The new 'dependent agent' definition

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Our client currently has a buy/sell group distribution network, which has grown through acquisition. At one of the CFO's previous organisations, they operated a centralised buy/sell principle with commissionaires and the CFO is keen to explore whether this structure would be appropriate here. In particular, the CFO considers that such a structure would increase central control and visibility over distribution activities, and would increase the availability of consistent management information and optimise stock management. The CFO does not want to move any staff. In a post-BEPS environment, what advice should I give my client to mitigate the risk of multiple permanent establishments and reduce the tax compliance burden?

Firstly, we assume that the client has already considered the business restructuring issues and therefore in our response we will focus on the potential permanent establishment (PE) issues.

In the last three years, the Organisation for Economic Cooperation and Development (OECD) has sought to address a number of areas of international tax policy which, it considered, were leading to base erosion and profit shifting (BEPS). One of the areas addressed, via Action 7 of the BEPS initiative, was 'preventing the artificial avoidance of permanent establishment status'. The final report on this was issued in 2015 (PE Report 2015).

Prior to BEPS, many groups used a disclosed commissionaire arrangement in order to sell their products locally via group entities. In a disclosed commissionaire arrangement, the group entity (the commissionaire) sells products locally on behalf of a central principal entity (the principal) that is the owner of the products. Under civil law, contracts concluded by the commissionaire are not binding on the principal; and, pre-BEPS, this was used to argue that, in accordance with the OECD Model Tax Convention article 5(5), the commissionaire was not habitually concluding contracts on behalf of the principal. The commissionaire arrangement was more difficult to operate in common law jurisdictions such as the UK without creating a PE, as under common law the commissionaire *does* bind the principal. Consequently, a limited risk buy/sell distributor model was often used for jurisdictions such as the UK.

Another strategy successfully used to defend commissionaire arrangements from creating PEs was to argue that such commissionaires were independent agents, which don't create PEs; as opposed to dependent agents, which can create PEs. Some countries were happy to accept that if commissionaires had some element of control over their own profitability (for example, not being paid on a net cost plus basis), then they could be considered as independent agents which do not create PEs.

Therefore, your client's CFO is likely to have worked at an organisation where a commissionaire arrangement pre-BEPS was an operating model which did not give rise to PEs in the majority of countries, and in common law territories a limited risk buy/sell distributor which also did not give rise to a PE.

The post-BEPS position

However, the post-BEPS position is fundamentally different. The PE Report 2015 includes changes that will be made to the OECD Model Tax Convention article 5 and its commentary. The wording of article 5(5) is being extended to include not only circumstances where a dependent agent 'habitually concludes contracts' in the name of a principal; but also where a dependent agent 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'. In these circumstances, the dependent agents' activities shall be deemed to create a PE of the principal in the dependent agent location, unless the activities are considered to be preparatory or auxiliary in accordance with the new article 5(4).

The commentary of the new article 5(5) does indicate that the principal role leading to the conclusion of contracts typically means the person who convinces the third party to enter into a contract with the principal. This therefore includes the solicitation and receipt of orders. However, if the activities of the local group companies were restricted to merely promoting and marketing the goods in a way which does not directly result in the conclusion of contracts, this would not give rise to a PE under article 5(5).

One of the potential indicators the tax authorities will consider in determining whether employees habitually play the principal role leading to the conclusion of contracts is whether the employees receive a bonus on sales. Employees carrying out pure marketing activities are far less likely to receive a bonus on sales.

It is not clear from the facts whether it is possible to order goods online. The commentary to article 5 provides that even if the customer orders the goods online from the principal, this does not mean that the commissionaire has not created a PE. If the commissionaire has sent emails, made calls or visited the customer to convince them to buy the products, this can be construed as the commissionaire playing a principal role leading to the conclusion of the contract.

In addition, article 5(6) provides the independent agent a 'get out' from a deemed PE; however, this is being amended to tighten the circumstances in which the independent agent argument can be used for group entities. The revised article 5(6) provides that where 'a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise'.

Therefore, the conversion of your client's buy/sell distributors to commissionaires is likely to give risk to PEs of the principal in the location of the commissionaires. This is because the activities of the commissionaires would not be considered to be auxiliary or preparatory in nature; the commissionaires would not be considered to be independent agents; and, assuming that the marketing and negotiating activities of the commissionaires don't change, the Commissionaires are likely to be considered to be habitually playing a principal role leading to the conclusion of a contract.

Managing the compliance burden

Given that PEs are likely to be created, what can be done to manage the compliance burden?

One possible option would be to convert all the existing buy/sell distributors to branches and have a single principal company with branches. Of course, this depends on the ability to

convert from a legal entity to a branch in the locations in which your client is present. A number of groups have successfully employed this strategy both pre-BEPS and post-BEPS.

However, clearly, the transition into such a structure needs to be considered carefully. The benefit is that you can deliver on the CFO's business requirements by providing a single centralised P&L in a single principal company with control over the activities of the company and its branches. One of the reasons why some groups have embraced this structure is that it can also significantly reduce the finance function required locally, as compared to a buy/sell model. Therefore, the finance function can be centralised either in the single principal company location or another location.

From a tax compliance perspective, there may be a local requirement to produce branch accounts. However, the previous and continuing work of the OECD around the attribution of profits to PEs does mean that there is an internationally recognised set of principles around how such an attribution of profit should take place. Moving to a branch structure would mean that only one tax return needs to be filed; whereas, if you have a commissionaire and a PE in theory you have to file two tax returns.

If a branch structure is not appropriate for this business, but the CFO continues to seek a single point of contracting, then as stated above this is likely to give rise to the risk of a PE in the local company location. In the past, many countries, including the UK, have taken a pragmatic approach to whether there is a need to file both a PE tax return and the local company tax return. (As long as the local company transfer pricing reward reflects the combined profits of the local company and any deemed PE, i.e. there is nothing further to tax, a single tax return for the local company has been deemed sufficient.) In countries such as the US, a 'zero' tax return has been filed for the deemed PE to protect against penalties, again with the overall country remuneration recognised in the local legal entity.

However, the effect of BEPS will be to create greater PE risk. The recent discussion draft issued by the OECD, 'Additional guidance on the attribution of profits to permanent establishments 4 July – 5 September 2016', clearly envisages the creation of a local agent P&L and a separate PE P&L. At the public consultation on the draft held in October 2016 in Paris, there were consistent calls from the business community for stronger, more directive guidance on administrative relief to give certainty around when businesses would be required to file PE returns; and for assurance that no profits are attributable to those PEs if the article 9 transfer pricing reflected the full reward for all activities carried out locally. It will be interesting to see how the OECD responds to the calls for 'pragmatism' to be built into its guidance. The OECD reports are principle based and it is difficult to see how the OECD could advise ignoring the principles to deliver a non-principled result, no matter how pragmatic that would be.

In addition, there may well be local requirements for a principled approach. For example, this year the UK has enacted legislation to apply a withholding tax on UK sourced royalties that arise in a UK PE. For HMRC to understand whether this legislation is applicable, it may require a PE return to be filed. For this reason, among others, the UK may be less willing to adopt the pragmatic approach it has taken in the past.

Unfortunately, we are entering into a period of uncertainty about the extent to which individual countries will apply the 'letter of the law' by requiring PE returns. One of the ways to potentially gain greater certainty about material jurisdictions would be an advance pricing agreement, where the nature of the local filing requirements could be agreed.

It is also worth noting that the article 5 amendments, for many jurisdictions, will be enacted through the OECD Multilateral Instrument, which opens for signature in early 2017. Unless both the principal company location and the local company location sign up to the article 5 provisions of the Multilateral Instrument, the previous version of article 5 is likely to apply, depending on the wording of the existing bilateral double taxation agreement between the parties. ■

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