the contractual terms, with limited involvement of the overseas entity.

These changes do not, however, extend to situations where there is local marketing activity in a country, designed to identify sales opportunities, but where the contractual terms are actively determined and decided by a non-resident. The revised Commentary provides further guidance that the rule will typically be applicable to the person that convinced the third party to enter into a contract with the non-resident.

The changes provide a new set of tests, and businesses will have to analyse what these mean for their facts. The approach is, however, targeted, providing much less scope for uncertainty and disputes between tax authorities than the proposals in earlier discussion drafts, which looked at a party (or potentially multiple parties) that 'negotiates material elements of contracts'. It is now clear there will only be one 'principal role'.

The revised Commentary distinguishes arrangements that will be affected by the rules from distributor situations where the local entity is selling on its own account. It makes specific reference to 'limited risk distributors' and notes that any concerns over risk allocations will be dealt with under the transfer pricing aspects of BEPS. In particular, the Commentary notes that buy-sell relationships will not create a PE of a non-resident company, regardless of how long title to goods is held by the local company.

The changes also tighten the requirements for an agent to be considered 'independent'. Among other factors, an agent will not be considered independent where it acts 'exclusively or almost exclusively' for one or group companies. The revised Commentary indicates that 'exclusively or almost exclusively' broadly represents situations where more than 90% of an agent's sales are to related parties.

Fixed place of business PEs

The second set of changes focus on fixed place of business PEs. These include adding a qualification to the specific activities that do not create a PE even where there is a fixed place of business (the 'specific activity exceptions'), such that each activity, regarded alone or collectively, is preparatory or auxiliary in character in relation to the business as a whole. The specific activities include maintenance of a stock of goods for storage, delivery, display, delivery or processing; purchasing; and the collection of information.

There has been significant pressure to update these exceptions (originally agreed in the 1920s), given the way in which businesses operate in the modern, digitised business world. It is recognised that sophisticated and highly integrated supply chains, for example, may create significant value for a business by providing locally held stock that is accessible to the customer base at short notice.

The new 'anti-fragmentation' rule

A new 'anti-fragmentation' rule is included as a new paragraph in the OECD Model Treaty. It targets situations where groups fragment their activities in order to meet the exceptions for activities that are preparatory or auxiliary and avoid a local taxable presence. Under this rule, the specific activity and preparatory or auxiliary exceptions from having a fixed place of business will not be available where there is either an existing PE in the local country; or, importantly, the collective activities carried on by all group companies (including resident companies) in the local country are not of a preparatory or auxiliary nature. To be included, the collective local activities must constitute 'complementary functions that are part of a cohesive business operation'.

One interesting point to note here is that the anti-fragmentation rule applies only to the preparatory or auxiliary/specific activity exceptions. It does not apply, for example, to cases where there are no premises in the local country 'at the disposal' of the non-resident company. 'At the disposal' is a concept that has been included in the Commentary (but not Article 5 of the Model Treaty itself) for many years, but it appears to take on more significance as a determining factor as a result of these changes.

The revised Commentary notes that some countries consider that amendments to the specific activity exceptions are not necessary, as artificial avoidance could better be dealt with by the anti-fragmentation rule. The Commentary therefore provides an option for countries to agree in their bilateral treaties that specific activities are not subject to the preparatory or auxiliary condition, as long as the anti-fragmentation rule is included.

There are also changes to prevent artificial splitting up of contracts between group companies to circumvent the 12 month period rule for creating a PE in relation to building sites, construction and installation projects. This will be done either by the principal purposes test, proposed as part of the BEPS work on preventing treaty abuse, or by a specific rule to aggregate sub-contractor and main contractor activities for the purpose of assessing the 12 month period.

The timeframe

The changes to the OECD Model Treaty are expected to be implemented for many countries via the multilateral instrument to amend existing bilateral tax treaties from 2017.

The G20/OECD governments have recognised the need to provide supplementary guidance on how to determine the profits to be attributed to newly created PEs, and will provide this by the end of 2016. This is an important issue. Although the basic principles of profit attribution (as set out in the OECD's 2010 *Report on the attribution of profits to permanent establishments*) will not be subject to substantial modification, it is acknowledged that additional guidance is necessary, particularly in respect of businesses outside of the financial sector and to take account of the BEPS revisions to transfer pricing guidance.

There remains the possibility that, based on current principles at least, a number of newly created PEs will have no or limited taxable profit attributed, and will impose a compliance burden on businesses and tax authorities without changing the location or amount of tax paid.

The final changes are a significant improvement on the draft proposals, but a number of subjective areas remain that will concern businesses

Practical points

Changes to the threshold for PEs are a key issue for businesses (and governments), as they affect the location of taxation and associated compliance for ordinary trading activities. The test establishes the boundary between local source taxation and taxation in the country of residence – and, as such, can be subject to dispute between countries.

It is important that the rules (and the Commentary) provide as much certainty as possible to minimise these disputes, and that when disputes do arise they can be resolved swiftly through the Mutual Agreement Procedure (and binding arbitration for those countries that agree to it) in double tax treaties. It is inevitable that the changes will need some time to settle, as businesses and tax authorities come to a common interpretation of new fact-specific tests such as 'the principal role' leading to the conclusion of contracts.

The application of other longstanding concepts, such as 'preparatory or auxiliary', will also need to be determined in relation to, for example, the holding of stock.

While there is no doubt that the final changes to the PE threshold are a significant improvement on the highly uncertain proposals put forward in the drafting stages, a number of subjective areas remain that will concern businesses seeking to manage their tax compliance efficiently and with certainty as to the outcome. ■