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* These are additional comments since original publish on 12 January 2015.
ABB’s POSITION ON PROPOSED DISCUSSION DRAFT: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

Dear Ms. de Ruiter

We appreciate the opportunity to comment on the Public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status ("Discussion Draft").

ABB is a leader in power and automation technologies that enable utility, industry, transport and infrastructure customers to improve their performance while lowering environmental impact. The ABB Group of companies operates in roughly 100 countries and employs about 145,000 people.

The concept of Permanent Establishment is of central interest for ABB’s global operations, and the related degree of predictability is of utmost importance for the Group’s investment decisions.

In the following we focus on issues A and C of the Discussion Draft:

1. Artificial avoidance of PE status through commissionaire arrangements and similar strategies, and
2. Splitting-up of contracts.

1. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

As a general principle, the source country should be allocated the right to tax the profits of a foreign enterprise only under the condition that a business activity within its territory meets a certain degree of permanence, including the use of the source country's infrastructure and resources ("rootedness").

The basic question in relation to a commissionaire arrangement is whether or not the activities of such a commissionaire can be allocated to the principal leading to a dependent agent PE under Art. 5 para. 5 OECD Model Tax Convention. Only in case the substance of the activity of the agent can be regarded as an activity of the principal, a PE should arise. However, an
independent party receiving an arm's length remuneration, e.g. for its services under a commissioner agreement should not give rise to a source taxation of the principal in the country of the agent.

Although we support the OECD Action Plan on Base Erosion and Profit Shifting, as well as the intention to challenge artificial structures aiming for double non-taxation or a reduction of taxable profit in the source country, the proposed broadening of the PE definition creates considerable practical challenges. One of our main concerns is that the proposed changes will affect structures that are based on economic substance and, therefore, should not be under BEPS scrutiny. The proposed changes seem to assume that in many cases commissioner and similar structures were put in place in order to erode the taxable base of the country where sales take place (Paragraph 10 of the Discussion Draft). This assumption does not correspond to what we are seeing in practice. As per our experience, many MNEs are using their global footprint for selling products and services via a network of local sales agents, as this has proven to be the most efficient way of targeting customers abroad.

Practice also shows that the interpretation of the current version of Art. 5 para. 5 OECD Model Tax Convention often leads to controversial discussions with local tax administrations, for instance, regarding the requirements for reaching a dependent vs. an independent agent status, or the question as to what extent economic issues have to be considered during the PE test. We therefore welcome any change that aims to clarify the practical controversies included in the current version, e.g. a clear description of how to assess the substance of a specific arrangement.

However, from our view the intended changes add additional uncertainty by introducing several subjective criteria (e.g., "conclude contracts" vs. "engages ... in a way that results in the conclusion of contracts" (A) or "negotiates the material elements of contracts" (B); "contracts in the name of the enterprise" vs. "contracts which ... are on the account and risk of the enterprise" (C + D) or "concludes contracts or negotiates the material elements of contracts" (D). This will surely lead to practical challenges and ultimately broadens the PE definition, while at the same time adds complexity and legal uncertainty which is required for taking investment decisions. Also, the general policy expressed in Paragraph 10 of the Discussion Draft adds to this concern, as it potentially catches a scope that goes far beyond the targeted commissioner arrangements that are designed to artificially avoid the creation of a PE. The argument that principally all activities of a profit-driven MNE directly or indirectly lead to the conclusion of a contract could be used (or misused) by tax administrations to deem PE situations for a foreign taxpayer in an unpredictable way.

Another aspect of broadening the PE definition are the administrative burdens, including considerable costs related to the creation of each foreign PE on both the tax payer but also the tax authority side. In many cases, such administrative cost element will be higher than the tax payable by the agency PE itself, based on the fact that the functions and risk profiles of PEs would regularly only support the allocation of marginal results, resulting in insignificant taxable profits.

For MNEs such as ABB, the administrative costs related to the creation of multiple PEs may add up to several millions USD finally influencing investment decisions with potential negative consequences for source country economies.
2. Splitting up of contracts

One of the key strengths of ABB is its global presence and the ability to group together teams that are able to deliver the best results to its global customers including the ability to deliver a product or system that meets the high standards of ABB as well as of our customers.

In this regard, we are concerned about the proposals under section C of the Discussion Draft. As per our experience in the area of large cross-border construction projects it will be technically and commercially almost impossible to split a contract in an abusive way as described in the Discussion Draft without compromising on the technical performance side, i.e. the ability to deliver a product or system in line with customer requirements and within the contractually defined time frame. Therefore, we preliminarily conclude that although there may be a theoretical opportunity to avoid the creation of construction PEs as per Art. 5 para. 3 of the OECD Model Tax Convention by splitting up a contract between associated enterprises in such a way that none of the site terms exceeds the defined PE threshold, practical business reality will hardly allow for that.

Furthermore, we are strongly convinced that an "automatic approach", as mentioned in the Discussion Draft, would be excessive, as it will to a large extent be applicable to fully legitimate cases. In addition, many large MNEs with a diversified and decentralized business model would face severe difficulties in monitoring the multiple activities of the group companies in various customer countries.

Considering the two proposals, we prefer the general anti-abuse rule, but with an example that emphasizes in great detail, the abusive character of the specific transaction. Otherwise tax administrations may apply the anti-abuse rule to fully legitimate collaboration arrangements between two or more related enterprises jointly carrying out a construction project. The pure fact that in Example E, RCO and SUBCO accept a joint and several liability towards the customers does not necessarily point to an abusive character. In contrary, such arrangements are very common in international cross-border construction projects. We are concerned that the current example could lead to all contracts including such wording being exposed to the creation of PEs and we expect that this will drastically increase their number. Again this is something that decreases predictability and therewith potentially negatively influences investment decisions.

Whereas it should be possible to determine whether one activity is related to another (in order to meet the "same construction project" requirement), the situation is much more challenging with regard to a service PE scenario. In these arrangements, we see the considerable risk that all services carried out by a group of companies in a specific customer country are counted together, leading to the creation of PEs for multiple companies of this group.

Similarly, we want to highlight the immense administrative burden and cost connected to a broadening of the PE definition.

Although it should be clear that the automatic approach as well as the general anti-abuse rule deal with the question whether a PE is created and not with the profit attribution to this PE, we are concerned that such provisions are also used by tax administrations to increase the taxable profits attributable to such PEs.
3. Conclusions

Based on the above, our conclusions are as follows.

- Under all circumstances, keep the relation between a PE threshold and the use of the infrastructure and resources of a country in order to retain predictability and legal certainty.
- Do not indirectly broaden the PE definition by exposing fully legitimate cases to source taxation as this will lead to considerable practical challenges (e.g., monitoring of various activities abroad) as well as dramatically increase the administrative burden and cost for MNEs which will finally negatively influence future investment decision.
- Clearly define in detail the abusive transactions to which the new regulations apply, in order to avoid their application on fully legitimate cases.
- Avoid the implementation of subjective criteria in the treaty text, as this will open the ground for many controversial discussions between tax administrations. This may lead to increased administrative costs and potentially also to double taxation, while at the same time decreasing the degree of legal certainty.

Yours sincerely

ABB Asea Brown Boveri Ltd

Thomas Fuerer  Christian Pfarrg
Comments on Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Action Plan

Dear Ms de Ruiter,

The Association des compagnies d’assurances et de réassurances du Grand-Duché du Luxembourg (the ACA) is an association grouping insuring and reinsurance companies based in Luxembourg. Its aims are to protect and develop the interest of its members, to discuss any issue which may arise in the insurance sector and to improve the services rendered to the public. The ACA’s goal is to have an on-going contact between insurance companies to address any question which may arise in relation to their activities. In this respect, ACA wishes to comment on Action 7 of the BEPS Action Plan.

In Luxembourg, resident companies are subject to corporate income tax (impôt sur le revenu des collectivités) at a rate of 21%, municipality business tax (impôt commercial communal sur le bénéfice d’exploitation) at a rate of 6.75% (in Luxembourg City) and the contribution to the employment fund of 7% of the corporate income tax due. Insurance companies are not treated differently than other companies and are therefore subject to corporate income tax at the combined rate of 29.22% (in Luxembourg City).
Companies are taxable in another state if a permanent establishment (PE) exists in that other state. Currently, under article 5.5 of the OECD Model Convention (MC), an agent, other than an independent agent, who concludes contracts in the country of activity in the name of his principal may be considered a PE of the principal. If the agent does not conclude contracts, there will be no PE for the principal in the State in which the agent is active. In the event where a PE is created, the profit to be allocated to that PE, which will be taxable in the country of location, has to be determined as well under article 7 of the OECD MC.

In the BEPS Action 7, it is proposed, in particular, to amend the definition of PE in relation to insurance companies. In ACA’s understanding, three main changes are proposed in this respect, which affect the above “agency PE” and the way insurance companies may conduct their business. First, a similar provision as the one provided by the UN MC would be added. An insurance company would have a PE if it collects premium in the other contracting State or insures risks situated therein through a person other than an independent agent. Then, the OECD proposed to amend paragraph 5 of Article 5 of the OECD MC to replace “conclude contracts” by “conclude contracts, or negotiate the material elements of contracts” or “engage with specific persons in a way that results in the conclusion of contracts”. Finally, a person who acts exclusively or almost exclusively for one enterprise or for associated enterprises would not be considered as independent, and hence may be considered an agency PE.

ACA is of the view that no amendments to the PE criteria are needed to address the specific situation of insurance undertaking. ACA believes that the proposed changes do not sufficiently take into account the various business models of insurance undertakings (item 1), that emphasis on the collection of premium ignores the key functions of an insurance undertaking (item 2), that the proposed changes may result into practical difficulties (item 3) and that these changes are not needed to reach the main objective of the BEPS proposal, which is to fight tax avoidance and artificial tax structuring (item 4).

ACA does not comment on the general changes to the PE concept which go beyond the activity of insurance undertakings and are not specific thereto.

1. **Business model**

Insurance companies conceive and manage characteristics of the risk coverage they give in various types of insurance contracts.

Insurance contracts are then sold to clients via various distribution channels (see below). Brokers and agents are remunerated by the clients and/or the insurance company through a fee or commission. These remunerations are taxable in the country of residence of the broker or agent.
Insurance companies may be in touch with clients in another country in four different ways, basically either: (i) from their home base, or (ii) via the setting up of a subsidiary or a physical office in the country of activity, or (iii) via an agent based in that country or, finally, (iv) a broker (courtier) in that other jurisdiction. The choice between these business models is usually based on the historic business model of the relevant insurance undertaking and on legal and regulatory, rather than tax, constraints in the country of activity.

When using an agent (model (iii) above), it is the agent who makes the first contact to the prospective clients. The main roles of the agent are to inform the prospective client of the insurance company about the insurance contract and his commitments and to prepare the conclusion of the contract by the insurance company.

According to the directive 93/13/EEC on unfair terms in consumer contracts, insurance contracts are clearly defined as pre-formulated standard contracts. In fact, in most insurance contracts, the consumer can only accept or refuse to sign the terms and conditions of the insurance to which he subscribes, and the document signed is a pre-formulated standard contract drafted by the insurance company. The agent will often have no power to negotiate the contract drafted by the head office of the company\(^1\). The agent will have to be distinguished from the broker (dealt by article 5.6 of the OECD MC) who will be able to discuss or propose clauses in insurance contracts. The agent does also not collect premiums. If an insurance contract is concluded, the premium is usually directly collected by the insurance company itself.

It is indeed the insurance company itself which decides in view of its experience and its business model, and financial information gathered and processed often over decades, that assesses the risk, accepts the client and determines the level of premium in view of risk factors. In other words, the agent does not participate in the conclusion of the insurance contract, it is the head office of the company which accepts or rejects a client and sets the legal and financial conditions. According to the directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (the Solvency II Directive), insurance companies have five “key functions”. Those functions, enumerated in the Solvency II Directive, are risk management, own risk and solvency assessment, internal control, internal audit and actuarial function. The mere collection of premium is not part of these key functions of an insurance undertaking. Another important profit component for the insurance company is how premiums are invested, ie how excess cash is managed. This component, which is not addressed by the OECD paper on Article 7 of the BEPS Action Plan, shows that the business of an insurance undertaking cannot be reduced to the mere collection of premium.

\(^1\) According to US tax-treaty doctrine, no agency PE is recognised if the agent has no authority to fix price, ie where the key conditions are set by the principal. In case the principal is entitled to reject proposals to conclude made by the agent, usually no PE is recognised (Arvid Skaar, Permanent Establishment, Erosion of a Tax Treaty Principle, Series on International Taxation, Kluwer law and taxation publishers, 1991, page 496).
The insurance sector is thus too diversified to reach a “one size fits all” solution. Life insurance and risk insurance are very different in nature and in risk profile, and there are various ways how an insurance company may conduct business abroad. The insurance company is, to a certain extent, able to compensate various risk profiles by choosing an appropriate business model, mix of activities, mutualisation and diversification of risks including geographical spread over several countries.

It is therefore the input and activity of the head office of the company which enable a sound mix of activities, and it is at that level where taxation has to occur, because it is the head office of the company’s business which creates the balance between jurisdictions and activities - source taxation where premium is collected or individual risks are insured interferes with the traditional business model of risk spreading of an insurance undertaking. It also interferes with regulatory constraints of insurance companies, and in particular their solvency obligations and obligations to create risk reserves. These obligations can best be met by the head office of the company only.

2. **The preparatory character of the collection of premiums**

Article 5.4 of the OECD MC, if amended according to the BEPS proposition, would aim to avoid the presence of a PE whenever “the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity [...] provided that such activity [...] is if a preparatory or auxiliary character.”

As mentioned above, insurance companies have five key functions which do not include collection of premium. The activity of collection of premium is far from the actual realisation of profits. Profits are generated because of the variety of risks and sources, which enable the insurance company to achieve an appropriate risk allocation. Collection of premium is therefore only ancillary to the actual insurance business. It is not the collection of premium which generates a profit for the insurance company, it is the way these premiums are determined and how risk is assessed.

In the same vein, the OECD does not propose to recognise a PE at the occasion of settlement of claims - just as collection of premium, this activity is ancillary to the insurance company’s core business.

Insurance companies might be compared in this respect, to press agencies. Press agencies will be receiving news from different journalists located in different countries. The news are essential for the publication of the newspaper, however, the journalists will not be treated as a PE. Their activities will be considered preparatory or ancillary as referred to in article 5.4 d) of the OECD MC which provides that there will be not PE for “the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise”.

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From this perspective, ACA does not see why a PE should be recognised because of the collection of insurance premiums or the mere location of risk, as this would result in insurance companies being treated differently from other business undertakings. All companies may collect or sell goods in another jurisdiction, without this triggering a PE in case they have no physical presence there.

3. **Solutions that are proposed by the OECD have to be practical and business oriented**

An amendment to the PE criteria to specifically address insurance companies would result in additional complexity and hamper the development of this sector, thus be detrimental to end-consumers.

a) **Profit determination**

In case a PE is recognised in the source country, the determination of the actual profit taxable in the source country will be difficult, and there is a significant risk of double taxation, as the source country is likely to tax all premiums collected in its country or pertaining to a risk located therein.

b) **Conflict with new authorised OECD approach (AOA) for business taxation**

Under article 7 of the OECD MC, as revised in 2010, a PE has to be treated as operating as a complete independent entity dealing on arm’s length terms with its head office of the company. The trend in business taxation is therefore to allocate more, rather than less weight, to a PE. Hence, reducing the PE criteria in article 5 is contradictory with the new AOA, as the proposal for a revised article 5 in relation to insurance companies (but also globally) tends to reduce the PE criteria, so as to facilitate the recognition of a PE.

This is even more true for insurance companies given their complex business model and the key functions fulfilled by the head office of the company, as well as regulatory obligations, incumbent on them and usually fulfilled by the head office of the company.

c) **Location of risk**

The place of location of risk may be different from the place of collection of premium. Introducing two criteria (collection of premium and risk location) may lead to conflicts in taxation and multiple taxation.
However, risks could be insured in a State A where the PE is located but premium would be paid in State B in which an agent of the insurance undertaking is present. If the insurance company located in State C has dependent agents in both State A and State B and these states have tax-treaty based on the proposed amended article 5, State A could tax the premium based on the “insurance risk test” and State B could tax the premiums based on the place where they are collected.

In addition, the criterion of location of risk is a regulatory concept, and not a tax concept. Making reference to concepts which are not based on tax law implies that non tax changes, in particular those affecting regulatory rules, would impact on the right to tax. From a regulatory perspective, location of risk may depend on the location of the insured asset, the residence of the insured person, the place of conclusion of the insurance contract, etc. Hence, the risk location criterion is a concept which may itself be subject to interpretation and fluctuation, so that reference to this criterion for tax purposes would create fiscal unsafety.

ACA therefore suggests not to introduce a specific risk location criterion.

d) No need to treat differently insurance and reinsurance business

Reinsurance business is not addressed by the Action 7 of the BEPS Action Plan nor by the UN MC. Reinsurance consists on the insurance of the risks of other insurance companies, which will insure risks of clients. In a way, the OECD recognises that the location of the risk is difficult to determine as well as the country in which reinsurance business should be taxed. However, there is no fundamental difference between insurance and reinsurance business.

This artificial distinction between insurance and reinsurance shows, in ACA’s view, that the OECD is itself not fully convinced with a change of the PE criteria for insurance undertakings. In the Solvency II Directive, reference is made to insurance and reinsurance companies. There is no distinction between the two businesses and the key functions are the same for both insurance and reinsurance companies.

4. No need to adjust PE criteria from a BEPS perspective

One of the main objectives of the OECD in its BEPS initiative is to avoid double non taxation. ACA fully adheres to this approach. ACA insists however that the recognition or not of a PE in the country where insurance premiums are collected is not *per se* necessary to avoid double non taxation, as the premiums will in all events be taxable in the jurisdiction of the head office of the company. In particular, insurance companies are fully taxable undertakings and do not benefit from a particular tax concession.
On the contrary, the recognition of a source country PE may result in a risk of double taxation, which the OECD is keen to avoid. Indeed, an insurance company typically concentrates back-office functions, which are key to its business, in its jurisdiction of origin. These functions, which consist in modelisation, risk assessment, financial monitoring, to name only those which are specific for an insurance business, are cost intensive. The risk could therefore be that profits of a PE collecting premiums could not be offset with costs of the head office of the company, which would then not be recognised for tax purposes. The same holds true for solvency reserves that can only be booked by the head office of the company.

ACA would like to emphasise that BEPS Action 7 addresses abusive avoidance of PE in the source country of profits, via arrangements which may be considered artificial. OECD gives in particular the example of commissionaire arrangements replacing a local distribution subsidiary. These arrangements often are motivated by tax reasons. However, the collection of insurance premium by an agent is not motivated by any tax reasons whatsoever; this is simply the way insurance companies do business outside their home country. Hence, there is no need to adapt article 5 to tackle abusive tax structures insurance companies would have put in place.

Yours sincerely,

Marc HENGEN Marc LAUER
CEO President
Ms. Marlies de Ruiter  
Head Tax Treaties,  
Transfer Pricing and Financial Transactions Division  
OECD/CTPA  

Madrid, January 9th 2015  

Dear Ms de Ruiter,  

Taking the opportunity offered by the Committee on Fiscal Affairs to comment on the proposed Discussion Draft on Preventing the Artificial Avoidance of PE Status, the Spanish Association of Tax Advisers (Asociación Española de Asesores Fiscales, AEDAF) wishes to offer the following thoughts:

Setting the scope of application of the modification proposal is controversial and debatable. If, as can be inferred from the title of the Action 7 proposal of the BEPS plan, the purpose consists in preventing artificial situations that circumvent consideration as and existence of a permanent establishment, the reaction should lead back to application of the mechanisms put in place to prevent the abuses or artificial benefits deriving from the tax treaty. It is these antiabuse rules object of Action 6 of the BEPS plan that should be applied in cases of abusive use of the Treaty clauses, including those relating to the permanent establishment agency clause and those relating to negative delimitation of the concept of permanent establishment included in article 5.4 of the Treaty Model.

The same criticism may be levelled at utilisation of the expression ‘updating the definition of permanent establishment to prevent abuses’. A distinction should be drawn between the cases in which abusive use is made of the delimitation existing in the current configuration of the concept of permanent establishment — whether through the figure of the independent agent or through that of the preparatory and auxiliary activities of Article 5.4. of the Treaty Model — and those cases in which it has been observed that application of the current conceptual hypotheses does not allow suitable recognition of the taxation jurisdiction and its assignment to the jurisdictions in which value is actually created for the company.

For these last cases, la OECD posits a modification of the definition of the Treaty concept of permanent establishment as it exists and has been applicable to date, that goes beyond those cases in which an abusive or artificial avoidance of its requirements can be identified. In many cases, the changes of wording in articles 5.5, 5.6 and 5.4 of the OECD Treaty Model do not appear to be linked to cases of artificial prevention of the existence of a permanent establishment; rather, they clearly and forthrightly involve alteration of the cases and delimitation of the concept of permanent establishment, i.e. certain preparatory or auxiliary
activities, warehouses for delivery of goods, the purchase of goods or the collection of information.

As the OECD report on digital economy points out, one of the objectives of Action 7 of the BEPS plan consists in checking whether or not activities traditionally considered to be auxiliary or preparatory should continue to benefit from the exceptions to the concept of permanent establishment, for under the existing business models they form an essential part of those business models. In such cases, the objective consists in checking whether a reasonable and easily administered rule could be developed for the purpose.

A distinction must therefore be drawn between situations that constitute an artificial or abusive exclusion from the existence of a permanent establishment and situations in which, far from an abuse of the existing rules being identified, it is considered that the existing rules are not suitable for ensuring taxation of business income in the location in which its value is created or in which the corresponding activities are carried out. These cases have to be identified clearly, because the OECD proposal involves an outright and clear change of rules compared to the previous situation, such that the rules now proposed must be treated accordingly. This further means that the new rules regulation cannot be organised as a basis for interpreting the treaties previously in force. In this respect, we consider that the proposed changes to paragraphs 5.5 and 5.6 involve an alteration to the preceding rules applying to cases, and are accordingly not applicable to those situations subject to application of a Tax Treaty based on the wording currently in force of the OECD Treaty Model.

Lastly, we consider that the proposals for reformulation of articles 5.4, 5.5, 5.6 should necessarily be accompanied by a statement of the adjustment or adaptation mechanisms for the implications of article 7 for those cases which, with the new proposal, would now be considered as permanent establishment, without any of the current exceptions being applicable — whether of independent agent or of preparatory or auxiliary activity. However, the Draft presented by the OECD (paragraphs 43 and 45) considers it necessary to coordinate the work under Action 7 with the results of other actions (4, 8, and 9). It is thus illogical to anticipate the results of Action 7 without taking into consideration the consequences that appear to be linked thereto by actions whose consequences are far from being fixed and must still be subject to consideration and final consensus. Making definitive or advance proposals about the change in article 5 without taking into consideration a global and overall focus alongside the implications deriving from the application of article 7 to the new hypotheses is inconsistent and prevents making a properly weighed-up evaluation of the proposed changes.

Eduardo Luque
President
9 January 2015

By email to: taxtreaties@oecd.org

Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

Dear Marlies,

**BEPS Action 7: Preventing the artificial avoidance of Permanent Establishment (PE) status**

AFME\(^1\) and the BBA\(^2\) welcome the opportunity to respond to the OECD's discussion draft entitled "BEPS Action 7: Preventing the artificial avoidance of PE status published on 31 October 2014 (the discussion draft). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the OECD discussion draft, both organisations have decided to submit a single, combined response since our respective members share some concerns with the OECD's proposals in the discussion draft.

We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD's initial proposals. We believe that it is also valuable for

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\(^1\) The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

\(^2\) The British Bankers' Association (BBA) is the leading association for the UK banking and financial services sector, speaking for 180 banking members, headquartered in 50 jurisdictions and operating in over 180 territories worldwide jurisdictions, on the full range of UK or international banking issues. Collectively providing the full range of services, our member banks make up the world's largest international banking centre.
the OECD to take account of the views of business on the practical aspects of operating the
intended policy.

Given the relatively short time available to consider the discussion draft it has been difficult to
consider all aspects of the discussion draft in detail and we are therefore providing our
comments on the most important issues of concern to us. We may decide to write to you again
with further comments once we have had a chance to consider the proposals in greater detail.

**General Comments**

We note that the proposals in the discussion draft outline several ways in which the
establishment of a PE for tax purposes might be artificially avoided. Having reviewed these
proposals we are concerned that rather than targeting perceived methods by which a PE may be
artificially avoided, the proposals instead lower the threshold for what constitutes a PE. This
approach would logically lead to an increase in the number of PEs and we are concerned that
this may lead to an increase in double taxation – and potential disputes between jurisdictions -
as both source and residency countries seek to apply taxing rights to the same activity. We do
not believe that this would be a desirable outcome.

The discussion draft proposals also focus on how to determine whether a PE exists without
providing any new methodology for determining how much taxable profit is allocated to a PE.
We believe that it is important for the OECD to note that a new PE does not automatically lead to
any incremental tax liability. This would be consistent with the transfer pricing methodology set
out in the 2010 OECD Report entitled “Report on the attribution of profits to PEs”.

In addition we would also take the opportunity to highlight in the next few paragraphs below
several inadvertent consequences that may arise from an overall increase in PEs.

In several jurisdictions, registration for corporate tax purposes might also require firms to
register for - or bring them within the scope of - other taxes including indirect taxes, such as
VAT/GST, as well as taxes associated with the remuneration of employees. This could have a
significant effect on businesses’ supply chain management, create additional compliance
demands on business and increase the possibility of disputes arising between tax
administrations and businesses.

From an administrative perspective we would envisage that this would lead to greater demands
being placed on tax administrations’ resources to cope with a greater volume of work as
businesses seek to ensure tax compliance. We also note that the recognition of a new PE for tax
purposes could in some cases result in that jurisdiction’s regulatory authority examining
whether there was a PE for regulatory purposes. The costs and complexity of any increased
administrative burdens do not appear proportionate for those cases where the agent is
adequately rewarded. We would strongly encourage the OECD to ensure that any final
proposals strike the right balance in this respect.
Agency PE tests

Article 5(5) of the OECD Model Tax Convention

We note that Paragraph 11 of the discussion draft sets out four possible options (A to D) for amending the wording of Article 5(5) of the OECD’s Model Tax Convention. We understand that the rationale for introducing one of these options is to address the use of commissionaire arrangements and similar strategies to avoid having a PE in a jurisdiction.

Rather than making general changes to the existing dependent agent PE test under Article 5(5) of the OECD’s Model Tax Convention we believe that the OECD should seek to better define a commissionaire or similar arrangement and set out where this should be considered a dependent agent PE. This could be achieved by supplementing the wording of Article 5 to be explicit that a commissionaire is a dependent agent PE, rather than by changing Article 5(5). However we would also suggest that the OECD considers updating the Article 5 commentary to set out the types of commissionaire and similar arrangements which it considers should fall within the existing test of a dependent agent PE.

We are concerned that the suggested amended wording in options A to D is widely drafted and could capture arrangements which are generally considered to be part of the ordinary course of business of financial institutions, and which do not lead to base erosion or profit shifting. We note below some examples of activities which we would consider part of the ordinary course of business of banks which we believe may be impacted by a change to the dependent agent PE test. We would be happy to meet with the OECD in due course to discuss these examples in greater detail.

1. Banks with global operations will often centralise the trading of certain products or markets within hub entities for a variety of commercial and regulatory reasons, and will utilise sales people based in multiple local country or regional coverage entities to sell those products to clients globally. For example, a bank might centralise trading of the UK equities products within a UK based entity, and will utilise sales people in entities in other locations to sell those products to clients globally.

2. Similarly banks also spend a great deal of time and effort in establishing and building relationships with prospective clients. A bank may spend some years speaking to a prospective client in a jurisdiction before the bank is engaged on a mandate, or generates any revenue from the relationship. Some of those discussions may involve visits to the client’s jurisdiction; in some cases the bank may have local staff involved. Often the result of that relationship management may be transactions that are entered into with a member of the bank’s group outside of the client’s jurisdiction because that company is best placed to provide the relevant service, for example securing investors in another market for a new issue of shares by the client.

Under existing practices the above sales and relationship management activities would typically be rewarded on an arm’s length basis and would not generally be expected to create a PE. If a PE was created, it is unlikely that it would lead to any increased tax liability as the local sales activity has already been fully remunerated. If any of options A to D are adopted; we believe that
guidance will be needed to make that clear. In addition, guidance should address what is meant by “habitually”, to make clear that business personnel can undertake short term business travel to jurisdictions without creating a PE.

In the event that the OECD does go ahead with recommending one of options A to D there are other areas where we believe further guidance should be made available by the OECD.

This should include clarification of how close the link would need to be between the activities of an agent and the conclusion of contracts (as required under options A and C) and what is meant by negotiating the material elements of a contract (under options B and D). Without more detailed OECD guidance, there is a risk that a revised Article 5 would be interpreted on an inconsistent basis in different jurisdictions and this could have a distortive impact on cross-border trade. We also believe that any further guidance in the OECD commentary should make clear that in deciding whether or not a PE exists, all the relevant facts and circumstances should be taken into consideration.

We believe that the OECD’s policy objectives can be met by updating the Article 5 commentary rather than the wording of Article 5(5) itself. Should the OECD decide to amend the article itself, we believe that either of options B and D – where the suggested revised dependent agent PE test would require an intermediary to “conclude contracts, or negotiate the material elements of contracts” - would be preferable to either of options A or C – where the suggested revised dependent agent PE test is particularly unclear in requiring an agent to “engage with specific persons in a way that results in the conclusion of contracts”. We believe that the proposed dependent agent PE tests in either of options B and D would provide greater certainty for financial institutions than either of options A and C and would have less potential to disrupt activities which are considered to be in the ordinary course of business and which do not constitute base erosion or profit shifting.

**Article 5(6) of the OECD Model Tax Convention**

We note that each of options A to D of the discussion draft proposes that the wording of Article 5(6) of the OECD’s Model Tax Convention should be changed in respect of the test required to be met in order for an agent to be considered as an independent agent. In particular, we note the proposed new wording 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...”.

We consider that an associated enterprise can act as an independent agent, not least when it does so as part of a substantive operating business. For example a local subsidiary may face local clients; indeed this is sometimes required by the regulatory environment for financial services. However, the local subsidiary may not be the relevant entity for trading in a security which the client wishes to buy (e.g., UK shares may primarily be traded by a subsidiary in the UK). In that case, the local subsidiary could act as agent in facilitating the purchase from the relevant trading entity. We presume that the commentary on Article 5(6) will make clear that the local subsidiary can be an independent agent in such circumstances, for example because it has an extensive range of local activity, notwithstanding that some of its activities involve transactions as an agent - and possibly also as principal, with other group companies.
We believe that further consideration needs to be given to the impact on banks which would arise from changing the wording in Article 5(6) and once again we suggest that, rather than amending the wording in Article 5(6), the OECD considers providing more detailed commentary on the types of commissionaire and similar arrangements which should fall within the existing test of a dependent agent PE.

We are grateful for the opportunity to share our comments with the OECD on the discussion draft and we would be happy to discuss any of the above in greater detail with the OECD and would be pleased to contribute further as the OECD’s work develops.

Yours sincerely,

Richard Middleton
Managing Director
Tax and Accounting Policy
AFME

Sarah Wulff-Cochrane
Director of Policy
Taxation
BBA
Dear Marlies

We respectfully submit comments on the Discussion Draft on Prevent the Artificial Avoidance of PE Status (dated 31 October 2014) (“the draft”). If there is any specific point from our comments that you would like to discuss further, please do not hesitate to contact us.

1. Comments are requested on the changes to definition of PE to prevent the artificial avoidance of PE status in relation to BEPS through the use of commissionaire arrangements.

Comments:

The discussion draft put forth 4 options of wordings to be included in Article 5(5) which intends to widen the condition of “conclude contracts in the name of”. Each of the options are evaluated below, their practicality is considered while bearing in mind the object of these changes is to prevent the artificial avoidance of PE status:

Option A

• “habitually engages with specific persons in a way that results in the conclusion of contracts”

The above set of wordings is rather broad and subject to interpretation. If this wording is adopted, it will require examples to clarify the meaning of the words chosen. Terms such as “habitually”, “engages”, “specific persons” and “in a way that” can be difficult to interpret if the context changes. For instance:

  o “habitually” is a vague term and it can be interpreted differently in different situations (sector and businesses). For example, in the professionally services sector, like advisory or consulting, you may require multiple interactions with a "specific person", often over several years, to finally be able to "provide services"(with a contract or without). However, as the sector is relationship driven you may end up providing the service not to the company for which the "specific person" was working all those year (say company A) but with their new employer company B. In some industrial sectors (like construction of large infrastructures) you may require interaction with key decision makers (potential buyers) only once or twice a year. That can hardly be called "habitually" but if the "specific person" is the right person it could lead to significant orders. In some other sectors, like online retailing, you may need little or no interaction with people to be able to sale products: you don’t even need the power of a brand (whether the brand of the retailer or the brand of the product) a customer can just randomly purchase something (based on a discount for example) and then randomly again switch to another retailer and never buy on the first one again.
“engages” is also a broad term. Engaging may require physical interaction or not. There are different degrees of “engagement” and the definition is very subjective to each person involved. A sales person may find himself/herself very “engaged” with its potential customer whereas the potential customer may feel not engagement at all. This interaction may lead to a sale or not depending on other circumstances like availability of other providers, hierarchy of needs of the buyer, etc., which are completely unrelated to whether the seller “habitually engages” with the potential buyer.

“specific persons”: one person, two persons, a team, always the same person, different persons every time?

The phrase “in a way that” is also a subjective combination of words that allows for subjectivity as there could be various factors resulting in the conclusion of each contract. In the event where multiple factors were pivotal to the conclusion of contract and such factors were split between the commissionaire and enterprise, the position would be uncertain.

- “for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use” or “for the provision of services by that enterprise”

This essentially covers a commissionaire’s function and it will be difficult for a "non-artificial" commissionaire arrangement to fall out of this category.

Based on the explanation in the draft, the intention of the above is to move away from “who is bound by the contract by focussing on what is the object of the contract” and it is considered “sufficient taxable nexus” when “an enterprise mandates someone to act on its behalf and that person concludes contracts concerning property or services to be provided by the enterprise”. In the normal operations of MNEs, it is common for the enterprise to mandate various parties (in different jurisdictions) for closing of contracts, this rule could potentially increase the tax exposure of MNEs with such arrangements unnecessarily. We doubt it is the intention of the draft.

Option B

- “concludes contracts, or negotiates the material elements of contracts”

This wording, in comparison to Option A, is more targeted and closer to the intention of the draft. The term “material elements” may require further clarification, perhaps a commentary or example should be added to demonstrate what material means in different contexts. It could be a benchmark on the cost of such elements in relation to the consideration for the contract or a qualitative justification such as the communications and negotiation process of the contract.

- “for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use” or “for the provision of services by that enterprise”

Same comments as above in Option A.

Option C

- “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”

The explanation for Option C indicated that the intention of the wordings is to cover the legal and not economic relationship between foreign enterprise and the intermediary. We note that a non-
formal relationship could be excluded by this clause. Further, the legal relationship would cover agency contract, commissioneer contract, partnership contracts and even trust deeds which would point towards independent agent arrangement. These types of arrangement would be covered by paragraph 6, therefore seem redundant to mention in paragraph 5.

- “habitually engages with specific persons in a way that results in the conclusion of contracts”

Same comments as above in Option A. Overall Option C seems more confusing than clarifying.

Option D

- “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”

Same comments as above in Option C.

- “concludes contracts, or negotiates the material elements of contracts”

Same comments as above in Option B.

In all, we would suggest wordings which are more targeted to prevention of artificial avoidance of PE Status, for example:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, concludes contracts or negotiates material terms of the contracts with limited or insignificant input from the enterprise engages with specific persons in a way that results in the conclusion of contracts

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

2. Comments are requested on the changes to definition of PE to prevent the artificial avoidance of PE status in relation to BEPS through exploiting specific activities exemptions.

Comments:
The draft explored the options of subjecting the list of activities in Article 5(4) to the condition of being preparatory or auxiliary (Option E) or make targeted changes to the list of activities in Article 5(4) to address identified issues (Option F).
The prior has the clear advantage of a blanket provision which is closely aligned to the objective of BEPS. In fact, this is the position that OECD has adopted and explicitly stated in its commentary\(^1\) Paragraph 21\(^2\) for Article 5 and repeated in subsequent paragraphs. However, it also increases the reliance on the definition of the terms “auxiliary” and “preparatory”. Again, the OECD commentary Paragraph 22 to 27 of Article 5 attempt to clarify these terms by providing examples. Although it still leaves considerable room for subjectivity as “The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.”\(^3\), it is clearer than paragraph 14 of the draft.

Option E would therefore serve to provide additional clarity but not substantially alter the impact of Article 5(4).

- The word “delivery” in subparagraphs a) and b) of paragraph 4

Option F narrows the exempt activities by removing the reference to “delivery” from subparagraphs a) and b), which is a direct way to target this issue. It will mean that each time one of those listed activities becomes a channel for artificial avoidance of PE status, it will need to be removed.

- The exception for purchasing goods or merchandise or collecting information

The Article 7(5) of the 2008 OECD Model Treaty Convention can be inferred as an extension of subparagraph d) of paragraph 4, thus, the removal of the former should indicate an expiration of the latter. However, following the argument that Article 7(5) is not consistent with the arm’s length principle, it could eliminate the need to have Article 5(4) as a whole. All activities will have their functions, assets and risks and therefore profits should be attributable. In this perspective, the PE concept could be an unnecessary hindrance for the arm’s length principle to apply.

The removal of “purchasing activities” from subparagraph d) (Option G) or removal of the entire subparagraph d) (Option H) would have the same challenges as removing “delivery” from subparagraph a) and b).

- Fragmentation of activities between related parties

Instead of fragmentation of activities of an enterprise into various locations within the same state, organisations may fragment a cohesive operating business into places of business which belong to various related parties, and as such, avoid PE status in the mentioned state. It could be a business decision to do so, for example, to be able to divest, if necessary, a part of the business more easily.

The onus to prove the purpose of tax avoidance will lie with the tax authority. By applying a rule to evaluate the existence of PE through analysing the collective activities performed by related parties’ activities in the same state is tantamount to an extreme version of the force of attraction.

Both Option I and J will have that issue of enforcement and increase compliance burden on the taxpayers. This issue should be tackled by general anti avoidance rules which targets artificial arrangements in a wider scope.

3. Comments are requested on the changes to definition of PE to prevent the artificial avoidance of PE status in relation to BEPS through splitting-up of contracts.

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1 OECD Commentary to the Model Tax Convention 2010
2 Sentence 4 & 5 of Paragraph 21 of Article 5 in the OECD Commentary to the Model Tax Convention 2010
3 Sentence 2 of Paragraph 4 of Article 5 in the OECD Commentary to the Model Tax Convention 2010
Comments:
Option K is suggested to tackle the issue of splitting-up project\(^4\) contracts or service\(^5\) contracts which spans over the threshold stated in the OECD and UN Model Treaty Conventions. Wordings suggested excludes 3rd parties who may take over the construction and limit the exploitation of associated enterprise for artificial avoidance of PE Status in contracting states. We believe this option is a targeted and reasonable approach which could be adopted.

Although these scenarios can also be covered by general anti avoidance rules as suggested in Option L, Option K is simpler for enforcement and we cannot think of commercial reasons for related parties to take over a project one after another for limited periods, except perhaps in some cases to limit liability vis a vis third parties.

4. Comments are requested on the changes to Article 5 in respect of insurance activities.

Comments:
Option M provides specific rule for Insurance industry which is aligned with UN Model Tax Convention while Option N suggests the changes proposed in Option A to D will suffice in dealing with insurance enterprises. We believe Option M could be an optional add-on for states where insurance enterprises are highly regulated and therefore has more agents operating for foreign insurance enterprises.

5. Further Comments beyond the scope of this paper

Changing the definition of PE by widening the definition and minimising the exceptions could narrow the options of avoiding PE status, however, more than definition much of tax leakage is due to lack of enforcement. When businesses are conducted in a manner which does not require any form of registration, it limits the governments’ understanding business activities of enterprises in the state thus providing leeway for PE status avoidance. Thus, the effectiveness of the options suggested above is heavily dependent on the infrastructure of each contracting state.

We hope that you find our comments useful. Regretfully, we will not be able to attend the public consultation on 21\(^{st}\) January 2015, however, please feel free to contact us should you require any clarifications.

Best Regards,

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\(^4\) A building site or construction or installation project as stated in Article 5(3) of the OECD Model Tax Convention.

\(^5\) The furnishing of services, including consultancy services as stated in Article 5(3b) of the UN Model Tax Convention.
Dear Sirs,

OECD discussion draft 21 November 2014
BEPS Action 7: Preventing the Artificial Avoidance of PE Status

The Alternative Investment Management Association¹ wishes to comment on one specific matter in the proposals set out in the 31 October 2014 discussion draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status.

The discussion draft contemplates that Article 5(6) of the Model Treaty, relating to independent agents, should be amended to include the requirement:

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 within the meaning of this paragraph with respect to these enterprises.

A collective investment scheme may be established under the laws of one Contracting State (e.g. one of a number of “fund” jurisdictions) by a manager in the other Contracting State. The manager will be appointed by the collective investment scheme to act as such and in that capacity will be responsible, as agent, for the marketing of interests in the collective investment scheme and the management of its assets. These functions are carried out on an arm’s length basis and subject to the supervision of the directors of the collective investment scheme (being the principal).

In the case of many managers in the alternative investment funds sector, the management of one collective investment scheme will represent the whole, or substantially the whole, of the manager’s business. Whether the collective investment scheme may have net assets of $10 million or $10 billion, whether it may have 10 investors or 1,000 investors, it is the collective investment scheme on behalf of which the manager acts, and not the investors (however much they might in reality be considered such).

For other managers of collective investment schemes, it would be a situation that would arise at the commencement of business - or in a time of transition - when there is a sole collective investment scheme under management.

The consequence for a collective investment scheme that has an investment manager that is its PE in a Contracting State would be that (subject to the domestic laws of the Contracting State) income and capital gains of the collective investment scheme would acquire a source in the Contracting State and so would be subject to tax in the Contracting State. Such income and gains may include the “business profits” of the collective investment scheme, i.e. the net profits of the collective investment scheme arising from the transactions carried on for it by the investment manager, whether or not relating to financial instruments or other assets that of themselves constitute a source in the Contracting State.

¹ AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector - including hedge fund managers, funds of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.
Such a result would be harmful to the Contracting State’s financial services sector and in practice domestic law may provide exemption. Typically such exemptions have been modelled on, and adopt concepts from, the “independent agent” provision in the Model Treaty and as explained by the Commentary. The UK’s investment manager exemption is an example of such a domestic law provision. It permits the independence criteria to be satisfied where a collective investment scheme is the only or main person on behalf of which the investment manager acts provided that the investors in the collective investment scheme are sufficiently independent of the manager and each other.

AIMA’s concern is that such domestic law exemptions may come under pressure as apparently inconsistent with international standards or on grounds of unfair tax practice if the Model Treaty prohibits an independent agency from being found in these circumstances.

We therefore request that the language of Article 5(6) and/or the Commentary reflects the possibility of a wider interpretation of the enterprises on behalf of which the manager can be understood to be acting, so as to include investors in a collective investment scheme, such that the arrangements are not viewed as an agent acting exclusively or almost exclusively on behalf of one enterprise or associated enterprises (i.e. the collective investment scheme). This would permit the concept of an agent of independent status to extend to arrangements where the overall relationship between manager and investors is genuinely that of an independent agent and multiple unconnected persons.

One of the policy objectives of the OECD - for instance, as stated in its 2006 publication the Policy Framework for Investment - is to mobilise private investment that supports economic growth and sustainable development. The fund management industry is an important provider of international private investment, both as a primary investor and as a provider of liquidity in the secondary markets. The Model Convention should, as a uniform approach of internationally agreed rules that can provide certainty and coherence, recognise the role of collective investment schemes, consistent with the objective of the BEPS project to facilitate cross border investment as well as addressing double taxation and double non-taxation. The OECD should ensure that it does not, through inappropriate application of measures which restrict the scope of the independent agent exception, stifle private investment or increase the costs of its provision.

Yours faithfully,

Paul Hale
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Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
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Submitted by email: taxtreaties@oecd.org

Milan, January 7, 2015

PROPOSED DISCUSSION DRAFT: ACTION 7, PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

Dear Mrs de Ruiter,

AmCham of Italy is glad to provided you and the Organization for Economic Cooperation and Development (OECD) with its comments on Discussion Draft on Action 7 of the BEPS Action Plan issued 31 October 2014 (The Discussion Draft).

GENERAL COMMENTS

In an economic environment, increasingly global taxation is a crucial element of the competitiveness of countries and economic systems. A clear and balanced tax system not only increases the attractiveness compared to foreign investors and global business but also the benefits for local operators including tax administrations.

Nowadays major concerns for Multinational Enterpries (MNEs) are related to the great tax uncertainty which may result in an increasing millionaire tax assessments and litigations locally and internationally. Double taxation issues are constantly increased over the last decade the disputes among the States and the cost related, without a substantial benefits in terms of dispute resolution itself, often due to the lack of mandatory and binding International Arbitration tool.

In addressing the theme permanent establishment, the importance of the business model is crucial in understanding the boundaries of what in law and practice is explained as conditions of the existence of permanent establishment. The BEPS work would be efficiently dealt if simultaneously developed around PE re-definition (Action 7), Attribution of Profit and Transfer Pricing principles by focusing on
functions, assets and risks assumed.

**AMCHAM OF ITALY CONSIDERATIONS**

Our considerations would be mainly focused on Paragraph A. "Artificial avoidance of PE status through commissionaire arrangements and similar strategies"

The Executive Summary of the Discussion Draft states as follows:

"As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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."

*Prima facie,* the statement is wider than a mere reference to those entities operating under *commissionnaire* arrangements, it seems to include any entity having customers relationships for sales activities purpose, by including also a mere local support and services provider.

What is emerging strongly, starting from the Philip Morris Italian case law, according to which the mere attendance at the negotiation phase by employees not empowered to sign any contracts would be enough to exclude the existence of personal permanent establishment, it is a need for a policy statement and guidelines which narrow the scope and render a description of the sales activities and the way how they should be performed to address the PE issue.

Indeed, it must always be carefully considered the powers of any representative, attorney of the foreign company and to the meaning to be attributed essentially to the "*authority to conclude contracts*".

In this perspective for understanding the crucial elements of binding negotiation with third parties it must be first understood how multinational corporations have structured their business model and the decision-making and authorization system which operational effects would inevitably impact the Country where the business is carried on.

It is increasingly common for multinational companies to use production and sales facilities centralized by geographical areas of importance (ie EMEA, Asia, Americas) and located in one country where strategic decision in terms of production and/or distribution throughout the target area would be taken, by leaving the local business units responsible for execute sales activities as a commissioner/agent or a distributor (LRD) with business risk greatly reduced (ie, without obligation to warehousing and storage, no credit and/or exchange rate fluctuations risk) or as Services Provider of marketing and administrative services (ie orders delivery and customer care) whereas sales are directly made in a local Country from abroad by the foreign company.

In examining the patterns of multinationals operating in the particularly difficult market environment, they have reorganized all the countries in which operate to significantly reduce all types of costs, trying to optimize the results and to ensure uniformity to eliminate differential and expensive country implementation; the related decision-making and authorization system typically involves multiple levels (ie local, European and global). Levels at which necessarily correspond different levels of responsibility, autonomy and operational areas such as broken down by type of customers (ie multinational customers are almost always managed centrally whereas small and medium sized customers are often followed locally, etc.)
The process of negotiation and decision conversely might be affected by further factors related to the particular product and/or services sold and the details of marketing them. For instance, in case of products to be sold based on a price list defined centrally where the only option may represented by the quantities sold, it could be argued that in finalizing the contracts with customers, the local distributor (either LRD or commissioner/agent) does usually follow the principal's guidelines as sufficient to the definition of the economic factors relevant to the completion of the contract.

Before concluding on the existence of a personal permanent establishment it should be also proved, the following facts: the agent is dependent economically and financially by the principal, is acting without any autonomy and is not taking the risks of its own business or professional practice (say he is not under his ordinary course of business). In respect of this latter aspect an interesting point to understand, through a functional analysis, is the fairness of agent/distributor compensation, in the light of the risks and functions undertaken by the same locally.

Therefore, Sales Services (Marketing, Customer care, Market research and Analysis, etc.) rendered by a local entity to a foreign one, which seem to be included in the wider scope interpretation of the Discussion Draft, when properly remunerated under TP perspective based on a functional and risks analysis, regardless the status of associated entity or totally independent, should be clearly carved out from the transactions which may lead to PE exposure.

A complex business model requires a detailed analysis of each major step, as mentioned, to define the contractual will, by understanding the essential items to identify where the same is finalized to bind the company towards third parties. In such cases, an overly simplistic approach, because sometimes there is no hint or otherwise it is disregarded the background of the any business models adopted at the group level which is the guiding principles of every intercompany transaction at cross border level, could be totally misleading for the purposes of analysing the existence of the permanent establishment.

CONCLUSIONS

It is therefore necessary to balance the legitimate expectations of foreign multinational to carry on business under the reasonable certainty there would not be any tax risks implications, with the need of Local Tax Authorities to verify the fairness of the business model operating in the territory of the country, to ensure the meeting of law requirements of taxation and to tackle any artificial avoidance of PE status.

It has also become necessary to develop appropriate tools and interpretation to enhance true representation of the MNEs business model and the decision-making and authorization processes that are ancillary to the model; any oversimplification may lead to misleading conclusions since the business models of multinational companies are diversified and constantly evolving.

In the light of the above Option A and C might represent a wider and oversimplified reference unless further guidelines on the "empowerment process" in concluding contracts would be provided. Particularly Option C should clearly define the meaning of “engages with specific persons in a way that results in the conclusion of contracts” and how these options are interacting with and impacting the most recent matrix organization of MNEs worldwide. At present the proposed wording have a
negative impact on the MNEs Global structures and matrixes

**Options B and D**, should clarify definition, content, also by way of examples, of the “material elements” concept, which seems to be crucial for the purpose of the policy statement.

**Options A & B & C** The statement “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 within the meaning of this paragraph with respect to these enterprises” appears quite extreme for multinational Groups and subsidiaries normally acting on behalf of the Group. Furthermore this is also not consistent with the underlying legal principles: this should not be a matter of PE but rather of TP.

Any of these options would not represent an efficient tool in supporting BEPS goals and MNEs business on a global basis, without strengthening the coordination and interaction with TP policy and the Dispute Resolutions Practices at the same time.
Joint AOTCA/CFE Opinion Statement FC 1/2015 on the OECD 2014 Public Discussion Draft on Preventing the Artificial Avoidance of PE Status (BEPS Action 7)

Prepared by the CFE Fiscal Committee, agreed with AOTCA and submitted to the OECD in January 2015
CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries (16 OECD members) with more than 100,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe. CFE is registered in the EU Transparency Register (No. 3543183647-05).

AOTCA was founded in 1992 by 10 tax professionals’ bodies located in the Asian and Oceanic regions. It has expanded to embrace 20 leading organizations from 16 countries/regions.

Introduction

The following comments relate to the OECD’s Public Discussion Draft “Preventing the Artificial Avoidance of PE Status” (hereinafter: Discussion Draft), published on 31 October 2014, relating to Action 7 of the OECD/G20 BEPS (base erosion and profit shifting) Action Plan.

Please note that this version of our Opinion Statement is only preliminary. The final version will be published on the CFE website in the course of January 2015.

We will be pleased to answer any questions you may have concerning our comments. For further information, please contact Mr. Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.

1. General comments

Although being perfectly aware that the PE (permanent establishment) framework leaves some room for improvement, we are concerned that by means of the suggested broadening of the PE concept, we risk creating unnecessary burdens, further complexity for both taxpayers and tax authorities, with the further risk of creating more double-taxation.

Any review of the PE definition should ensure that no additional uncertainty nor any unnecessary burden be generated on taxpayers. Further guidance on the issue should be designed to provide greater certainty and to reduce the possibility of disputes (between taxpayers and tax authorities). In our opinion, the suggested changes might end up producing an increase of PEs, which would necessarily generate further compliance burden on businesses, and which would hamper the desired level playing field and negatively affect foreign investment. Moreover, the issue concerning the case where a tax authority argues that the subsidiary is itself a PE of the parent company should be properly addressed and further guidance should be provided.

Moreover, we are particularly concerned with a possible increase in the use of subjective tests (included in all of the options suggested within the Discussion Draft), which would not contribute to the above-mentioned desired certainty. Instead, the use of agreed legal terms and objective criteria should be favoured.

Finally, effective dispute resolution mechanisms should be ensured. We support the use of mandatory binding arbitration.

2. Specific Comments to the issues proposed in the October 2014 Discussion Draft

A. Artificial avoidance of PE status through commissionaire agreements and similar strategies

With regard the suggested amendments to improve the PE framework, for the sake of consistency and clarity, and in order to avoid penalizing perfectly legitimate business practices, we support the use of objective criteria rather than the use of subjective tests (as suggested in the Discussion Draft), and favour the use of agreed legal terms. In our view, all of the options could be improved. We are concerned that, due to the vagueness of the wording, these options will target more than just commissionaire agreements.

From the various alternative formulations of paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention, we prefer Option B, as Options A and its variation of Option C seem incompatible with the desired legal certainty. The suggested wording (“with specific persons in a way that results in the conclusion of contracts ...”) is extremely vague, making use of notions that are not legally clear – clarity is crucial for taxpayers. Option B seems the most balanced one, so as to allow the clarity that business, taxpayers and tax administrations require.

Nevertheless, we believe that more guidance is needed (and, if possible, some examples should be provided), especially as to the significance of “material” elements of contracts (page 13), in order to avoid uncertainty and further disputes.

In addition, and for the sake of clarity, specific examples on what is deemed “similar arrangements” should be provided (all the options seem to affect more than commissionaire arrangements, exceeding the scope of the Discussion Draft).

Finally, we do not support the suggested amendment with regard to “independence” of the agent (whenever an agent works exclusively/almost exclusively for associated enterprises), since it seems to go beyond the concept of independence of legal entities (especially when the agent is correctly remunerated at arm’s length and there is evidence of its economic and legal independence). This is particularly so when the whole BEPS project is meant to be based upon the arm’s length principle.

B. Artificial avoidance of PE status through specific activity exemptions

We have some concerns with regard to the possibility of an effective and consistent implementation of such rules by different countries.

B.1. The exceptions are not restricted to preparatory or auxiliary activities

Option E, “amends Art. 5(4) so that all its subparagraphs are subject to a “preparatory or auxiliary” condition” would subject all of the activities currently listed in paragraph 4 of Article 5 to the condition of being either preparatory or auxiliary (which might be regarded as a potential advantage), excluding e.g., delivery, purchasing and data collection. Further practical guidance (and further examples) will still be needed so as to ensure an effective implementation by both,
taxpayers and Tax Administrations. This option presents the disadvantage of exposing all of the listed activities to a possible challenge.

Although we agree with the purpose of the amendment, it is of the view that the proposal has been formulated in a manner that is far too complicated. We suggest the following wording (changes below in bold letters):

“4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include the following activities as long as they have a preparatory or auxiliary nature:

a)...[unchanged]
b)... [unchanged]
c)... [unchanged]
d)... [unchanged]

e) [To be deleted. Reasoning: “The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity” adds nothing once the phrase “of a preparatory or auxiliary character” is moved to the beginning of Article 5 (4), as proposed”]
f) [To be deleted. Reasoning: Again, if the reference to the preparatory or auxiliary nature is included at the beginning of Article 5 (4), there is no need to repeat it in f].”

B.2. The word “delivery” in subparagraphs a) and b) of paragraph 4

We believe that it is preferable to add the overall condition of “preparatory or auxiliary” to Article 5(4) (Option E previously addressed) than simply deleting the reference to “delivery”. Addressing the concern raised by some specific cases does not justify removing the reference to “delivery” especially when such activity is not the core activity of the company.

B.3. The exception for purchasing goods or merchandise or collecting information

Again we believe that the general inclusion of the reference to “preparatory or auxiliary” character suffices to overcome the problem posed by the purchase of goods, and that the exception for purchasing should be retained. We do not support Options G and H, since by eliminating such activities would result in increasing the number of PEs. The possibility granted to “test the market” without having a PE in the market is an aspect that is rather important for business purposes, as it significantly impacts on investment. The reasoning inserted in the Discussion Draft is in our opinion insufficient and should be subject to further assessment and study. The exception for data collection should be kept.

On the other hand, the problem of how profits should be calculated in the case of a permanent establishment which merely purchases goods for its group cannot be overlooked.

B.4. Fragmentation of activities between related parties
Although we believe that the abusive use of fragmentation activities between related parties should be limited, the options proposed to address such issue (I and J) are in our opinion not suitable given that both seem to challenge the concept of separate entity reporting. In any case, Option I would be preferable to Option J (it seems less extensive than Option J).

C. Splitting-up of contracts

We believe that in those cases where the general anti-abuse rule proposed as part of the work on Action 6 can apply, there is no need to include specific clauses.

It is our opinion that Options suggested in the Discussion Draft do not seem fit for purpose, in view of their intrinsic difficulties with regard to implementation and monitoring (“automatic rule”) and the potential legal uncertainty that they might engender (“principal purpose test”).

E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing

It is quite clear that the allocation of profits to the PE is a fundamental issue and we are of the view that it is absolutely necessary, in order to properly address the changes to the PE definition, to identify the few areas were additions/clarifications are needed, and to coordinate those suggested changes also with the work carried out within Action 9 of the BEPS Action Plan (risks and capital).

Although the Discussion Draft specifically ensures under paragraph 3, page 10 that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income”, we are concerned that the proposed changes to the PE framework, taken without proper coordination/guidance on profit attribution, may give rise to uncertainty and double taxation among countries.

In our view, further clarification and guidance are necessary, along with some due consideration on other BEPS Actions addressing transfer pricing issues.
The Agency Permanent Establishment in BEPS Action 7: Treaty abuse or business abuse?

Dr. Arthur Pleijssier*

1. Introduction

The Base Erosion and Profit Shifting (BEPS) Focus Group\(^1\) published a discussion draft paper\(^2\) on 31th October this year fully devoted to action number 7: preventing the artificial avoidance of PE status. Early in the BEPS project it became apparent that the OECD wishes to maintain the Permanent Establishment (PE) concept. The OECD announced it wants to directly address the flaws in the current system instead of developing a new system.\(^3\) The current PE concept was developed at the end of the 19th century in 1899 in Germany\(^4\). In those days there were not many multinational companies. Cross border business transactions usually concerned local market traders who lived next to the border and sold their products on the nearby market across the border. One hundred and fifteen years later the PE concept is apparently still the right concept to combat treaty abuse (Action 6) and prevent the artificial avoidance of PE status (Action 7) according to the OECD.

Action 7 reads:

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

The mind of the OECD is made up beforehand; using a commissionaire is per definition regarded as artificial avoidance of PE status. This view is confirmed on page 6: "As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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."

Where originally the commissionaire was the target, now the scope is broadened. The sentence is a strange one, namely especially the phrase: "regular conclusion of contracts to be performed by a foreign enterprise ". What does it mean: "contracts to be performed"? An agent is an intermediary who tries to create profits for its client, the principal. When

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\(^1\) The Focus Group on the Artificial Avoidance of PE status.

\(^2\) From hereon referred to as the discussion draft. The draft report can be found on: http://www.oecd.org/ctp/BEPSActionPlan.pdf


\(^4\) An Agency PE (ständige Vertreter) provision was first found in the double taxation treaty between Prussia and Austria/Hungary. The text of this treaty can be found in The Consolidated Treaty Series, vol.187, Oceana Publications Inc., Dobbs Ferry, New York, p.360.
the agent brings in a new customer, the principal actually concludes the contract. Abuse? I believe we are talking about a regular business transaction, not about abuse. The phrase used here covers all sales transactions of multinationals; any intermediary used is regarded as treaty abuse. This creates sufficient taxable nexus, according to the Task Fore. I do not think it is reasonable and defendable to also include business conducted via limited risk distributors. The abovementioned OECD quotes seem to imply that. There appears to be one exception, namely if the intermediary is acting in the course of an independent business. This is really deceiving because only third party intermediaries are regarded as independent. I will elaborate on this further when I analyse the proposed changes to art.5 (6) OECD Model containing the independent agent clause.

In the discussion draft there also a couple of other topics related to the PE that are discussed, namely the artificial avoidance of PE status through the specific activity exemptions \(^5\), the splitting up of contracts regarding the construction PE \(^6\) and the specific situation concerning insurance agents. These topics will not be discussed in this article; I will specifically focus on the Agency PE in relation to commissionaires and limited risk distributors in multinational companies. \(^7\) I will now analyse the proposed changes to art.5 (5) OECD Model and art.5 (6) OECD Model and conclude this article with my recommended changes to both articles.

### 2. The current Agency PE definition

The current art.5 (5) OECD Model reads:


dose basically an Agency PE is present if a person:

1. Is acting on behalf of an enterprise, meaning that it should be for the account and risk of the principal. The sales revenue is therefore revenue of the principal.
2. Concludes contracts in the name of the enterprise. Over the years this condition developed in a sense that even if the contracts are not concluded literally in the name of the enterprise, this condition is met if the person by means of his activities binds the enterprise.
3. The activities of the person need to be performed habitually, so one-off deals are excluded.

\(^5\) Art.5(4) OECD Model.
\(^6\) This relates to the possibility of avoiding the Construction PE of Art.5(3) OECD Model, by splitting up contracts to keep the duration of the contract below the term set in the respective double taxation treaty (often 12 months).
\(^7\) Discussion draft, p. 6-7.
3. The four BEPS proposals

The BEPS Focus Group developed four possible changes to the Agency PE concept of Art.5 (5) OECD Model.

Proposal A reads:

"Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts

a) In the name of the enterprise, or

b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) For the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

In the explanation given by the Focus Group they advocate that this proposal avoids the issue of "who is bound by the contract". As I mentioned in par.2 of this article, if a person does not literally conclude contracts in the name of the enterprise, but the person binds the enterprise, this condition of the Agency PE definition is met. The Focus Group points to the transfer of ownership of property (b) and the provision of services (c).

This implicates that any transfer of ownership of property creates a PE. What is considered property? Property is a really broad concept, not only pieces of real estate but basically it also captures a possession, something owned. If the Focus Group has the broad definition in mind, it implies that any transfer of ownership by means of anyone but the legal owner leads to a PE. An entrepreneur who sells goods to its limited risk distributor would subsequently face possible PE assessments.

In any multinational services are daily performed between different group companies. One of the benefits of being a large multinational company is the scale it operates on. Creating efficiency and cost benefits led to the establishment of shared services centers or centers of excellence. These centers provide services in the group. Because of the tax requirements contracts within the group are concluded to obtain these services. I cannot imagine these business transactions should lead to a PE; the current proposal seems to achieve just that.

The first sentence of proposal A is remarkable. If the person “habitually engages with specific persons in a way that results in the conclusion of contracts.....”. This cryptic sentence is explained in the same cryptic manner:

"This would include not only cases where the contract is concluded by the intermediary but also cases where the intermediary habitually interacts with identifiable persons in a way that directly results in the
conclusion of contracts. The determination of whether the intermediary’s interaction with specific persons results in the conclusion of a contract would require a direct causal connection between that interaction and the conclusion of the contract. It would not, however, require that the contract be formally concluded by the intermediary.\(^8\)

Who are these specific persons, also named identifiable persons? If an agent discusses a new client with the business director of the enterprise at head office and the enterprise ultimately concludes a contract with that specific client, one could point to the business director as being the specific identifiable person. Communication between agent and the business director actually led to the conclusion of a contract. According to the Focus Group, this fact leads to a PE. It looks like the mission of the Focus Group is to prevent normal business instead of fighting treaty abuse if this proposal would be accepted.

Proposal B reads:

“Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, that are

a) In the name of the enterprise, or

b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) For the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”

Proposal B is almost similar to proposal A except for one new element. The earlier mentioned cryptic term of “specific persons” is not used in proposal B. Instead the definition resembles the current definition, at least the first part. The new element is that a person who negotiates the material elements of contracts is explicitly included in the Agency PE definition. This is more or less in line with the current definition. You cannot avoid an Agency PE by simply not literally signing the contract although actually the deal is fully negotiated and only lacks a signature, which might be a mere formality.

Proposal C reads:

“Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”

\(^8\) Page 12 of the discussion draft.
This proposal uses the cryptic phrase of Proposal A, namely “engaging with specific persons resulting in the conclusion of contracts” but adds a new element. The contracts should be, by virtue of the legal relationship between that person and the enterprise, on the account and risk of the enterprise. On the account and risk of the enterprise is a different way in saying “on behalf of” the enterprise. Because they use this term in the beginning of Proposal C I feel that the repetition adds no value and can therefore be omitted. The person, also known as (aka) the intermediary, engages with specific persons resulting in the conclusion of contracts based on the legal relationship between that person aka the intermediary and the enterprise. But the explanation refers to a different legal relationship. The Focus Group explains that they refer to the legal (not economic) relationship between the person and the intermediary. I am confused, and I am sure I am not the only one. In the picture below I try to shed some light on this.

Person 1 is the intermediary who concludes contracts on behalf of the enterprise. The legal agreement between Person 1 and the enterprise can be an agency agreement or a commissaire agreement. But what would the legal agreement be between Person 1 and Person 2? Do they refer to an employment agreement? Is Person 2 a sales rep on the payroll of Person 1? If that is the case, this addition is completely superfluous because this employee binds Person 1 anyway, so legally what employee Person 2 is doing is being regarded as actions of Person 1. Is Person 2 a sub-agent of Person 1? Also in that case a superfluous addition. The Focus Group believes the legal relationship between Person 1 and Person 2 might be a commissaire agreement. This would imply that Person 2 would conclude contracts in its own name but on behalf of Person 1. So person 1 is a principal who is taxed in that country on its revenue. No treaty abuse, no base erosion nor profit shifting. Legally Person 1 is conducting its own business. The relationship between the enterprise and Person 1 cannot be an agency relationship, because Person 1 is contracting with commissaire Person 2. Person 1 cannot be a commissaire of the enterprise because he acting on his own behalf. So this proposal is not workable.

Proposal D reads:

“Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are
This proposal has a strong relation with the current Agency PE definition. A person who is acting on behalf of an enterprise and habitually concludes contracts currently falls within the Agency PE definition. The addition here is the fact that also persons, who negotiate material elements of contracts, so without signing and finally concluding the agreement, are pulled into the Agency PE concept. The second addition – compared to the current Agency PE definition – is that these contracts need to be based on the legal relationship between the person - the intermediary - and the enterprise. If a contract is concluded via an intermediary that is not based on a legal relationship between the two parties, the intermediary acted without any legal basis and therefore the enterprise is not bound by the contract. The core of the current Agency PE provision is the legal concept of agency. An agent who concludes contracts in the name of an enterprise acts on a legal agreement governed by civil law. Even the addition that agents who do not literally conclude contracts in the name of the enterprise but negotiates the terms of the contract, do legally bind the principal. This fact is based on the common law concept of agency. In other words, the second addition of Proposal D disregards this fundamental element of the Agency PE, namely the legal core of this provision. Deviations from the legal core of this concept will inevitably lead to legal uncertainty and will surely lead to court cases where the outcome might not be what the OECD and governments have in mind with the BEPS project.

4. The current independent agency provision

The current art.5 (6) OECD Model reads:

*“An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.”*

The OECD Commentary on Art.5 (6) differentiates three conditions regarding the independent agent. The agent needs to be legally and economically independent and acting in the normal course of its business. Legally independent means that the agent may not be subject to detailed instructions and comprehensive control. The principal is not supposed to intervene in the agent's daily business. The principal may certainly demand that the agent respects certain wishes and acts accordingly, but daily intervention will not be regarded befitting an independent agent. Economical independency is interpreted as running entrepreneurial risk and not being solely dependent on one client. If that client would terminate the agency agreement, the agent would have no income, which would indeed lead to the conclusion that such an agent is not economically independent. Acting in the ordinary course of its business is a test that will analyse the activities of the agent and compares these to similar agents active in the same business and in the same country.

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9 OECD Commentary on Art.5 (6), par. 37.
The independent agency clause originates from the UK Finance Act 1915. In that law the general commission agents were exempted for UK taxation because they acted for any number of principals. The commission agent who acted exclusively for one principal was not exempted. Over the many years since then, the same principle was firmly upheld. In 1968 this principle was confirmed in a UK court ruling where it was ruled the an independent agent (in that specific case it related to a general commission agent) is an agent “who holds himself out as being ready to work for clients general, and who does not confine his activities to one principal, or even an insignificant number of principals.”

There is a US court ruling dating from 1996 (Inverworld Case) where the court ruled that the agent was not to be considered independent because he almost exclusively (90%) worked for the foreign principal. In other words, the rule that the independent agent will not be considered independent if he works for one or few principals is really undisputed over the years.

5. The BEPS definition of independent agent

The Focus Group proposed the following text regarding the independent agency provision:

Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other contracting State carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of that business. 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 within the meaning of this paragraph with respect to these enterprises.

The explanation given by the Focus Group only regards the term “associated enterprises”. This term is intended to mirror the Art.9 OECD Model concept of associated enterprises, with one difference, namely that the term used in this proposal would apply to enterprises of the same State or of third States. The Focus Group does not make any distinction between the different types of independent agents, so no reference to brokers or general commission agents. I believe certainly for the sake of clarity, this view of the Focus Group should be supported. Let’s not forget that civil law and common law uses different nomenclature in the case of the different types of agents. This created a lot of interpretation difficulties in the past that will now, hopefully, be avoided.

This proposal clearly embraced the view that an agent who works for one principal cannot be regarded as being economically independent. So this element is lifted from the Commentary and possibly transformed into treaty text. The historical wording of this concept as I alluded to in Par.4 of this article supports this view.

12 Fleming versus London Produce (1968) 44 TC 582, at 596.
14 Last paragraph p.12 of the discussion draft.
15 As I have analysed in Chapter 2 called “Agents in Commercial Law” from my dissertation on the Agency Permanent Establishment (Universitaire Pers Maastricht, 2000).
6. Recommendations

6.1 The Agency PE concept

After analysing the four proposals put forward by the Focus Group, I believe that proposal D after some modifications, would be most suitable. Important is that artificial arrangements used in multinational enterprises (MNE) can be captured by the new Agency PE definition. Another important factor is that the Agency PE concept still needs to be based on the legal agency concept. If the OECD would decide to make changes that basic assumption, there is likelihood that the new provision contradicts the legal concept of agency (there are signs of that as I have alluded to in my analysis in the previous paragraphs). I predict many difficult and cumbersome court cases. If that would indeed be the case.

What is an artificial arrangement regarding agency cases in MNEs? If a group company (legal entity) buys and sells goods in the country of residence in its own name and for its own account, and in that entity there is the needed substance to indeed perform these activities, one cannot seriously regard this set-up as an artificial arrangement. There is no agency relationship, but a distributor relationship. The LRD can therefore not be included in the Agency PE concept. What if this group company has a very limited to zero inventory risk because the legal title transfer is done in “a flash”? This flash title transfer is legally supported by an agreement between two legal entities. The fact that someone else bears the inventory risk does indeed have an impact on the taxable base of both companies. But on the other hand, bearing risk also entails a possible downside. If the inventory suffers from, for example, water damage, the subsequent costs need to paid by the legal entity bearing the inventory risk. So can this set-up be regarded as an artificial set-up? I believe not. Therefore I recommend that the limited risk distributor (LRD) - if properly supported by the right amount of substance – will not be labelled as an artificial arrangement and therefore should not lead to a possible Agency PE. When the question arises how much taxable profits should be allocated to the LRD, general transfer pricing rules are more than able to resolve this in a satisfying manner. The determination of allocable taxable profits should be based on functions and risks, but only if functions are really performed with the appropriate substance and the risks are also actually managed in the correct legal entity with the appropriate substance. I do not deny that there are certainly companies who have pushed the envelope in a sense that they did reorganise and allocated functions and risks to other group companies without backing this up by the appropriate amount of people and the right level of people (decision making).

What about the commissionaire? The commissionaire acts on behalf of the enterprise but concludes contracts in its own name. The commissionaire is a civil law type of agent without the power of representation. Are commissionaire arrangements artificial? That certainly cannot be upheld. A commissionaire in an MNE environment typically is a group company (legal entity) who has a marketing and sales function. There is no inventory or accounts receivable risk. Where the LRD acts on its own behalf and does

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16 In many cases supported by tax consultants.

assume accounts receivable risk, in the case of the commissionaire everything belongs to the principal: the revenue, inventory and accounts receivable risks. From a business perspective one cannot claim that a commissionaire is an artificial set-up. From a tax perspective, however, one could argue that a commissionaire is an agent who very much resembles the agent in the current Agency PE definition from Art.5 (5) OECD Model. The only difference is the fact that the commissionaire contracts in its own name. When an agency concept is introduced which abstains from civil law or common law definitions, it might be considered a reasonable approach to include the commissionaire in the Agency PE definition.

The choice of the OECD to use the current permanent establishment concept means that the core of this provision binds the OECD; namely that the Agency PE concept is based on a legal concept of agency. The originally civil law definition might be broadened to also include a common law concept. But in any scenario, the new provision needs to make sense from a legal perspective.

I therefore propose the following text:

"Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, habitually concludes contracts, or negotiates the material elements of contracts, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph, and unless the person acts on its own behalf."

This text will lead to the practical implications that commissionaires acting in a multinational group will likely be deemed to constitute an Agency PE unless it acts as a true independent agent. The limited risk distributors (LRDs) acting in a multinational group will not be deemed to constitute an Agency PE because they are legally distributors (acting in their own name and on their own behalf) and no agents.

6.2. The Independent Agency concept

The independent agent clause as formulated in the discussion draft contains, in my view, a reasonable concept. It cannot be upheld that a group company who acts as an agent on behalf of the group, can be considered a truly independent agent. As I have highlighted in par.4 of this article, at the birth of this concept in the UK in 1915, the agent who exclusively worked for one principal was not exempted for UK taxation. This view was consistently upheld during the development of the concept over the many decades. The 1929 report of the League of Nations, for example, clearly stated that the commission agent was exempted because he acted in his own name for any number of clients. In the OEEC 1958 Model Tax Convention the current Art.5 (6) OECD Model provision was first introduced. In 1977 OECD Commentary the condition was introduced that the independent agent should be both legally and economically independent and should act

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19 The OECD was founded in 1948 as the Organisation for European Economic Cooperation (OEEC). In 1961 the OEEC was changed into OECD. The U.S and Canada joined and therefore “European” not appropriate anymore.
in the ordinary course of its business. All these changes upheld and supported the view that an independent agent acting for one or few principals cannot be regarded as an independent agent. So I cannot conclude otherwise than supporting this Task Force proposal because it is fully in line with the original purpose of the exemption.

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Centre for Tax Policy and Administration

OCDE
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75775 Paris Cedex 16
Via e-mail taxtreaties@oecd.org

Dear Sirs,

On 31 October 2014, working party N°7 of the Committee on Fiscal Affairs of the OECD released a Proposed Discussion Draft: Preventing the Artificial Avoidance of the PE Status, for interested parties to provide written comments.

A3F is pleased to respond to the OECD’s request for comments on this discussion draft.

A3F background.

A3F, French Women Tax Experts Association-Association Française des Femmes Fiscalistes, was founded in 2005. A3F is a French-based network of professional women from diverse horizons representing most players of the French and international tax system (experienced tax executives and experts, tax advisors from a wide range of French and Foreign companies and law firms, University professors, etc). The ever changing and rapidly evolving corporate and individual tax policies in France and around the world are a major concern for businesses. A3F provides its members with opportunities to exchange ideas and best practices, and to contribute to the shaping of tax policy through participation in public debates. A3F currently counts members (of which two third are business representatives), all with a recognized work experience.

Since December 2014, the President of A3F is Marie José Lefebvre, Corporate and Tax Manager of a French Media Group.

A3F appreciates this opportunity to provide its view on OECD Discussion Draft on Preventing the Artificial Avoidance of PE Status. These comments were prepared in an “ad hoc” working group. We welcome an opportunity to participate in the subsequent public consultations and related discussions.

Respectfully submitted,

For Association Française des Femmes Fiscalistes
1. **Key messages**

The OECD Action 7 is mainly focused on the prevention of abuses such as the commissionaire arrangements, specific activity exemptions and splitting up of contracts with the aim to better capture DE impact, but without treating DE as a separate case.

It wants to address circumstances in which these artificial arrangements relating to sales of goods or services of one company pertaining to an MNE effectively result in the conclusion of contracts such that the sales should be treated as if they had been made by that company.

We understand the concern to be able to define a minimum substantial threshold through transactions with customers. We also acknowledge that the actions under BEPS are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.

We understand options have been proposed to change article 5 of the OECD Treaty Model and a basic assumption has been made in that respect:

“As a matter of policy, where the activities that an intermediary exercises in a country 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 unless the intermediary is performing these activities in the course of an independent business.”

This approach is dedicated to allow the existence of a PE even if legally speaking the contract has been concluded abroad by the foreign enterprise arguing sufficient nexus is characterized through a direct causal connection between the intermediary interaction and the conclusion of contracts.

The discussion draft contains several proposals aimed at lowering the Permanent Establishment (PE) thresholds, in particular with regard to dependent agent (DA) rules, and narrowing available PE exemptions. It appears inevitable that the proposed changes will lead to a material shift towards source-based taxing rights through the creation of a PE.

Broadening such a definition creates legal uncertainty for the existing structures. Indeed, it leaves more room to the local authorities to tax under the PE concept despite any legal structure duly grounded and having substance.

2. **Comments on Section A - “Artificial avoidance of PE status through commissionaire arrangements and similar strategies”**

If the proposed changes under Section A are intended to target commissionaire structures, a better approach would be to reference the commercial law definition of a commissionaire in the language of the Article itself and explicitly limit the provisions to such situations, without changing the provisions relating to Dependent Agent (DA).
The current draft proposals go beyond commissioner structure and bring significant changes to Dependent Agent (DA) rules: they would move away from the « concluding contracts » requirement to a much broader scope.

2.1. Comments on options A and C

- Both options A and C refers to vague new terms and concepts ("habitually engages with specific persons","in a way that results in the conclusion of contracts »), which would cause high levels of uncertainty and hence are open to interpretation and abuse. It is likely to lead to disputes.

- The replacement of “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts” represents a large shift in policy. Currently the threshold is “concluding contracts”, now policy shifts to activities intended to result in conclusion of contracts. This language is too obtuse to be workable in practice and is likely to lead to many instances of double taxation.

Moreover, there is no guidance as to what types of activities may represent a contractual intent.

- Therefore options A and C should be deleted.

2.2. Comments on option B and D

- Although these options also have downsides, they seem less detrimental than options A and C, as they use the “concludes contract, or negotiates material elements” which is much more specific than the “engages ... in a way that results in the conclusion of contracts” terminology.

- However, if one of these options is to be adopted, it needs to be accompanied by

  o a clear statement and distinction that the language only applies to active contractual negotiation and not to other in-country activities such as sales support, promotion/evangelism and information sharing. For instance, it should be clear that the language will not apply to situation where teams in a country only present to potential customers the terms &conditions which are contained in standard / on-line contracts (as in such case there is no negotiation, only information).

  o clear guidance on what is considered a “material element” of a contract.
  - Examples could be price, key SLA’s, etc.
  - Clear guidance on what is not considered material would also be helpful.
  - The goal should be to draft practical, easy to apply and objective criteria.

- These provisions also need a mechanism to permit some in-country flexibility in the following situations:
  o Permitting in-country personnel to negotiate material provisions without creating a PE when they are permitted to agree terms only within limited, pre-approved and pre-defined boundaries;
o Permitting Industrial/Engineering companies, and other type of enterprise dealing with complex contractual structuring for activities in emerging countries, to use local operators and local business connections in the negotiations, without creating a PE.

We fear the enlargement of PE definition in that way is, in fact, so close to the concept of business connection that it could allow a major risk in term of drastic attraction of revenue as deemed source income.

These new definition may for example in India, reopen the way to the application of the well-known concept of business connection which allows to pierce the Corporate veil and triggers major impact in term of taxable scope. As a matter of example, please refer to the Indian tax code, section 9 of Income Tax Act 1961:

“A business connection involves a relation between a business carried on by a non-resident which yields profit or gains and some activity in India which contributes to the earning of these profits or gains. A business connection can arise between a non-resident and a resident if both of them carry on business and if the non-resident earns income through such a connection.”

The business connection concept or the “effectively connected concept” are widely spread in many internal legislation worldwide.

These changes may drastically increase the cases of double taxation for which in the past many litigations have been successfully engaged because the treaty model was clear and explicit, which would no more be the case if the PE definition is enlarged in the way proposed by the current draft.

- Whilst all options proposed have downsides, the most acceptable (if had to have one) would appear to be option B. Indeed, the language of this option appears to be the most precise and with relatively less opportunity for ambiguity. If such option is implemented, it should be accompanied with the flexibility and guidance mentioned above.

3. Comments on Section B - “Artificial avoidance of PE status through the specific Activity Exceptions

3.1. Comments on preparatory and auxiliary activities

The main proposal is to limit the application of the exceptions by making them all subject to the “preparatory or auxiliary” condition. This proposal will create substantial uncertainty, for the following reasons:

- There is no additional guidance provided as to what types of activities may be considered preparatory and auxiliary. Rules implemented should be clear and easy to apply (with bright line test) to ensure compliance certainty.
- The proposal is likely to lead to increased pressure on the threshold question of whether a location constitutes a “fixed place of business” of the foreign enterprise. Given the
exceptions are only relevant when an enterprise is seen to maintain a fixed place of business in a country, the impact of the proposed changes at this stage is speculative without clearer resolution on this point.

The A3F does not support fundamental changes to the preparatory and auxiliary exemption. Current rules are reasonable and should not lead to BEPS concerns.

Should the proposal under Section B be adopted, they must be accompanied with a clear definition of preparatory and auxiliary activities.

3.2. Comments on the fragmentation of activities between related parties

The proposals represent a significant shift from the basic international tax tenant that separate legal entities should be respected.

If there is a desire to move forward in this area, then we suggest that the OECD acknowledges that this provision represents an anti-abuse rule with application limited to specific circumstances.

4. Comments on Section C – "Splitting-up of contracts"

Proposal to introduce a general anti abuse rule based on the principal purpose test appears to create a lot more uncertainty than a clear identification of additional time period for similar activities within the same project performed by associated enterprises."

5. Additional comments

5.1. Lack of clear guidance/updates about profit attribution rules

The fact that the Public Discussion Draft lacks clear guidance and updates in this area is a major issue. Indeed, clear rules on profit attribution are as key as clear rules on permanent establishment recognition, in particular given the fact that implementing lower thresholds for Permanent establishment will place greater emphasis on profit attribution.

The discussion should not be just with respect to recognition or not of a Permanent establishment, but also to what extent profits / losses are allocated to such Permanent establishment. Indeed, countries are quick to assert Permanent establishment, but not accept losses properly attributable to the Permanent establishment.

5.2. Compliance impact of the determination of a deemed Permanent establishment

There is a need for some sort of guidance as to the compliance impact of the determination of a deemed permanent establishment, in particular on the following issues:

- Would the permanent establishment need to file a separate tax return or could the impact be addressed through a transfer pricing adjustment only?
- Intended transaction tax (e.g. VAT) impact of deemed PE situations. In many countries a PE determination results in the need to also register for local transaction taxes, which is potentially hugely impactful from both an operational and financial perspective.
The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK’s total net worth and contributing £11.8 billion in taxes to the Government. Employing over 315,000 people in the UK alone, the insurance industry is also one of this country’s major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to protect themselves, their families, their homes and assets, provide for a financially secure future and manage the risks faced in their businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The ABI

The Association of British Insurers (ABI) is the voice of the UK insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI’s role is to:

• Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
• Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
• Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
• Promote the benefits of insurance to the government, regulators, policy makers and the public.

Introduction

1. The ABI welcomes the opportunity to comment on the discussion draft\(^1\). We support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. We therefore support the objectives of the discussion draft in combating aggressive tax planning aimed at preventing the artificial avoidance of Permanent Establishment (“PE”) status. Our comments reflect our desire to ensure that any measures are workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations. In the spirit of working constructively with the OECD and member governments, we offer information and suggestions as to how the proposals could be improved to help achieve objectives whilst at the same time avoiding inadvertent consequences that impact on the normal conduct of insurance business models.

\(^1\) Discussion draft on OECD BEPS Action 7 (Preventing the Artificial Avoidance of PE Status) released 31 October 2014.
Executive Summary

2. The policy problem that BEPS Action 7 is addressing is stated to be preventing:

“... the artificial avoidance of PE status in relation to BEPS, including through the use of commissionnaire arrangements and the specific activity exemptions.”

3. In our view, the proposals set out in the discussion draft go much wider than this stated aim and could have a significant impact on insurance commercial business models. As we explain in the body of our response there is an enormous difference between commissionaire arrangements and the commercial selling of insurance. If insurance commercial business models are impacted it may result in making insurance more expensive with less availability in certain markets and reduced product choice and/or choice of insurers for customers.

4. In the insurance industry, sales via agents and brokers are not “put in place primarily in order to erode the taxable base of the State where the sales took place” but are due to both commercial and regulatory reasons. Therefore, there should be no overriding BEPS concern with insurance operations undertaking sales via agents and brokers.

5. We do not believe that there is a need for a specific provision in Article 5 that applies to insurance activities and the collection of insurance premiums by an agent as outlined in Option M. The collection of insurance premiums by agents is in no way a BEPS activity. Furthermore, Insurance Premium Tax is often payable on the gross premiums for risks insured that are situated in a country. We believe any discussion relating to the taxation of the insurance industry and any perceived BEPS issue should take into account the allocation of risk and capital in the business, and the regulatory environment in which the industry operates. These issues should be considered as part of the discussions on Actions 4 and 9 rather than as part of the PE discussion draft.

6. An insurance group will generally consist of both insurance companies which undertake regulated insurance activities (the assumption and management of insurance risks) and non-regulated companies undertaking other activities (such as services companies, investments companies etc.). A consequence of the current proposals, particularly the insurance specific proposal and options A-D, is that an insurance tax PE could be created in a territory where the insurance group is only undertaking non-insurance activities. This would create confusion and an additional compliance burden.

7. The current definition of a PE for tax purposes is generally quite similar to the definition of a PE for regulatory purposes. We believe that this alignment is important to maintain. If it is not maintained, which would be the outcome of Option M, a disproportionate compliance burden would be placed on insurers with minimal, if any, additional tax being paid in the territory in which premiums are collected or risks insured through an agent.

8. There is further a concern that the proposals will create an additional compliance burden for insurers if they have to track the movement of customers from the territory where they
purchased a policy to a new territory where the insurer undertakes no activities other than collecting premiums through an agent. This could lead to reduced access to insurance products and/or make insurance products more expensive for internationally mobile customers. We do not think this is a desirable or an intended outcome of the proposed changes. We expand on the concerns in paragraph 24.

9. The discussion draft appears to suggest that Options A - D are aimed at tackling the artificial avoidance of PE status through commissionaire arrangements. However, each of these options is widely drawn, both in terms of strengthening the dependent agent threshold and replacing “conclude contracts” with wider terminology. Each of the options also catches more than the stated target.

10. The proposal to strengthen the dependant agent threshold would potentially create numerous PEs where routine low value functions are performed.

11. Our view is that in comparison to options A, C and D, option B appears to better targeted and would have less impact on insurers’ commercial business models whilst at the same time catching commissionaire arrangements. However, we suggest that the wording could be made more precise by using “negotiating the material terms” rather than “negotiating the material elements”.

12. Options E – H are aimed at tackling the artificial avoidance of PE status through the specific activity exemption. Option H, which removes the “collecting of information” exemption, could have an impact on insurance business models. We believe that a better approach would therefore be for the exemption to be more targeted rather than removing it altogether.

13. Options I and J are aimed at fragmentation of activities. We believe Option J, which is widely drafted, will create a PE where a group entity provides preparatory and auxiliary services just because there is a related company operating in the same state. As Option I would continue to permit preparatory and auxiliary activities to be performed by an associated enterprise without a PE being created, it would seem to be the better approach.

14. On a general point, whichever options are ultimately adopted as changes to the current wording of Article 5, it is essential there is clear guidance that defines the key terms and that sets out the precise circumstances to which the new rules apply. The new rules also need to be construed objectively and be easy to apply. Otherwise there will be uncertainty for business, an increase in disputes and an increased risk of double taxation. We would welcome the opportunity to help the OECD with the drafting of the guidance to the extent it is relevant to the insurance sector.

15. For ease of reference we have used Key Entrepreneurial Risk-Taking (KERT) in this response to describe the risk/business that is assumed and managed by appropriately skilled employees of an insurer as this together with the capital that is required to be held against these risks is where insurers have their economic substance.
Detailed Response

16. We have structured the body of our response as follow:

I. Insurance Specific Proposal
II. Artificial avoidance of PE status through commissionaire arrangements and similar strategies
III. Specific Activity exemptions
IV. Fragmentation of activities
V. Splitting of Contracts
VI. Profit attribution to PEs and interaction with actions points on transfer pricing.

I. Insurance Specific Proposal (Options M and N)

Preference - Option N
We are strongly of the view that there is no need for a specific provision that applies to insurance activities and the collection of premiums by an agent as outlined in Option M. The only material difference between the effect of this proposal and the general proposals is that agents who collect premiums, but who would otherwise have no KERT functions will, if not sufficiently independent, create tax PEs which would have no or minimal additional profit attribution, but create a disproportionate compliance burden. Therefore, we are strongly of the view that option N is the most appropriate.

17. There is no explanation given in the discussion draft why the insurance industry has been identified as requiring specific treatment under BEPS Action 7. The discussion draft expresses concern about some insurance companies doing large scale business in a State without being taxed in that State. In the European Union this is consistent with regulated insurers being permitted to write business on an EU Freedom of Services basis - Appendix 1 includes a brief description of EU Freedom of Services and EU Freedom of Establishment. Under Freedom of Services an EU regulated insurer is able to write insurance policies in its home jurisdiction which covers risks written in another EU member State. EU Freedom of Services therefore enables an EU insurer to sell “into” another EU member state without having a regulatory PE; although some preparatory and auxiliary activities such as sales support may take place in that member state (with an appropriate arm’s length fee being paid for the services provided). The assessment, assumption and management of risk would be in the home EU member state and the insurer’s capital requirement would be regulated by the home regulator and held in the home state. So, the PE for both tax and regulation will be the same (the home state) and not the state in which the insurance policies are actually sold. We are therefore struggling to identify the actual BEPS concern that option M is seeking to address, given the insurance supply chain and value drivers which are explained in detail in the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) (“Part IV”).

18. Furthermore and more generally, the current definition of a PE for tax purposes is generally quite similar to the definition of a PE for regulatory purposes. This ensures that tax and

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2 EU Life Insurance and Non-Life Insurance Directives.
regulatory reporting requirements can be aligned. We believe that this alignment is important to maintain. To do otherwise, which would be the outcome of Option M, a disproportionate compliance burden would be placed on insurers with minimal, if any, additional tax being paid in the territory in which premiums are collected or risks insured through an agent.

19. The functions performed by insurers in the insurance business value chain and the relative importance of those functions to their business depend on various factors including the type of insurance business (general, life or reinsurance), the line of business and the products sold. This is recognised in Part IV where it is acknowledged that sales and marketing is only one of the functions in the insurance value chain. The collection of premiums alone does not necessarily create value for the insurer. Nor do the activities of an agent through whom risks in a territory are insured. Paragraph 117 of Part IV recognises that, if the person (i.e. agent) collecting the premiums does not make the decision to accept the risks/business associated with the insurance policy then the collection of premiums does not mean that insured risks/business have been accepted by that person. This is an important point because the main KERT of insurers is generally the assumption and management of insurance risk/business. This is recognised in Part IV a number of times, for example in paragraph 94. Furthermore, this matches with insurance regulations where only regulated insurers holding sufficient capital are permitted to accept insurance risk/business.

20. The KERT function is with the entity which is accepting and managing the risk/business and therefore under Part IV all or nearly all of the profit will be attributed to the insurer’s territory of residence. This will be the case even if a PE is deemed to exist by virtue of the collection of premiums by, or risks insured through, an agent. Given it is the acceptance and management of insurance risk which drives the insurer’s regulatory capital requirement and puts that regulatory capital at risk of loss, the profits of the insurer should also belong where that capital and risk is held.

21. This is particularly in point where insurers undertake business in a territory where they sell insurance exclusively through agents. The role of the agent primarily consists of providing a point of contact for clients seeking to purchase insurance and would include the collection of premiums. As the agent is acting purely as an intermediary and is neither accepting nor managing the risk/business on behalf of the insurer there is no regulatory PE. Currently on Article 5 principles there is also no tax PE of the insurer. The agent receives a fee which will have been negotiated on an arm’s length basis between the insurer and that third party agent. The fee will therefore be commensurate with the services provided and would be subject to tax in the territory in which the agent is operating under normal principles. Therefore, the territory is already receiving the appropriate amount of tax revenue based on the level of activity being performed locally.

22. Furthermore, it is also worth noting that a number of territories have introduced Insurance Premium Tax which is payable on the gross premiums for risks insured that are situated in their country. Such premium taxes are common, for example, in most EU jurisdictions where the EU Freedom of Services permits EU based insurers to cover a risk in another member country
without having an office there. It can therefore be seen that risks insured in a country where an insurer does not currently have a PE already suffer a tax burden.

23. Where the agent is not undertaking the KERT function (as identified under Part IV) any amount that would be attributed under Part IV to a PE related to the collection of premiums will therefore be small and effectively equate to a fee. Since the income of the insurer is already subject to tax in its home territory any attempt to attribute profit to a local PE, in addition to the arm’s length fee paid to the agent, would result in double taxation unless the home state was prepared to offer relief. This would be contrary to the principles of insurance regulation which do not require capital to be held against the collection of premiums. Furthermore, there will be years when insurers make losses (but would still pay tax on the fee deemed attributable to the local PE), which exacerbates this issue.

24. It can therefore be seen that the outcome of option M could be the creation of a significant number of PEs for insurers that write global risks, where there is no regulatory PE and with no or minimal profit being attributed (with any being attributed being equivalent to the fee income equivalent to the fee income already paid for the services provided). This would therefore create a disproportionate compliance burden on insurers (requiring a tax return to be completed and a profit attribution calculation in addition to the insurance premium tax returns already prepared etc.) for the collection of little additional tax and potentially exposes insurance groups to additional and unnecessary disputes as well as placing a strain on competent authority procedures. There would also be the possibility of double taxation.

25. Other potential impacts for insurance products include:

- insurance business models established in light of the simplified regulatory compliance afforded to EU passporting products will now need to be reconsidered in light of their potential to create a taxable PE where previously there was none.
- An impact on the legitimate “fronting” arrangements (see Appendix 2 for a description) entered into between insurance companies in order to write business in specific territories where an insurer may not have a local presence as required by global clients.
- in order to manage the PE risk exposure, product terms for new policies could be altered resulting in the withdrawal of products or termination of policies where customers leave the territory in which the policy was purchased. This could have a detrimental impact for customers particularly in relation to access to long term savings and investment products for globally mobile customers. It may also result in increased administration costs which ultimately would need to be passed on to the customer making all products more expensive.
- the taxation status of particular products might be changed as a result of the tax status of the product provider (the insurer) which could be also harmful to customers.
- the inclusion of the insurance specific proposal opens up a number of uncertainties which could lead to different interpretations or an approach which is unworkable and costly for insurers to apply e.g. it is possible that some tax authorities might interpret customer self-
execution, in the forms of fund switches or other platform transactions, as creating a PE for
the insurance company in a territory where a customer is resident.

- additional compliance burden on insurers given increasingly global mobility. For example, a
customer could move from the territory where they purchased a policy to a new territory
where the insurer undertakes no activities other than collecting premiums. Normally this
would be done by direct debit. However, if an agent were involved it would seem
particularly onerous to deem a tax PE unless there is a regulatory consequence from the
collection of premiums in that particular territory.

26. As the discussion draft recognises, the commentary on the Model Treaty acknowledges that it
was not thought to be advisable to insert a similar clause to option M in the treaty. This was
again looked at in 2011 when Article 5 was reconsidered. It was again thought not to be
appropriate to include such a clause as it is was considered to be a policy issue and so more
appropriate for individual territories to include if they considered it necessary. This seems the
correct approach, particularly as this is a source/residence divide and not a BEPS issue. We
further note that few jurisdictions have taken steps to include such a clause in their tax treaties.

27. In light of the above, we are strongly of the view that insurance should not be specifically
targeted. The only material difference between the effect of the insurance specific proposal and
the effect of the general proposals is that agents who collect premiums, but which would
otherwise have no KERT functions will, if not sufficiently independent, create PEs which would
have no additional profit attribution, but would result in a disproportionate compliance burden,
the creation of disputes and potentially lead to double taxation. Therefore, we are strongly of
the view that option N is the most appropriate.

II. Artificial avoidance of PE status through commissionaire arrangements and similar strategies -
Options A – D

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| In comparison to options A, C and D, option B appears to be better targeted and would have less
impact on insurers’ commercial business models whilst at the same time catching commissionaire
arrangements. However we believe that the wording could be more precise by using “negotiating
the material terms” rather than “negotiating the material elements”. Whichever of “terms” or
“elements” is used clear guidance would be needed to ensure that there is consistency in how these
words are interpreted by different tax authorities. This would be in addition to the clear guidance
that would be needed as a result of strengthening the “independence” requirement which we cover
under “Dependent Agent threshold” below. |

General comments on options A-D

28. We understand why the OECD wishes to counter commissionaire arrangements that lead to
BEPS. However, options A – D are widely drafted. The risk of widely drafted provisions is that
they are difficult to apply in practice and invite variation in interpretation by tax authorities
which can lead to long periods of uncertainty for business. This can create costly disputes for businesses and the possibility of double taxation. Any change should therefore be focused on tackling the specific avoidance and should not impact upon ordinary commercial business structures.

29. Our comments made in the “insurance specific proposal” section on profit attribution, compliance burdens and the impacts of creating PEs where there is no KERT function apply equally to options A-D.

30. It is important to remember that within the insurance industry, sales via agents and brokers are not “put in place primarily in order to erode the taxable base of the State where the sales took place” but are due to both commercial and regulatory reasons. Therefore, there should be no overriding BEPS concern with insurance operations using agents and brokers in the sale of insurance policies.

31. In our view there is an enormous difference between commissionaire arrangements and the sale of insurance. We believe the main differences are:

- The insurance or reinsurance intermediary has no contractual relationship\(^3\) relating to the insurance contract with the customer and is legally unable to accept insurance risk on the insurers behalf.
- With commissionaire arrangements the commissionaire in Territory X is effectively assuming the role of the ultimate seller (located in Territory Y) in transacting with the customer. The transfer of goods to the customer takes place in Territory X. In an insurance broking arrangement, the broker in Territory Y and the insurer in Territory X perform roles which are commercially distinct from one another. The broker helps the customer determine what insurance coverage is needed and which insurers are the best providers of coverage. The customer then transacts directly with the insurer, who makes the decision whether to assume the risk (and performs the functions supporting that decision) in Territory Y. Therefore, the agent/broker is acting purely as an introductory agent in these circumstances and not assuming the role of the ultimate seller in transacting with the customer.
- Insurance is closely regulated and to operate in a particular territory requires an insurance license. Insurance regulation is designed to protect the customers of insurers by ensuring the company writing the risk has sufficient capital available to meet any claims. The agent or broker is unable to enter into insurance contracts on behalf of the insurer as it is not a regulated insurance entity and holds no regulatory capital.

An intermediary (the Independent Financial Adviser (IFA)) selling a typical UK life insurance product into or in the UK does have a contractual arrangement with the customer but the key is that this is separate and distinct from insurance contract between the customer and the insurer. Recent new regulation (Retail Distribution Review) now means that the reward the intermediary receives is an arm’s length fee agreed and paid by the customer that properly reflects the value of the service. In the case of a UK life insurance product it will relate to advice given to the customer and intermediating the sale. This new regulation reflects and promotes that the services of the intermediary are provided to the customer not the insurance company.
• The insurance agent model differs from commissionaire arrangements in that the customer/insured has no legal contract relating to insurance with the broker. Generally, there is no recourse to the broker in the event of a dispute over the insurance contract. It is only with the insurer that the legal contract relating to insurance exists. The broker is therefore not at risk in the event of any events/claims under the insurance contract and therefore receives a purely commission based fee relating to the intermediation services that have been provided.

32. In view of these differences we do not believe that insurance business models should be impacted by any actions to counter commissionaire arrangements if the economic risks and economic benefits are aligned. We believe there is a risk that as currently drafted each of options A-D could impact on commercial insurance business models. Therefore there needs to be targeted commentary and a tightening up of the wording, even if our preferred option B is adopted.

33. The policy problem that BEPS Action 7 is addressing is stated to be preventing “… the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements ….”. As can be seen from below our view is that the current drafting of Options A to D goes much wider than tackling commissionaire arrangements and impacts on insurance commercial business models. In particular, there is a view that the drafting catches fronting arrangements. It is unclear whether this is the intention. We do not believe that fronting arrangements, as described in Appendix 2, involve BEPS activity. We would therefore find it helpful to have clarity from the OECD on whether or not such fronting arrangements are caught by these proposals, so that we can properly assess the potential impact.

Dependent Agent threshold

34. All of the Options A-D propose amendments to paragraph 6 of Article 5 and widen the dependent agent threshold, by excluding an unconnected 3rd party agent who “acts exclusively or almost exclusively……on behalf of associated enterprises” from being an agent of independent status. Although this is indicative of dependency it should not be automatically assumed that this is the case without a full consideration of all the facts and circumstances. Furthermore, it will be important for guidance to define very clearly what “almost exclusively” means in this context. Otherwise there is a risk that tax authorities will interpret those words differently leading to disputes and possible double taxation. For instance, some insurers have a number of Delegated Underwriting Authority (DUAs) (see Appendix 2 for a description) in place, most of which are with unrelated third parties. In the vast majority of cases, whether an agent has a diversified client base would be easy to identify. For the smaller operations, it would be more difficult for insurers to identify the proportion of an agent’s business that comes from the insurer. In view of the strictly limited authority granted under a DUA, we do not believe the intention is for the activities of the agent under a DUA to create a PE of the insurer. However, if this is not the case and if the proposed dependent agent threshold forms part of the final recommendation then very clear guidance would be needed on the meaning of “almost exclusively”, so that a process that enables an insurer to identify the proportion of an agent’s
business that comes from the insurer can be introduced. In addition, clear guidance on how “person” should be interpreted will be needed. For example, if a DUA is given to a major independent broker, it may well be that one individual of that broker is focused on sourcing business on an insurer’s behalf and may have binding authority. A sensible interpretation of a “person” operating “exclusively” on an insurer’s behalf should not trigger a dependent agent PE in these circumstances.

35. Furthermore, the words “acts exclusively or almost exclusively……on behalf of associated enterprises” could be interpreted as meaning that a related party can never be independent if it has little or no third party business of its own. This potentially has wide consequences. For example, a group parent company could substantively negotiate outwards reinsurance contracts on behalf of the whole group, with all operating entities being covered under the same global contract. This would be a small and insignificant part of the parent company’s activities. However, the widening of the dependent agent threshold could result in PEs being created for all the operating entities.

36. Similarly, an employee of one of a group’s service companies is likely to have the authority to bind multiple insurance operating entities in relation to procurement contracts (e.g. purchasing paper clips, or legal advice, or IT outsourcing etc.). The service companies would charge all of their costs (including employee costs) on an arm’s length basis to the operating entities. Therefore, all of their income (and activities) would be from (and for) related parties. So, if the extended wording in options A-D is adopted numerous PEs could be created. This would create a disproportionate compliance burden for little or no additional tax. One insurer has suggested that 200+ PEs could be created as there would need to be a PE for every single operating entity, in multiple territories, as a result of relatively insignificant back office purchasing (and similar) activity. This issue would not be limited to procurement companies, but is also relevant to other routine non-KERT functions performed by an in-house service company, such as back office processing of applications, claims handling, investment management, administrative support and / or consultancy services.

Option A

37. This option proposes that the words "concludes contracts" in the existing model tax treaty be extended to "engages with specific persons in a way that results in the conclusion of contracts". We believe that this wording is too broad and uncertain and even with commentary and guidance as to what is intended to be caught there will still be a risk that different territories will have a different interpretation leading to disputes and potentially double taxation.

38. In the insurance context the actions of agents, brokers and independent financial agents (IFAs) are clearly vital in the insurance operating model and are often subject to regulation as intermediaries. They introduce clients to insurers and so there could be seen to be a causal link between their actions and the conclusion of the contract. However, the reason why they cannot conclude the contract in an insurance context is because they are not permitted to accept insurance risk as they are not regulated insurers. They also do not have the capital at risk nor do
they bear the risk of loss under the contract. This is mandated by insurance regulatory rules rather than by seeking to avoid having a tax PE. The agent receives an arm’s length fee in this context commensurate to the services provided. Furthermore, the vast majority of insurance agents are third party brokers and so the commissions etc. are negotiated between third parties.

39. It would also appear that the extended wording could capture any activity leading up to the conclusion of a contract which presumably includes sales and marketing. This would have a real impact on the ability to write insurance business in territories where the insurer is able, from a regulatory perspective, to write business cross border with a local presence, as even travelling to meet the client and to view a facility, to assess the insurable risk, could be enough to create a PE. In reality this could in some cases cause businesses to ban travel in certain situations as the risk of creating a PE could be too great. This would severely limit the ability of an insurer to assess the insurable risk and operate on a global basis. This would limit their ability to offer the services that clients require. It could also impact the availability of insurance in some cases e.g. non admitted or surplus lines business in the US.

40. As stated above, the definition of a PE for regulatory purposes and of a PE for tax purposes are currently quite similar and any change to the wording of Article 5 along the lines suggested will remove this similarity. The current similarity is helpful as underwriters and other employees of insurers understand the need to be compliant under local regulation and therefore generally have a clear understanding of what can and cannot be done in order to remain compliant. If there is a different standard for tax purposes then this becomes confusing and complex to administer and could lead to a reduction in insurance products offered and thus the choice to customers.

Option B

41. This option would have the least impact in insurance commercial business models as it refers only to “negotiating the material elements of contracts” (in addition to concluding). A PE would be created when material elements of the negotiation are done in the local territory but the contract is bound in the home territory. The benefit of this wording over the other options is that pure sales and marketing function or initial research should be capable of being carried out in the local territory without creating a PE. However, we believe that the wording could be more precise by the use of “terms” rather than “elements”. The wording would therefore become “negotiating the material terms of contracts” and would tackle commissionaire arrangements, but would cause less uncertainty for business.

42. Whichever of “terms” or “elements” is used clear guidance would be needed to ensure that there is consistency in how the words are interpreted by different tax authorities. It should also link this guidance to insurers' key activities as set out in Part IV. Without this there is a risk that different territories will have a different interpretation leading to disputes and potentially double taxation.
Options C & D

43. The comments made under option A above in relation to extending the words "concludes contracts" in the existing model tax treaty to "engages with specific persons in a way that results in the conclusion of contracts", apply equally to option C.

44. Options C and D propose adding the words "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise". While this wording is intended to catch "commissionaire" selling arrangements, it will have unintended consequences, particularly where risk, as is the case with insurance, is the business of the entity in question. In particular, it is possible that quota share reinsurance (see Appendix 2 for a description) could fall within the extended wording as the contract is partly "on the account and risk" of the quota share reinsurer by virtue of the “legal relationship” (i.e. treaty) between it and the cedant. Quota share reinsurance is a common form of reinsurance, which is undertaken for commercial reasons and we do not believe quota share reinsurance should create a PE for the reinsurer in the territory of the cedant.

45. There is a need for clear guidance on the meaning of “on the account and risk of” to ensure that there is consistency in how these words are interpreted by different tax authorities. Without this there is a risk that different territories will have a different interpretation leading to disputes and potentially double taxation.

III. Specific Activity exemptions – options E - H

**Preference - Option E**

Provided that the preparatory or auxiliary character is maintained within this exemption then, none of options E, F and G should have a material impact on insurance business models. However, option E would seem to be the most appropriate. Option H would potentially have a material negative impact on insurers' ability to undertake research.

46. We understand why the OECD wishes to counter the use of the specific activity exemptions that lead to BEPS.

47. Options E – H contain different proposals relating to changes to the specific exemptions in Article 5(4). Provided that the preparatory or auxiliary character is maintained within this exemption, then none of options E, F and G should have a material impact on insurance business models. However, option E would seem to be the most appropriate.

48. However, option H, which removes the “collecting of information” exemption could have an impact on insurance business models. Insurers often collect data with a view to better understand the market in order to write risks in a territory on a freedom of services basis, or to decide whether to do business in a territory, or to research a market for expansion reasons. Data collection is also an important part of risk assessment. For example, an insurer may visit a
factory overseas to assess the level of risk management or an auto insurer writing risks in a small
country may use data from a larger market to inform the amount of losses likely for a particular
make of car. Furthermore, any information-gathering activities carried on by an agent other than
an agent of independent status could give rise to a PE.

49. We believe that the collection of data by insurers in the circumstances described above would
clearly be within the “preparatory or auxiliary” exemption in Article 5 (4). However, if this is not
the case we believe that a better approach would therefore be for the exemption to be more
targeted rather than removing it altogether.

IV. Fragmentation of activities – Options I and J

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<th>Preference - Option I</th>
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| As Option I would continue to permit preparatory and auxiliary activities to be performed by an
  associated enterprise without a PE being created, it would seem the better approach. However,
  clear commentary and guidance on the meaning of “constitute complementary functions” and
  “cohesive business operation” would be needed to ensure that there is consistency in how these
  words are interpreted by different tax authorities. |

50. We understand why the OECD wishes to counter the use of the specific activity exemptions that
counter the fragmentation of activities that leads to BEPS.

51. We believe Option J, which is widely drafted, will create a PE where a group entity provides
preparatory and auxiliary services just because there is a related company operating in the same
state. This related company could be engaged in completely unrelated activity. This approach
seems contrary to the purpose of taxing entities based on where economic value is generated.
The better approach to this would be to use a transfer pricing analysis.

52. As Option I would continue to permit preparatory and auxiliary activities to be performed by an
associated enterprise without a PE being created, it would seem the better approach. However,
clear commentary and guidance on the meaning of “constitute complementary functions” and
“cohesive business operation” would be needed to ensure that there is consistency in how these
words are interpreted by different tax authorities. Without this there is a risk that different
territories will have a different interpretation leading to disputes and potentially double
taxation.

V. Splitting of Contracts – Options K and L

53. We understand why the OECD wishes to counter splitting of contracts that leads to BEPS.

54. We have no specific comments on options K and L.

VI. Profit attribution to PEs and interaction with action points on transfer pricing
55. The way in which profit is attributed to an insurance PE is set out in Part IV. The development of Part IV involved a significant amount of work and we would urge caution before amending the PE rules such that Part IV needs to be fundamentally rewritten.
Appendix 1

EU law Freedom of Establishment (‘FoE’) and Freedom of Services (‘FoS’).

In the EU there is a single market for insurance – see the EU Life Insurance and Non-Life Insurance Directives. These Directives effectively provide for insurers in one EU member state to be able to sell in or into other EU member states either under FoE or FoS.

FoE is typically where an insurer resident in one EU member state sells “in” another EU member state through a branch, i.e. has a physical presence. Despite this physical presence the insurers’ capital requirement will be regulated by its home regulator and not the regulator in the EU member state where it has the branch. For tax purposes we would expect the insurer to have a PE in the EU member state in which it is selling that business as a result of its physical presence.

Under FoS, the insurance policy issued is written in the insurer’s home EU jurisdiction but covers a risk located in the other EU member state. FoS therefore enables insurers to sell “into” another EU member state without having a regulatory PE; although some preparatory and auxiliary activities such as sales support may take place in that member state. All Key Entrepreneurial Risk-Taking functions (e.g., assessment, assumption and management of risk) would be in the home EU member state and the insurers’ capital requirement would be regulated by the home regulator. So, the PE for both tax and regulation will be the same (the home state) and not the state in which the insurance policies are actually sold.

If the scope of PE is widened, this could mean that insurers who operate under FoS would have additional tax PEs, where there is no regulatory PE and where there is no true risk assumption activity.
Appendix 2

Quota Share Reinsurance

One common type of reinsurance is proportional reinsurance (e.g. quota-share reinsurance and co-insurance). This is where the reinsurer reinsures a certain percentage of each of the policies written by the ceding company. Once the reinsurance treaty is entered into, the reinsurance is automatic.

The ceding company may seek a quota share arrangement if it does not have sufficient capital to retain all of the business that it can sell. By reinsuring 50% of it, it can write twice as much business. The ceding company may also seek reinsurance simply to limit its exposure to risks it has written. For multinational groups this is a key mechanism that provides underwriting capacity efficiently to smaller markets.

Delegated Underwriting Authority (DUA)

Under a DUA an insurer delegates authority to enter into contracts of insurance on its behalf to independent coverholders/agents. This authority is strictly limited as to the size and nature of risks which can be accepted. The insurer also specifies, in advance, the terms on which the business can be written. Any business purported to be entered into by the agent which exceeds this authority is void.

Fronting Arrangements

Fronting arrangements are where a primary insurer acts as the insurer by issuing a policy, but then passes all or a portion of the risk to another insurance company. The most notable drivers of such transactions are:

a) To allow an insurer writing a multi-country insurance policy to provide cover in all required countries, including those in which the insurer is not itself licensed;

The fronting insurer will issue the policy and will enter into a formal reinsurance agreement with the program carrier.

b) To access the enhanced credit rating of the fronting company;

An insured may require its insurer have a particular credit rating. To the extent that a program carrier wishes to write a policy and it does not have a sufficiently high credit rating, they will often work with a licensed carrier with the required rating to front for them. The reinsurance relationship is the same as above, with the fronting carrier assuming the credit risk of the program carrier.

The fronting insurer generally issues the policy, undertakes the policy administration, pays any premium tax, deals with claims and cedes all, or a portion, of the risk back to the program carrier. In return the fronting insurer retains a commission which is commensurate with the activities undertaken. So there is no BEPS.
I. Introduction

These comments are being submitted to the OECD by the Banking and Finance Company Working Group on Base Erosion and Profit Shifting (BEPS), a group of global banks and finance companies, in response to the public Discussion Draft released on 31 October 2014 by the OECD entitled “BEPS Action 7: Preventing the Artificial Avoidance of PE Status.”

The Working Group is concerned that the options in the Discussion Draft could create substantial uncertainty in situations that do not involve artificial avoidance of permanent establishment status and would lead to significant administrative burdens for both taxpayers and tax authorities and a serious risk of double taxation.

In respect of banks and finance companies, the OECD and its members have already made policy judgments relevant to PE matters after extensive study and discussion. In particular, in its work on Action 7, the OECD should take account of the analysis of global banking and securities businesses in the Report on the Attribution of Profits to Permanent Establishments (the “2010 OECD Report”).

Importantly, we believe the purposes of Action 7 can be accomplished with a more targeted approach that more narrowly focuses on particular BEPS activities of concern, without requiring new PE rules of general application that would have implications well beyond the intended scope of Action 7.

1 The Banking and Finance Company Working Group is comprised of members of the Securities Industry and Financial Markets Association (as represented by Citigroup, T.D. Bank, JPMorgan Chase & Co., Barclays, Bank of America, State Street, and Goldman Sachs), and General Electric and American Express. The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information and a complete list of SIFMA members, visit www.sifma.org
II. Taxation of multinational banking and financing operations

The 2010 OECD Report focuses on the methodology for attributing profits to a recognized PE, and not on the criteria for determining whether a PE exists. However, the report recognizes the interaction between PE and transfer pricing principles in determining the appropriate allocation of profits of global businesses conducted through subsidiaries. The report specifically recognizes that individual countries may determine in a particular case that it would be more appropriate and more efficient to rely on transfer pricing principles rather than PE taxation to ensure that a group’s profits are attributed correctly. The report also takes into account the regulatory environment in which multinational financial services firms operate, which limits their ability to separate taxable income from the activities that generate it. For example, a bank must have a physical presence in a jurisdiction to engage in substantial deposit-taking activity with retail bank customers.

The Appendix at the end of these comments illustrates the paradigmatic case in which countries have made the judgment that arm’s length pricing obviates any need to deem a taxable PE. The example involves a global bank group with transactions between two active operating affiliates based in different countries. The fact that the total amount of tax payable in each country by members of the global banking group in the illustrative example may be the same regardless of whether a PE is deemed to exist shows that base erosion does not result from not deeming a PE to exist in the circumstances described. This approach appropriately places the focus on determining the amount of revenue allocable to each operating company on the basis of established transfer pricing methodologies.

A multinational banking or finance company group typically will have many subsidiaries operating in different countries that deal with each other as part of the group’s business. Uncertainty regarding whether ordinary-course transactions between related parties could create deemed PEs would have unnecessarily burdensome consequences. In the case of a global bank or finance company group, the creation of deemed PEs also would give rise to collateral issues, such as how much capital should be attributed to each PE and the potential and inappropriate application of withholding taxes, which would create further complexity, uncertainty, and the risk of double taxation. If there is a concern regarding proper capital allocation between affiliates, this issue should be addressed through transfer pricing methodologies addressed in the 2010 OECD Report.

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2 “The Commentary on Article 7 confirms that the principle reflected in Article 7(2) corresponds to the arm’s length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises. The arm’s length principle has thus always been at the heart of Article 7. … Accordingly, the authorised OECD approach is to apply the arm’s length principle of Article 9, as articulated in the Guidelines, to the attribution of profit to a PE using the arm’s length principle under Article 7(2).” (2010 OECD Report, p. 23, paragraphs 52-53)

3 Imagine the potential complications (and the number of PEs that could be deemed to exist) if a global banking or finance company group conducts activities through substantial operating subsidiaries in 25 countries, and each of those subsidiaries enters into transactions with each of the others.
Moreover, the cost of compliance with tax filing requirements for the large numbers of deemed PEs in multinational banking and finance company groups that would most likely result from adopting any one of Options A through D in the discussion draft would be enormous. The administrative costs to the tax authorities would also be substantial and would likely be disproportionate to the increased tax revenue, if any, from any reallocation of income.

Global banks and finance companies, and the tax authorities of the countries where they conduct active businesses, have applied the principles of the 2010 OECD Report successfully and determined that it is more practical to rely on transfer pricing principles than to deem PEs in circumstances such as those in the illustrative example. In particular, this is because determining arm’s length pricing of transactions between separate entities within such a group is a practical approach, is well understood by taxpayers and tax authorities in light of the 2010 OECD Report and, importantly, because the ultimate profit attribution should not differ significantly. The recommendations under Action 7 should acknowledge the continued appropriateness of this practice. The Commentary to Article 5 should expressly state that any modifications made in connection with Action 7 are not intended to prevent the use of transfer pricing principles, rather than PE taxation, in appropriate circumstances.

III. Need to limit the scope of proposed changes to Article 5(5) and 5(6)

The discussion draft and the description of Action 7 in the Action Plan refer specifically to commissioner arrangements in connection with the proposed modifications to Article 5(5) and 5(6) of the OECD Model Treaty under Options A through D. However, as discussed above, these proposals would have significant implications, and would create substantial complexity, uncertainty and risk of double taxation, for business models that do not involve commissioner arrangements. Therefore, we urge the OECD instead to develop an option that is more targeted to the commissioner arrangements that are the intended target.

In addition, we believe that the independent agent definition in Article 5 should accommodate situations in which an operating company with independent substance acts for nonresident affiliates. Taxpayers should be able to rely on Article 5(6) of the OECD Model Treaty to support the position that transactions effected by an entity for a nonresident customer in the ordinary course of the entity’s business do not result in the creation of a taxable PE of the nonresident customer merely because the customer is a related party. To clarify this point, we would suggest that the Commentary to Article 5(6) include language such as the following:

If a person conducts substantial activities with unrelated enterprises in the ordinary course of its business, then the determination of whether that person acts exclusively or almost exclusively on behalf of an enterprise or associated enterprises shall be made by reference to all of that person’s activities.

IV. Need for guidance regarding “habitually” and “engages … in a way that results in the conclusion of contracts” under proposed changes to Article 5(5)
Options A through D in the discussion draft would look to whether a person “habitually engages with specific persons in a way that results in the conclusion of contracts” or “habitually concludes contracts, or negotiates the material elements of contracts,” in addition to other conditions being satisfied. We are concerned that this language would create uncertainty regarding (1) how often a person needs to engage with others in order for the engagement to be considered “habitual” and (2) how to determine whether a person is engaging in a way that results in the conclusion of contracts. For example, in the banking and finance business (as in many other industries), it is not unusual for employees of an entity based in a particular country to travel to another country for meetings with customers or potential customers. If a contract were to be concluded at the entity’s home office after several such meetings in the foreign country over the course of, say, 12 months, could it be said that the employees had “habitually engaged” with the customer who entered into the contract? If so, what criteria would determine whether or not the employees had engaged “in a way that results in the conclusion of contracts?” The explanation to Option A says that a “direct causal connection” between the interaction and the making of the contracts would be required. Determining causal connections between events is notoriously difficult, however.

If any of Options A through D were to be implemented, guidance in the Commentary to Article 5(5) would be needed on the meaning of “habitually” and further explanation would be needed as to the level of work and type of engagement necessary to establish a causal connection to the conclusion of contracts.

V. Collection of information as a preparatory or auxiliary activity

Option H in the discussion draft would delete from Article 5(4) the exception from PE status for a fixed place of business used for collecting information. We are concerned that this could inappropriately create the risk that, for example, the mere provision of assistance by an affiliate in connection with due diligence or credit review in a country where a prospective borrower conducts significant operations could be treated as giving rise to a PE even though such activity clearly is of a preparatory or auxiliary character and the affiliate providing the assistance does not play any role in decisions regarding whether and on what terms to extend credit. Moreover, this information gathering may be done by a subsidiary that does back office operations for other subsidiaries in the group. This information gathering activity should not be considered to give rise to a deemed PE of the related subsidiaries for which the information is collected.

If Option H were to be implemented, it should be narrowed so that it excludes from the Article 5(4) exception only information collection activity of a type that is not preparatory or auxiliary in character.

VI. Need for guidance on “complementary functions”

Options I and J in the discussion draft, relating to fragmentation of activities between related parties, are intended to prevent enterprises from shifting profits out of a taxing jurisdiction by artificially disaggregating an integral business activity into separate narrowly defined functions. In doing so, it could be possible to argue that the profits should be attributable to a taxing jurisdiction on an entity-by-entity basis and that each entity, considered separately, is entitled to a very small remuneration. Options I and J should not be relevant to regulated banks and finance
companies, because such businesses do not engage in artificial disaggregation and would not be permitted to do so as a regulatory matter. Therefore, the OECD’s guidance on this issue should confirm that the conduct of activities through separate legal entities for regulatory or other non-tax business reasons is not indicative of a problem.
Appendix: Global Banking Group Example

A global banking group conducts business through regulated subsidiaries in country A and country B ("SubA" and "SubB"). Each subsidiary conducts an active banking and dealer business with unrelated customers and maintains a substantial physical presence, with a large number of employees, in its country of operation. Further, each subsidiary is subject to substantial regulation by its local country regulator, as well as the regulator of its parent’s jurisdiction, and earns significant income that is subject to local tax. Neither subsidiary is dependent on, nor is an outpost of, the other. Neither subsidiary conducts activities that have been artificially limited for tax reasons. Regulators have not taken the position that a deemed branch of SubA exists in country B or that a deemed branch of SubB exists in country A.

In the ordinary course of business, employees of one subsidiary often will effect transactions for the account of the other subsidiary or its customers. For example,

- A customer in country A wishes to buy a government security issued by country B. The customer calls a salesperson at SubA. The salesperson calls the trader responsible for managing SubB’s positions in that security. Depending on local regulatory considerations, the resulting transaction may take the form of a purchase and resale of the security (in which event SubA’s profit will take the form of a markup) or a sale directly by SubB to the customer (in which event SubA’s profit will take the form of a commission).

- A customer in country B wishes to enter into a derivative in respect of a country A risk. The customer enters into the derivative with SubB. SubB hedges its exposure by entering into a matching derivative with SubA. SubB’s profit consists of the spread between the terms of the customer derivative and the terms of the hedge. Alternatively, the customer derivative could be booked directly into SubA in which case SubB will earn a commission.

- SubA and SubB maintain very substantial positions in securities and derivatives traded in various markets worldwide. During periods in which the markets in country A are closed, a trader employed by SubB is responsible for monitoring SubA’s positions in markets outside country A and taking action, within tightly constrained limits, to respond to market developments. A trader employed by SubA performs a similar function for SubB during periods when the markets in country B are closed.

SubA determines that the transactions effected for its account by SubB in country B do not result in the creation of a PE of SubA in country B for tax purposes. SubB makes the same determination in respect of country A. The tax authorities respect these determinations, and conclude that profits attributable to the transactions between SubA and SubB have been allocated appropriately, and in accordance with arm’s length standards.

SubA earns 100 of income, and pays 30 of country A tax. SubB also earns 100, and pays 30 of country B tax. If, alternatively, the transactions that SubB effects for the account of SubA were deemed to create a PE of SubA in country B, that PE would earn 10 of income and pay 3 of
SubA’s country A source income would be reduced from 100 to 90, and its tax liability in country A would be reduced from 30 to 27. The same consequences would arise in country B if transactions effected by SubA for the account of SubB were deemed to create a PE of SubB in country A. Thus, each country would receive 30 of tax revenue from the group regardless of whether taxable PEs were deemed to be created.
 Comments on OECD Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. de Ruiter,

It is our pleasure to provide comments on the BEPS Action 7 Discussion Draft supporting our belief that changes to the definition of Permanent Establishment (“PE”) should be narrowly focused to prevent abusive transactions and avoid the creation of a large number of PEs from transactions with legitimate business purpose. Without narrow and objective rules in place widely varying interpretations of the tax treaty law are likely, resulting in an increase in unintended PEs, disputes and litigation and the potential for double taxation of income where two (or more) countries interpret the rules in different ways.

As discussed below, we feel that certain suggested changes in the Discussion Draft add subjectivity to an already complex area of tax law and, in addition to a great increase in the number of PEs, would add uncertainty and additional administrative burdens to MNEs thereby harming cross border trade and investment. We urge the OECD to consider the burden to taxpayers and governments that a broad expansion of the PE regime would bring. Any changes to the PE regime should provide clear and objective rules a taxpayer can rely on when structuring business deals.

The Discussion Draft fails to adequately address areas which are inseparable from the determination of PE status – dispute resolution and profit attribution. The existing instruments for dispute resolution are insufficient and have to be improved considerably in order to prevent double taxation as subjectivity and vagueness will lead to an increase of the number of disputes. Additionally, any changes...
to the definition of PE would need to specifically address the attribution of profits to such PEs. Many of the changes suggested in the Discussion Draft would result in an increase in the number of PEs without actually capturing untaxed profits that are the target of the BEPS Action Plan.

In addition the connection between PE and wage taxes in Art. 15 needs to be taken into account when lowering the PE threshold is considered. Not only are the administrative burdens for taxpayers disproportionate – especially in cases where no or only minor profits can be attributed to a PE – it leads as well to a different allocation of taxing rights as regards wage taxes which hasn’t been mentioned at all in the Discussion Draft.

The Discussion Draft draws a picture of a changed understanding of a fair allocation of taxing rights and intends to shift more taxing rights to the source state. Nevertheless, we urge the OECD to maintain the principle that the creation of a PE should remain an exception and a clear nexus to the source state should remain necessary to constitute a PE. With some of the proposed changes (especially the changes as regards the currently exempted activities) doing business in the source state creates a PE rather as a general rule than as an exception, even for legitimate business transactions. Some of the other proposals result in an increased number of PEs (e.g. for commissionaire PE) where the attributable profit potential to the PE will be merely based on risk and capital employed by the PE. This, in our opinion, contradicts the OECD’s efforts in the area of transfer pricing which focuses on significant people functions. The Action Point should therefore reduce its scope back to the prevention of abusive transactions.

Below are our comments addressing the individual areas covered in the Discussion Draft.

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The Discussion Draft notes that the current PE rules allow a MNE to replace the traditional structure under which a local subsidiary acted as a distributor with a commissionaire structure thereby shifting profits from sales out of the country into which such sales are made. The Discussion Draft identifies “commissionaire” and “similar arrangements” as potential areas of BEPS abuse; it does not, however, give an example of a “similar arrangement”.

The Discussion Draft aims to end commissionaire arrangements, but certain of its proposed changes would likely apply PE status to legitimate businesses such as a limited risk distributor who purchases and sells goods at an arm’s length price. The OECD has been a proponent of arm’s length pricing in inter-company transactions and we are concerned that some of the proposals with respect to PE are diametrically opposed to this concept.
Independent Agent

All four alternatives A-D contain phrases which make the definition of an independent agent more restrictive. Specifically, the Discussion Draft suggests a change to paragraph 6 of Article 5 to add the language “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.”

Being part of a group seems to be perceived as a potential tax avoidance scheme. A change in the rule regarding independent agents must be coordinated with a rule pertaining to the attribution of profits. If an agent is paid at an arm’s length rate and such agent is presumably subject to taxation in the country in question, there is nothing to gain by asserting PE status to the principal. Rather, the result would be additional administrative burden for the principal (and the taxing authority) without any additional tax revenue for the country. Furthermore, when transactions are completed at arm’s length, implementing different treatment for a principal which transacts through a related-party agent versus one that acts through a third party agent is unjust and does not advance the principles of stopping BEPS. Businesses have legitimate reasons (e.g. legal, risk protection, etc.) for utilizing agents. As long as arm’s length principles are applied we do not think that such relationships are abusive and therefore should not be a target of this Action Item.

Conclusion of Contracts

Alternatives A and C replace the reference in paragraph 5 to “conclude contracts” with the broader “engages with specific persons in a way that results in the conclusion of contracts”. The Discussion Draft states that the intent in making this change is to cover contracts for property or services to be provided by the enterprise, thereby avoiding the issue of who is bound by the contract.

The suggested phrasing adds a level of uncertainty as to the types of activities that may “result in the conclusion of contracts” and the nature of the “specific persons”. We believe that a more specific phrasing and examples should be provided to clarify the types of activities that would be considered to “result in the conclusion of a contract”. The proposed change goes beyond commissionaire arrangements and even potential “similar arrangements”. For example, what would be the outcome for PE purposes where a sales agent for a principal does not have authority to conclude a contract, but instead has authority only to take orders with final approval of such order by the principal required? Would this be considered engaging in a way that results in the conclusion of contracts and therefore resulting in the principal having a PE in the country where the sales agent resides? Additionally, what would be the ultimate result asserting that the principal had a PE in that country? It is likely that at most a minor amount of the overall profit of the transaction between the principal and the third party customer can be attributable to that country in addition to the arm’s length price the sales agent receives. Yet the principal would bear the administrative burden of complying with the laws of that country. Furthermore, if the sales agent was an unrelated third party the result would be different.
than if they were related and using an arm’s length rate to compensate the support. This disparate treatment is in contrast with the general concepts of arm’s length pricing. An arm’s length pricing already ensures a fair allocation of profits between contracting states.

Alternatives B and D replace the reference in paragraph 5 “conclude contracts” with “concludes contracts, or negotiates the material elements of contracts”. The Discussion Draft states that this addresses situations where contracts are not formally concluded by the intermediary who is acting on behalf of the enterprise. While this language is more specific than that offered in the previously discussed alternatives, we feel that more precision is required as to which parts of a contract rise to the level of being “material elements”. As with any changes that might be made we would prefer that specific examples be given so as to provide certainty to the types of negotiations that would give rise to a PE so that taxpayers can make decisions accordingly. It should also be made clear that the person must have an active role in the negotiations; the mere presence of an agent during a negotiation or the pure forwarding of conditions the principal has determined should not be sufficient to constitute a PE.

Alternatives A and B, in addition to the changes discussed above, suggest adding the phrasing “contracts for the provision of property or services by the enterprise” to paragraph 5. Generally, a “commissionaire” arrangement is limited to the conclusion of contracts for the sales of goods. With this addition the Discussion Draft seems to go beyond the scope of stopping commissionaire arrangements. Further clarification is needed as to the intended target of this changed phrasing. Including these services suggests that it shall not be necessary that the local entity enters into the contract in the name of the foreign enterprise. All local support services hereby potentially constitute a PE, regardless of the pricing of these support services. In combination with the other changes alternative A therefore leads to a level of uncertainty that is unbearable.

Alternatives C and D address the perceived problem concerning the wording in the existing dependent agent test of “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”. This is the type of vague and subjective phrasing that would add complexity and uncertainty in the PE determination and, as such, we oppose the adoption of such language. Countries could have varying opinions on the types of legal relationships that are covered by this phrasing. It is foreseeable that a country in search of additional revenue could assert that this applies to almost any related entity, no matter how minimal that entity’s actual participation in the contract is.
Summary

With the proposed options the threshold at which a PE is constituted in the source state would be substantially lowered and probably even legitimate intercompany agency business in the future would constitute PEs. Such a lowering of the PE threshold should not be recommended without considering the allocation of profits. In the majority of cases only minor profits can be attributed to, e.g., an agency PE. No additional employees (other than business travelers) or assets can be allocated to such a PE and therefore the profit allocation can only be based on a remuneration for the risk assumed. This contradicts to the efforts of the OECD in the area of transfer pricing to only remunerate significant people functions. Along the same lines, expenses related to the risk should also be attributed to the PE. As a result the net profit would be low.

We recommend the retention of the current wording of Article 5 paragraphs 5 and 6. If changes to the current wording are deemed necessary by the OECD, we identify alternative B as the most objective. Assuming that additional guidance is provided as to which parts of a contract are considered material this is the alternative that would not materially alter the way legitimate business is done and also could serve to address structures that are perceived to be abusive. However, more specificity and examples would be needed to ensure that taxpayers have certainty when structuring their cross-border transactions.

B. Artificial avoidance of PE status through the specific activity exemptions

Specific activity exemptions

Paragraph 4 of Article 5 of the Model Convention provides specific exceptions for when a PE is deemed not to exist where a place of business is used solely for certain listed activities. The listed activities were generally considered not to generate significant profits to an enterprise and therefore were exempted to provide some certainty to taxpayers when structuring their business endeavors. The Discussion Draft suggests six alternatives (E through J) in addressing perceived abuses of the exempted activities. The main targets of the Discussion Draft include warehouses, purchasing offices, and offices used for gathering information. Although we agree that certain abusive business structures are rightfully targeted by the suggested changes, we feel that the Discussion Draft needs to be further refined in order to avoid casting a wide net which captures legitimate transactions.

Alternative E suggests making all of the activities currently listed in paragraph 4 subject to the requirement of being “preparatory and auxiliary.” Among the suggested alternatives this option is the broadest and leaves the most room for subjective interpretation. As stated previously, we believe that, to the extent possible, certainty and objectivity should be guiding principles in drafting tax laws as this is the best way to foster cross-border investment and trade. If this alternative were adopted,
the OECD should also provide clear guidance on what types of activities would be considered “pre-
paratory and auxiliary”. We prefer that the OECD provides specific activities that it considers to be
not preparatory and auxiliary and address those activities specifically. Generally, this alternative
leaves too much to interpretation among varying countries and we can foresee it leading to prolonged
litigation among taxpayers and taxing authorities. Moreover, the creation of a PE would be rather the
rule than the exception. Especially in commodity type business with low overall profit margins a
fragmentation into purchasing PEs, warehouse PEs and agency PEs with its related profit attributions
might result in unreasonable base erosion in the country of production and excess profit attribution to
the PEs. This might in some cases even result in double taxation.

Alternative F suggests removing the word “delivery” from subparagraphs a) and b) of paragraph 4.
The Discussion Draft notes that the exception for delivery is difficult to justify where an enterprise
maintains a large warehouse in which a significant number of employees work for the main purpose
of delivering goods that the enterprise sells online. The Discussion Draft does not, however, state
that the goods must be held by the entity for delivery by that entity. If this option is adopted it should
be made clear that an entity that holds goods in a warehouse in a country, but uses a third party for
delivery of those goods does not create a PE. Additionally, as the Draft Discussion aptly points out,
“even if the delivery of goods is treated as giving rise to a PE, it may be that little income could
properly be attributed to this activity.” It should also be made clear that the only profits that could be
attributable to the PE are profits attributable to the sales into the country in which the related entity
maintains a warehouse. The deletion of the word “delivery” goes far beyond targeting only digital
conomy companies although this was the motive to change the specific activities exemption in the
first place.

Alternative G suggests deleting the exception for “purchasing” in subparagraph d) of paragraph 4.
The Discussion Draft indicates that when the provision was originally drafted there was a supposi-
tion that no or little profits could or should be attributed to purchasing activities. We think this still to
be the case. The Discussion Draft provides an example of a case in which an enterprise effectuates
inter-company sales from a manufacturing facility to a purchasing office located in the same state
with the purchasing office claiming certain purchasing discounts. While this may be a legitimate ex-
ample of abuse, such abuse is better addressed with a transfer pricing rule pertaining to profit attribu-
tion rather than simply pulling the purchasing office in as a PE. We think that eliminating the excep-
tion for purchasing has too many overreaching effects to justify leaving it out entirely. In most cases
the purchasing of materials will not, by itself, generate profit; thus, if the purchasing exception is
eliminated there would still be very little to gain by taxing those profits and this does not justify the
administrative burden that would be imposed by asserting PE status on the entity.

Alternative H suggests deleting subparagraph d) of paragraph 4 in its entirety. The Discussion Draft
states that “Concerns have been expressed…that some enterprises attempt to extend the scope of [the
exception for data collection]…by disguising what is in reality the collection of information for other
enterprises by repackaging the information collected into reports prepared for these enterprises.”. We
think that the exception for data collection, and the subparagraph in its entirety, should remain. Similar to our reasoning throughout this response, we think removing this subparagraph would result in the proliferation of PEs thereby increasing the burden on taxpayers and stifling cross-border trade. Neither of the activities of purchasing goods or collecting information are highly profitable stand-alone endeavors. As such, the administrative burden is not justified by the relatively low amount of tax revenue that could be generated by the removal of these exceptions. In addition this alternative might lead to companies refraining from investigating the markets of developing countries and thereby this alternative prevents MNEs from investing into such countries. This would harm the economy of developing countries as MNEs support growth for example by employment and infrastructure.

**Fragmentation of Activities Between Related Parties**

Alternatives I and J both address the fragmentation of activities between related parties wherein one entity undertakes one of the activities exempted in paragraph 4 and a different, related entity, undertakes a different one of the exempted activities. Both alternatives suggest adding a new paragraph (4.1).

Alternative I essentially amalgamates the operations of any related entities located within the same country when at least one of the entities is a PE and the other entity’s operations “constitute complementary functions that are part of a cohesive business operation”. Alternative J is similar, but amalgamates the operations of related parties within the same country where the “overall activity resulting from the combination of the activities … is not of a preparatory or auxiliary character”, thus not requiring that any of the related entities constitutes a PE by itself. We feel that both options are too broad in scope and would result in a tremendous increase in the number of PEs. And to reiterate a point made throughout this letter, these PEs are not likely to have significant profits to them that would justify the administrative burdens that would accompany PE status.

Both alternatives I and J challenge the concept of separate entity reporting and treat third party transactions more favorably than arm’s length transactions between related entities. Furthermore, both alternatives have the potential to greatly expand the number of entities that fall within the definition of a PE. Consider another example in which Company X has a manufacturing facility in Country A. Company X has affiliates in Countries B and C. If salespersons from the affiliate entities travelled into Country A to sell products of Company X the proposed alternatives could lead Country A to assert PE status to each of the affiliates. This is true regardless of the extent of the activities the affiliates perform in Country A as long as their activities are considered to be part of the same business that Company X is undertaking. Again the question of profit attribution arises. If these agents have minimal activity within Country A (e.g., a single trip) such that little to no profit could be attributed to their activity then this rule could become overly burdensome on MNEs. Besides this a company has to be aware of all the business the whole group is doing in a country in order to be able to evalu-
ate if its auxiliary activity might be considered to constitute a PE. This is in practice not feasible. Disputes over the assessment which activities form a “cohesive business operation” are inevitable.

C. Splitting up of contracts

Article 5 of the Model Convention provides that building sites give rise to PE if they last more than 12 months. The Discussion Draft raises a concern that an enterprise could avoid PE status by using various related entities on a building site, each for a period less than 12 months. The Discussion Draft provides two alternatives to address this.

The first alternative, known as the “automatic rule” would add up the activities provided by related parties at the same building site to determine whether a PE exits. This alternative would seem to be difficult for tax authorities to administer. We are concerned that, in their attempt to administer an “automatic rule”, governments will impose additional reporting requirements on companies in order to track the amount of time that employees of any one entity spend at a construction site. Additional guidance is required as to how an “automatic rule” would be enforced.

The second alternative applies a general anti-abuse rule by providing a new example in order to show that the “Principle Purpose Test” would be applicable to the splitting up of contracts. Here we reiterate our opposition to a “Principle Purpose Test” as stated in our comment to BEPS Action Item 6 – namely, our aversion to the proposed subjective principle purpose test lies in the fact that this creates greater transactional uncertainty. A “Principle Purpose Test” is too subjective and can be interpreted too broadly by various governments. As we have stated throughout this letter, businesses need as much certainty as possible in order to be able to structure their transactions without having to be concerned about the application of subjective rules.

D. Profit attribution to PEs and interaction with action points on transfer pricing

Not only the interpretation of tax treaties regarding the definition of permanent establishments has to match between the member states in order to avoid double taxation; what is even more important is that the allocation of profits between source state and state of residency are congruent. The Discussion Draft spends very little time addressing the subject of profit attribution, but it does note that this must be a key consideration in determining which changes should be made to the definition of PE. We agree with this sentiment.

With the proposed options the Discussion Draft suggests a change in the understanding of a fair allocation of taxing rights between Member States. The definition of a PE can therefore only be the start-
ing point. A change in the allocation of tax base is what leads to the desired shift in the profit allocation between source state and state of residency. Those two topics are so closely interwoven that they cannot be separated from each other. Therefore we urge the OECD not to make changes to the PE definition that would create PEs that would be attributed very little, if any profits. For example it won’t be possible to justify a more than minor profit allocation to purchasing activities or information collection. The risks and functions assumed have to be taken into consideration.

E. Summary

The Discussion Draft goes far beyond what can be considered as preventing the artificial avoidance of PE status. The proposed options draw indeed a picture of a changed understanding of a fair allocation of taxing rights between the source state and the state of residency. The threshold for permanent establishments is lowered which leads to additional administrative burdens for enterprises like registration, bookkeeping or filing of tax returns obligations and to additional costs connected with these obligations. This can negatively impact cross-border investments and trade. Additionally, we feel it is imperative that any change to the definition of a PE must specifically address profit attribution and dispute resolution as it pertains to PEs.

Furthermore, the connection between PE and wage taxes must be taken into account when the lowering of PE threshold is considered. This could lead to wage tax duties in a country even if an employee of the state of residency only stays for a short business trip in the source state. This is particularly true in proposed options where the activities of the whole group constitute a PE whereas this wouldn’t be the case if each legal entity would be considered separately. This would be a severe hindrance to business. Not only are the administrative burdens for taxpayers disproportionate, it leads as well to a different allocation of taxing rights as regards wage taxes which hasn’t been mentioned at all in the Discussion Draft. If the OECD deems the lowering of the PE threshold to be necessary the link in Art. 15 to the PE should be deleted.

The foremost necessity of international enterprises with cross-border business is a reliable planning base that enables the accurate consideration of tax costs and administrative tax burdens in business decisions. The creation of unintended PEs has to be prevented. In relation to the BEPS work on Action 7 this means that even if the current allocation principles of taxing rights would be changed fundamentally it is of utmost importance that such new principles are accompanied by objective criteria and clear guidance on which companies can rely. Furthermore it has to be prevented that such reallocation of taxing rights on business profits in favor of the source state leads to double taxation. Such a double taxation would be disadvantageous for cross-border business and therefore be harmful for the economy.
Above the negative effects resulting from the lowering of the threshold itself there is even a greater negative impact on cross-border trade and business which results from the imprecise and subjective criteria applied to the definition of permanent establishments which are proposed by the Discussion Draft. This will increase the number of cases of differences in the definition of permanent establishments in the interpretation of treaties between the contracting states and leave companies in legal uncertainty. Resulting double taxation could only be abolished by mutual agreement procedures, which are inefficient due to their duration of several years and lack of obligation to reach an agreement in cases where the arbitration rules are not yet included in the treaty. Even if an agreement is reached the result is not binding for the competent tax authorities. These uncertainties added to increased complexity result in incalculable tax costs which impose a burden on cross-border investments. This leads to economically inefficient results and distortions. A change in the definition of PE must be accompanied by a considerable improvement of the instruments for dispute resolutions so double taxation is avoided sustainably in a timely and cost efficient manner.

Additionally, the broadening of the definition of a permanent establishment can’t be discussed without taking into consideration the profit allocation to such permanent establishments. The creation of a permanent establishment definition to which in the end very little, if any profit can be allocated makes no sense. We believe that some of the proposed options can already be ruled out as only minor profits if any can be allocated to such newly considered PE-creating functions.

In any case the tax benefits the countries are supposed to receive by the implementation of options of the Discussion Draft of Action 7 into the OECD Model Convention or by introducing a multilateral tool to implement the measures have to be carefully weighed up against the additional administrative burdens, negative impact on cross border trade and increasing costs for dispute resolutions.

Sincerely,

BASF SE
Central Department for Taxes and Duties

Meera Patel Eva Carolin Brücher
This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Sol Picciotto and Jeffery Kadet, with comments and input from Tulio Rosembuj, Cristián Garate, Maria Villanueva and Yansheng Zhu.

We are grateful for the opportunity to contribute these comments, and would be happy also to participate in the public consultation on this issue.

1. GENERAL REMARKS

1. A central technique in BEPS strategies is to devise corporate structures which take advantage of the separate entity principle by fragmenting business functions and activities among affiliates to minimise taxable presence in high tax countries. This Action Point is therefore a key one in tackling BEPS. The proposals in the discussion draft are important, as they include changes to the text of the Model Convention. They involve a welcome shift away from stubborn adherence to the separate entity principle. The approaches suggested are not new, but in many respects return to original understandings, which have been retained or revived in some countries, although they entail a change of direction for the OECD as a whole. They could provide a basis for more effective solutions to some of the BEPS problems caused by exploitation of corporate fragmentation.

2. Regrettably, however, the proposals in the discussion draft are minimalist, and would deal with only a few specific types of abuse. First, they would restore the right for a country to tax a firm’s income from sales in that country if it has an affiliate or agent there which habitually deals with customers in a way which results in the conclusion of contracts. However, this would not affect firms with local affiliates which support sales but without involvement in contracts. Secondly, an anti-fragmentation rule is proposed, but only in relation to pre-sales-related activities, such as storage, display or delivery. These proposed changes would therefore not affect other types of structures which fragment functions such as manufacturing, purchasing, design, marketing and customer support. The submission by the Trade Union Advisory Committee (TUAC) gives a very apposite example which seems typical of the trend in the past ten years or so towards corporate restructuring based on functional fragmentation, largely for tax reasons. Moreover, the current proposals would have limited application to services. They seem designed especially for richer countries with consumer markets, and are of less relevance to developing countries, which are more affected by contract manufacturing, as well as provision of services with little physical presence.

3. We may focus specifically on the common case of stripped-risk contract manufacturers as an excellent example. One way to deal with this would be for the Commentary to make clear that where decisions are made locally in a country by personnel of any group member or agent that affect the commercial risks borne by any group member, then that group member will be considered to maintain a ‘place of management’ within that country within the meaning of Paragraph 2 of Article 5. The only exception that the Commentary should provide is for any situation where the entity assuming the risk is also the employer of the relevant
management personnel supervising the local decision-maker and is tax resident and fully taxable on a current basis in the country where the management personnel reside and perform their employment roles. Hence, this exception would not apply where the group member was tax resident in a territorial-basis country and claimed that the relevant earnings were exempt due to being earned outside the country of tax residence. This approach could apply as well to any other arrangements that involve locally based personnel making decisions, the risk for which is assumed by any other group member.

4. The cautious approach which has been adopted, which was already evident in the terms of reference for Action 7 in the Action Plan, is no doubt due to the difficulties of reaching a broad consensus on more ambitious proposals. However, this creates its own risks. Countries would still be able to adopt their own preferred solutions. The UK has now proposed a Diverted Profits Tax, which would attribute a PE if any activities take place in the UK ‘in connection with’ the supply of goods and services there, in a way which it is ‘reasonable to assume’ is designed to ensure that no PE is created. This clearly goes beyond the limited proposals in the current DD. Other alternatives which also go beyond what is proposed, e.g. to deal with contract manufacturing, are already employed by some countries, even in the OECD (e.g. Australia, Spain). The failure to deal more comprehensively with fragmentation of functions will place further strain on transfer pricing rules which unfortunately remain subjective and resource-intensive to administer. In relation to services, unless an adequate solution can be found for a new definition of business presence many, especially developing countries, will resort to taxation of fees paid to foreign service providers (as some already do). The result will be an increase in competing tax claims on companies, as well as conflicts between countries.

5. Hence, in our view a more ambitious approach should be adopted, to reach an international consensus on this important issue. This should entail a reconsideration not only of paragraphs 4, 5 and 6 of article 5, but also paragraph 7, and of its relationship to article 9. These provisions lie at the heart of the problem of BEPS. They have been interpreted in recent years so as to harden a separate entity principle, although neither of them requires related entities to be treated as if they were independent. Article 5(7) simply creates a presumption that the fact that two companies are under common control shall not “of itself” constitute one a PE of the other, hence in appropriate circumstances it may; while article 9 empowers tax authorities to adjust the accounts of a company which is an associated enterprise, to prevent profit shifting. Interpreting these provisions as a creating a requirement to treat related entities as independent facilitates (indeed encourages) the tax avoidance strategies now described as BEPS.

6. The need for a reconsideration of article 5(7) is now evident. The Commentaries to the OECD MC on this paragraph extensively discuss the problems it poses both for e-commerce and for services. The unsatisfactory nature of the view taken on e-commerce by the OECD a decade ago, embodied in the Commentary on article 5(7), has resulted in the inclusion of Action 1 in the BEPS project, to address the issue of the digitalized economy. Yet the report on Action 1 published in September deferred consideration of solutions, including revision of the PE definition, while expressing the hope that work done on the other action points would resolve most if not all of the problems. In our view, more could be done under the present action now. For example, Paragraph 40 of the Commentary under article 5 now provides, in part:

1 See Adolfo Martín Jiménez, Preventing the Artificial Avoidance of PE Status. UN Tax Committee, 2014, especially section 5.3.2 on Spain.
Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

Additional guidance could be provided, immediately after this sentence, such as the following:

Where, however, the conduct of the trade or business carried on by the subsidiary is an integral part of the trade or business carried on by the parent company or of any other associated enterprise similarly managed by the parent company or any other associated enterprise, then the subsidiary company can be a permanent establishment of the parent company or any other relevant associated enterprise. In particular, this will be the case where the trade or business of the subsidiary involves complementary functions that are part of a cohesive business operation conducted by the parent company or any other associated enterprise.

7. The relatively limited nature of the proposals in this discussion draft means that significant work would remain. Such work should clearly extend to the field of services, since digitalisation has greatly expanded the ability of companies to provide cross-border services without the physical presence needed for a PE. Indeed, fragmentation is particularly characteristic of businesses in service sectors, or for which provision of services is a major element. Although often organised through fragmented corporate structures, they generally entail a cohesive business, which should justify their treatment as a unitary one for PE purposes. The UN Committee of Tax Experts is currently considering taxation of cross-border services. That body may provide a more suitable forum to consider these wider issues, if they seem to go beyond the scope of the BEPS project.

8. While in our view it is essential to move away from the separate entity principle, and to do so more decisively than is proposed in this discussion draft, it is also important to take into account the implications of this. An extension of the concept of a PE would result in an increase in the allocation of income to the source country even though the firm concerned has relatively low direct expenses there, the bulk of the costs being incurred within the home office, and/or other branches. This concern about whether a country will fully allow direct and indirect expenses physically incurred outside its borders is often a reason indeed for a company to form a separate affiliate to be responsible for a new operation or specific project, which would allow the charging of relevant costs under transfer pricing rules and with fully documented inter-entity transactions and agreements, all of which are subject to normal inter-company transfer pricing rules. This is of course in contrast to the more nebulous charging of direct expenses and allocation of indirect expenses to a PE’s gross income (or determination of an arm’s length charge for functions performed by the home office or other branches where the 2010 amendments to Article 7 apply).

9. This move away from the separate entity principle, and other changes being considered that would expand the role of the profit split method, also have important implications for the amendments adopted by the OECD in 2010 to Article 7. However, these changes have so far been included in few tax treaties even between OECD countries, and have been rejected by some OECD and most non-OECD countries. In our view some of these changes should be reconsidered. In particular, where activities of one or more associated companies conducted on behalf of a company making sales or providing services cause that company to have a PE in a particular country, a profit split approach may be the most appropriate method to determine not only the relative profits of the several companies, but also the profits to be reported by the PE. Note that apportionment of profits is still permitted under Article 7(4) of the UN Model treaty, which is in force in many treaties, especially with developing countries.
10. The discussion draft rightly states that the issue of definition of a PE needs to be considered in conjunction with other action points, including those on transfer pricing. Since a number of states are likely to seek to adopt an expanded PE definition, both taking advantage of and going beyond what is proposed here, it seems to us all the more important to develop PE gross income recognition methodologies and expense allocation approaches which ensure that PE net income is calculated and taxed according to where economic activities take place and value creation occurs. Indeed, where a gross income recognition methodology cannot be reasonably applied, a profit split method or other profit apportionment method would be used. The reasons which led the OECD to withdraw that method were stated in Paragraph 41 of the Commentary on Article 7:

For the Committee, methods other than an apportionment of total profits of an enterprise can be applied even in the most difficult cases. The Committee therefore decided to delete that provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm’s length principle.

Given the fast growing recognition that the profit split method will be of increasing importance amongst associated enterprises, the same recognition must now be reflected in the re-inclusion of paragraph 4 in the OECD Model, and in amended language to the Commentary on Article 7. We have made more detailed proposals for implementation of the profit split method in our submission on Action 10 *The Use of Profit Splits in the Context of Global Value Chains.*

2. COMMENTS ON SPECIFIC PROPOSALS

A. Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies.

1. As with other Action Plan reports (e.g. those on hybrids) these proposals create unnecessary difficulties and serious complexities because they assume the separate entity principle, and hence attempt to provide definitions applicable to both related and unrelated enterprises. The example in paragraph 7 (based of course on an actual case) concerns related enterprises. Yet the wording of article 5(5) is directed at independent entities, hence it refers to ‘acting on behalf of an enterprise’. An integrated firm can fragment its overall sales activities into ‘parallel’ functions, such as marketing or customer support, which can be assigned to affiliates so that no one affiliate acts ‘on behalf of’ another, although they are managed in an integrated way. A number of activities involving engagement with customers relate to sales. From an economic and business perspective, there is a big difference between keeping these in-house (i.e. carrying them out through an affiliate) or contracting them out to truly unrelated suppliers. Hence, where a firm decides that it is more profitable to carry out such activities in a jurisdiction through an affiliate, it is justifiable to treat this as a taxable presence for the firm as a whole, and not only for that specific function. Conversely, where it decides to contract out, a taxable presence should only be justifiable in a narrower range of cases.

2. In our view, as mentioned in the previous section, a more comprehensive approach should be adopted to deal with the problem of fragmentation of functions by the same firm among several affiliates. Under such an approach, there should be a presumption that an associated enterprise constitutes a PE for its parent, at least if it is engaged in related activities. This should not be limited to where there is an involvement with negotiation of contracts, but should apply if the activities ‘constitute complementary functions that are part of a cohesive
business operation’, to use the term proposed for the anti-fragmentation rule in Options I and J.

3. This would simplify the definitional problems caused by attempting to specify the degree of involvement in contracts which justifies treating an independent entity as a dependent agent. Of the options presented, our preference is for Option C. Taking the various components of the alternatives separately:

(i) we see no reason to limit the provision to contracts for the provision of property or services as proposed in Options A and B;

(ii) the formulation ‘engages with specific persons in a way that results in the conclusion of contracts’ is better than ‘concludes contracts, or negotiates the material elements of contracts’ suggested in Options B and D;

(iii) we prefer the formulation ‘contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of’ to ‘contracts in the name of’ as proposed in Options A and B;

(iv) the wording for article 5(6) appears to be identical in all four Options.

B. Artificial avoidance of PE status through the specific activity exemptions

1. As outlined in section 1, we consider that the key issue to be addressed in this Action Point is the fragmentation of functions among different affiliates. Hence, we welcome the proposal in subsection B.4 to deal with this specifically through a new treaty provision. This is an important advance compared to previous reports on this subject, which considered that the problem was adequately dealt with in paragraph 27.1 of the Commentaries, and by domestic anti-abuse rules. The proposals for a new paragraph 4.1 begin to move away from the reinforcement of the separate entity principle which has characterised OECD work for too long, and towards a more realistic appreciation of the reality of integrated operations of multinational corporations. However, we regret the limited scope that has been given to the proposed anti-fragmentation rule by restricting it to the sales-related functions in article 5(4).

2. In our view, it is clearly desirable to adopt Proposal E, to make it clear that all the activities currently listed in Article 5(4) are subject to the condition of being preparatory or auxiliary. This should be done in conjunction with the anti-fragmentation rule put forward in Option J, to deny the application of the exceptions of paragraph 4 where complementary business activities are carried on by associated enterprises, at the same or different locations, even if none of those places alone constitutes a PE, but the combined activities go beyond what is preparatory or auxiliary.

3. Consideration of these specific activity exemptions reveals the limitations of the proposals concerning dependent agents. Even if activities of storage, display, delivery or collection of information are regarded as involving a PE, they would still be treated as separate unless the entities performing them can be said to be involved also with the conclusion of contracts. Although some types of marketing activities may be considered to contribute to the conclusion of contracts, most of these delivery-related activities would not. Hence, many firms could continue to fragment activities, so that the attribution of profit among them would continue to depend on transfer pricing rules. As is pointed out in the extract from the UN Commentary to article 5 quoted in paragraph 19, under current transfer pricing rules it may be that little income would be attributed to functions such as delivery. Internet-based sales are closely integrated with and dependent on the firm’s ability to deliver quickly and provide good customer support. (The significant attention that Amazon has been receiving is an excellent example of this.) Yet a firm could continue to attribute substantial income to a
sales affiliate, which can easily be located in a low-tax country, and only low profit margins to the sales-related activities. This is inconsistent with the aims of the BEPS project to ensure taxation ‘where economic activities take place and value is created’.

4. We therefore strongly suggest that guidance be provided stating that all sales-related local activities will cause there to be a permanent establishment of any associated enterprise. These local activities should include (i) any local activities supporting an associated company’s sales, leases, licenses or provision of services, and (ii) post-transaction services paid for by any affiliated enterprise. Under this standard, for example, after-sale services contracted directly by the enterprise performing the local activities with unrelated customers would not cause any permanent establishment of any associated enterprise. Where the same services are contracted for and/or paid for by any associated enterprise rather than by customers, then they would cause a permanent establishment of the associated enterprise.

C. Splitting-up of contracts

1. This is an overdue recognition of the need to deal with another type of fragmentation, separation of work by the same firm into contracts with different affiliates. This should be dealt with by a modification of article 5(3) as proposed in Option K, and not through an anti-abuse rule, which is the view the OECD has taken in the past. As shown by the draft example proposed in Option L, application of an anti-abuse rule would tend to be limited to circumstances where the main motive is tax avoidance, allowing firms to make business and legal arguments, often spurious, which may be agreed to by tax authorities having little understanding of actual business and legal needs. Work done at the same site by a firm, even if through different affiliates, should in principle be aggregated for the purposes of determining taxable presence.

D. Insurance

1. We consider that it would be a desirable step for the OECD Model to include a provision similar to that in the UN Model, as proposed in Option M. As the draft explains, many treaties already include such a provision, and it has been found suitable.

E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing

1. The discussion draft correctly points out that the issue of definition of a PE must be considered in conjunction with methods for allocation of profits. Certainly, as long as the OECD continues to emphasise the independent entity principle, transfer pricing rules will continue to bear much of the strain. However, it is important to address the question of taxable presence on its own merits. As we pointed out in section 1, a shift away from the separate entity principle is desirable and necessary, but it should involve coordinated actions for apportionment of both income and costs. Transfer pricing methods should move away from attribution of profits according to artificial concepts such as risk, and move towards apportionment based on concrete factors which better represent the extent of real activities. We have provided more extensive proposals on how this should be done in our comments on Action 10, *The Use of Profit Splits in the Context of Global Value Chains*.
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris Cedex 16

Attn: Mr. Raffaele Russo (via Raffaele.RUSSO@oecd.org)

Dear Mr. Russo,

You have requested of Sol Picciotto that the BEPS Monitoring Group (“BMG”) provide comments on the Article 7 implications for tax base apportionment of a wider permanent establishment definition under Article 5. This wider definition arises both from the current Action 7 efforts to prevent artificial avoidance of permanent establishment (“PE”) status and from certain of the Action 1 efforts regarding the digital economy.

At Mr. Picciotto’s request, I have prepared this separate letter to assure that certain Article 7 implications can be submitted by 9 January 2015, the deadline for Public Discussion Draft for BEPS Action 7: Preventing the Artificial Avoidance of PE Status. This will assure that these Article 7 issues can be addressed at the same time that the related Article 5 issues are considered.

**Background**

The 31 October 2014 Public Discussion Draft for BEPS Action 7: Preventing the Artificial Avoidance of PE Status, provides various options designed to expand the PE definition. These expansions focus principally on structured arrangements intended to avoid PE status such as commissioner agreements, certain activities conducted directly or indirectly such as “delivery”, and the fragmentation of certain activities so as to arguably qualify them as “preparatory or auxiliary”.

January 7, 2015
Addressing the Tax Challenges of the Digital Economy, Action 1: 2014 Deliverable, issued 16 September 2014, sets out background and directions for future BEPS efforts concerning the digital economy. In particular:

…the Task Force will need to more thoroughly evaluate: (i) the extent to which businesses in the digital economy are in fact able to achieve significant sales in a market country without maintaining physical presence; and (ii) the participation of users and consumers in value creation in the digital economy, including in particular the use of data provided by users in multi-sided business models. [From section 8.4.2 Options requiring further development by the Task Force, page 153.]

From the Conclusions section beginning on page 157:

Increasing reliance on data collection and analysis, and the growing importance of multi-sided business models raise questions about valuation of data, nexus, and profit attribution, as well as characterisation. [Emphasis added.]

Discussion

The comments in this letter assume that the Article 5 definition of PE has been expanded, thereby causing PEs of foreign tax residents in source countries even with limited or no assets or employees being located in these source countries. Under certain assumed Article 5 expansions, this letter will propose approaches to determining profits attributable to such PEs.

We will comment on the following possible Article 5 expansions:

• Local taxpayer employees and/or related or unrelated commissionaire, agent and/or service provider constitutes a PE of a foreign tax resident due to sales activities, other sales support, and/or after-sales service activities.

• The creation of value due to the participation of local users and consumers causes a PE of a foreign tax resident.

In the following discussion, it is assumed that the particular facts do not support an easy application of any specific traditional transaction method or the transactional net margin method as a means of determining the revenue and ultimately the profits of a PE of a foreign tax resident. The approaches recommended in this letter reflect most importantly the dual desires to achieve (i) simplicity of administration and (ii) maximum alignment of taxation with actual activity conducted and value creation. These are principal goals of the BEPS project.
Assume a situation where a taxpayer in county A (Aco) makes sales to customers in country B. To support its sales efforts and after-sales obligations to its customers, Aco has employed personnel in country A and/or contracted with various service providers, both related and unrelated. It is further assumed that under expanded Article 5, Aco maintains a PE in country A.

The general transfer pricing principles (as referenced for Article 7 purposes in paragraph 16 of the Commentary under Article 7) require that functions, assets, and risks be considered in arriving at an arm’s length price. With the expansion of the PE definition to include situations where activities formerly ignored under Paragraph 4 of Article 5 are now considered to be core business functions and/or where the activities of service providers are included as core business functions, it is necessary to consider what adds value to Aco’s business. In doing so, we must consider how to administratively deal in an easy and non-cumbersome fashion with calculating the profit attributable to the PE in a manner that aligns taxation with actual activity conducted and value creation and that is fair to the taxpayer and to countries A and B.

In this situation, we recommend the use of three allocation keys with the indicated weighting as follows:

- **Sales (weighted at 25%)**

  The inclusion of sales as one of the allocation keys reflects the importance of each market and its customers to the global business of the taxpayer. The country of sale is determined by the location of the customer and not the legal terms of the sales contract. (See concluding comment in this section concerning this sales allocation key.)

- **Marketing and Distribution Expenses (weighted at 25%)**

  Para 2.138 of Transfer Pricing Guidelines provides, in part:

  An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added. For example, marketing expenses may be an appropriate key for distributors-marketers if advertising generates material marketing intangibles, e.g. in consumer goods where the value of marketing intangibles is affected by advertising.

  Total marketing and distribution facility expenses make an excellent allocation key that reflects the amount of resources that a taxpayer invests in each market. This key would include categories of expenses such as:

  Salaries and bonuses of marketing and distribution personnel (allocated by location of personnel)
Advertising expenses (allocated by market that advertising targets)

Depreciation of owned facilities and rental of leased facilities used in marketing and distribution activities (allocated by location of the facilities)

All other direct and allocated expenses of marketing and distribution, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (A taxpayer will often pay other legal entities, whether related or not, for sales activities, other sales support, and/or after-sales service and support activities. These payments economically include all personnel costs, office and warehouse costs, etc. of the legal entity performing the marketing and/or distribution functions for the taxpayer.)

- Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

This allocation key recognizes all inputs other than those for marketing and distribution. As such, it covers all manufacturing activities, research and development, management and support functions, etc.

This key would include categories of expenses such as:

Salaries and bonuses of all personnel other than those involved in marketing and distribution functions (allocated by location of personnel)

Depreciation of owned property, plant and equipment (collectively, “facilities”) and rental of leased facilities used in all functions other than marketing and distribution (allocated by location of the facilities)

All other direct and allocated expenses other than those related to marketing and distribution functions, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for all operational functions other than marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (For example, this category includes situations where a taxpayer pay another legal entity, whether related or not, for contract manufacturing services. These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer.)
Note that there is no allocation key for property or inventory. By including depreciation and rental expenses, all property whether owned or leased is effectively included. Further, by including relevant commissions and service fees paid to other parties, the location of property owned or leased by those service providers is effectively included as well. Finally, while location of inventory may be a factor in determining whether a taxpayer maintains a PE in a source country, the sales allocation key measures the importance of the source market and suggests that inventory and inventory transportation costs could be duplicative, to some extent.

Note that both risks and intangibles (e.g. patents, manufacturing processes, trade names, knowledge of market channels, etc.) are not directly included in the analysis. With the fact of there being only one taxpayer along with the very few tax treaties that incorporate the 2010 amendments to the OECD Model Tax Convention, it seems both appropriate and simplifying to ignore these risks and intangibles as separate allocation keys. Both are, however, indirectly included through the other factors. For example, to the extent of risks and intangibles related to manufacturing that is solely conducted in the home country or elsewhere outside the source country, then the higher-weighted allocation key for all expenses other than those for marketing and distribution will reflect them. As for marketing risks and marketing intangibles, the marketing and distribution expenses factor will similarly reflect them. For example, if relatively higher paid marketing executives in the home country make sales and credit decisions regarding buyers, then relatively more profit will be allocated to the home office and relatively less to the PE, thereby reflecting the risk that is being managed from the home office. On the other hand, if sales personnel in the PE are performing important functions such that they are paid bonuses based on their productivity, then the value they add will be reflected in their bonuses with relatively more profit allocated to the PE.

An alternative approach would be to eliminate the “sales” allocation key and then equally weigh the remaining two keys. This would leave the “sales” key to be used only in cases where there has been a meaningful creation of value due to participation of local users and consumers. If the “sales” key were eliminated, then consideration should be given to including a key for the value of inventory allocated by location where maintained.

The Creation of Value due to the Participation of Local Users and Consumers Causes a PE of a Foreign Tax Resident

We assume that an expanded Article 5 defines a PE to include situations where Aco, tax resident in country A, has within country B many users of Aco’s software, applications, and tools, including websites through which products and services are sold or licensed. The 2014 Action 1 Deliverable, Addressing the Tax Challenges of the Digital Economy, refers to some such situation in Paragraph 8.2.1.2 on pages 143-145 as “fully dematerialised digital activities” and suggests that where Aco has a “significant digital presence” in country B, that will be sufficient for a taxable presence.
Addressing the Tax Challenges of the Digital Economy, Action 1: 2014 Deliverable in Box 4.1 on pages 83 and 84 describes various possible income models. While this is perhaps oversimplifying a little, the various described models can be broken down into two categories.

- In the first category, Aco directly charges the many users of its software, applications, tools, and/or websites. For example, a user might pay Aco for the use of Aco’s accounting software. Or, a user might pay a monthly fee for the streaming of music.

- In the second category, Aco provides some or all of its services free to the users, but instead charges third parties for access to all or a defined portion of the users. For example, an advertiser may pay Aco for the ability to present its advertisements solely to users in country B whose history of internet use demonstrates some potential interest in or relationship to the advertiser’s product. As another example, Aco might sell non-personal user data and/or market research to various types of purchasers.

While these two income model categories are not necessarily mutually exclusive for any Aco, we assume in the following discussion and recommendations that they are mutually exclusive. This is for simplicity.

It will be noted that the recommendations below do not include the value of property as an allocation key. For tangible property, typically any Aco conducting partial or “fully dematerialised digital activities” will have little or no tangible property important to its value creation. Where such exists, then this will be reflected through inclusion of depreciation and rental in the operating expenses allocation key. Similarly, for intangible property, the allocation key for operating expenses will reflect the creation and maintenance of Aco’s intangible assets.

A. Aco Revenue is paid by Users of its Software, Applications, Tools, and/or Websites

In this situation, we recommend the use of two equally weighted allocation keys as follows:

- Revenue from Sales, Licenses, etc.

  The inclusion of revenue reflects the importance of each market and Aco’s users therein to the global business of Aco. The country of sale is determined by the location of the user and not the legal terms of the applicable sales contract, license, or other document.

- Operating Expenses

  This allocation key recognizes all operational inputs. As such, it covers all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.
This key would include categories of expenses such as:

- Salaries and bonuses of all operations personnel (allocated by location of personnel)
- Depreciation of owned tangible property and rental of leased tangible property used in all operational functions (allocated by location of the facilities)
- All other direct and allocated operating expenses (allocated by location of personnel or facility to which the expenses relate)
- Commissions and service fees paid to other parties for all operational functions (allocated by location where the other party provides the services) (These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer.)

B. Aco Revenue is Paid by Third-Parties Rather than by Users

In this situation, we recommend the use of two equally weighted allocation keys as follows:

- Users
  Using users as an allocation key reflects the importance of each market and the value of Aco’s users to the global business of Aco and Aco’s fee paying third-party customers. The country is determined by the location of the user and not the legal terms of any contracts, licenses, or other documents with either users or the third-parties that pay Aco for advertising, aggregate user data, etc.

- Operating Expenses
  This allocation key recognizes all operational inputs. As such, it covers all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.

  This key would include categories of expenses such as:
  - Salaries and bonuses of all operations personnel (allocated by location of personnel)
  - Depreciation of owned tangible property and rental of leased tangible property used in all operational functions (allocated by location of the facilities)
  - All other direct and allocated operating expenses (allocated by location of personnel or facility to which the expenses relate)
Commissions and service fees paid to other parties for all operational functions (allocated by location where the other party provides the services) (These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer.)

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I would be pleased to respond to any questions that you might have concerning the above.

Faithfully,

Jeffery M. Kadet

c.c. Mr. Sol Picciotto
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Via email to s.picciotto@lancaster.ac.uk
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January 9, 2014

Ref: PROPOSED DISCUSSION DRAFT: PREVENTING THE ARTIFICIAL AVOIDANCE OF Permanent Establishment (PE) STATUS

Dear Marlies,

BIAC thanks the OECD for the opportunity to provide comments on its Discussion Draft on Action 7 (Prevent the Artificial Avoidance of PE Status) of the Base Erosion and Profit Shifting (BEPS) Action Plan issued 31 October 2014 (the Discussion Draft).

The current PE rules have worked well for the past fifty years, in that they provide a level of certainty and stability which has encouraged business to engage in long-term cross-border trade and investment. Many of the major principles, such as the authority to conclude contracts, are well-understood legal concepts with broadly agreed meanings. We understand, however, that in recent years some governments have discerned planning techniques, which they believe seek to exploit elements of the current rules, for example, those on the conclusion of contracts and the preparatory or auxiliary rules.

We understand that the PE rules are likely to change, but we would make three observations. First, any rule which makes it easier to establish the presence of a PE will almost certainly increase the substantive and administrative costs of doing cross-border business for companies. Second, if the rules are changed, then it is crucial that any new rules be clear, and at least as well understood as the rules that they replace. If there is any vagueness and ambiguity in the new rules, then that will inevitably increase disputes between countries with a resultant increase in double taxation, and this second problem will be exacerbated if it proves difficult to make substantial progress on dispute resolution under Action 14. Finally, in its current form, this project does, at some level, implicate the balance between source and residence country taxing rights that is, explicitly, not a part of the BEPS project. It might, however, be better to have that conversation directly rather than through the proxy of the PE rules.

We look forward to working with you on this, but we would ask you to be very attentive to the dangers of changing the PE rules without broad agreement (including some tacit understanding on a reallocation of taxing rights between source and resident countries), and of doing so in a way that broadens rather than narrows ambiguity surrounding the presence of a PE.

Sincerely,

Will Morris, Chair, BIAC Tax Committee
Introduction

1. Treaties have historically clarified the right to tax to avoid the negative impact that multiple assertions of taxing jurisdiction can have on cross-border trade and investment. This has greatly supported the growth in such cross-border trade and investment.

2. The proposed rules would significantly lower the threshold at which an enterprise of the state of residence would be considered to have a PE in the other state. BIAC is concerned that adoption of the proposed rules could result in the proliferation of PEs. Furthermore, although BEPS has been defined as relating to double non-taxation, lowering the threshold for the creation of a PE will not specifically target double non-taxation, but will instead inevitably lead to a change in the balance between source and residence taxation. The proposals may instead lead to double-taxation in cases that are not the intended target of the BEPS project.

3. The burdens of complying with corporate income tax obligations (as well as indirect tax obligations), including the administrative burdens, like filing tax returns or audited accounts, bookkeeping, invoicing and other reporting obligation, are significant, and companies consider these obligations in deciding whether to and how much of an investment to make in another country. The administrative costs are primarily those associated with creating systems that generate the data specific to each PE as well as advisory costs — these can run into multiple millions of dollars.

4. To provide an example, in many jurisdictions, corporate tax and VAT registrations go hand in hand i.e. enterprises are automatically registered for corporate tax and VAT. Lowering of the PE threshold will therefore trigger additional VAT registration and compliance obligations and consequential administrative costs, particularly in those jurisdictions which do not allow the application of the reverse charge mechanism to keep foreign suppliers out of the local VAT net. The recognition of a PE can also have customs implications in some jurisdictions.

5. Businesses may decide that an investment is not worth the administrative and tax cost, and take additional steps to limit PE exposure. Taxpayers may also take such steps to avoid other risks, such as the prospect of criminal sanctions from certain countries with respect to accusations of fraudulent income declarations or having never submitted a tax return for a deemed PE. Decisions to limit PE Exposure will reduce the global footprint of a business, which would impact local employment and investment. For each individual company, these decisions may not have a significant impact, but replicated globally, such decisions in the aggregate, could have an important, negative impact on cross-border trade and investment. Thus, the significant expansion of the PE concept will likely create a concerning trade barrier, and may restrict the level playing field between foreign and local investments that is encouraged through Trade Agreements, Bilateral Investment Treaties and the EU freedom of establishment.

6. If the proposed rules are adopted as they stand, many of the PEs created would be the result of little, if any, activity in the “source” jurisdiction. Such limited activities would often not generate significant taxable profit. In response to the expected proliferation of PEs, BIAC expects companies would make fundamental changes in their business models to mitigate the negative consequences as far as possible For example, the proposed rules on extending

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1 We are attempting to gather information relating to these costs and will provide such data as soon as possible.
the fragmentation of activities to activities of associated enterprises might cause companies to disaffiliate portions of their operations. If, for example, a Multinational Enterprise (MNE) owns a contract manufacturing facility in country A, and another affiliate maintains a stock of goods solely for the purpose of processing by that enterprise, it would seem, under the proposed rules, that the second enterprise would now have a PE in country A. On the other hand, if the contract manufacturer were unrelated, then the PE would not exist. Thus, one response to these rules would be to decontrol the contract manufacturing affiliate. Alternatively, MNEs may consolidate manufacturing in a jurisdiction that does not apply that particular rule.

7. Another possibility is that, in response to the broad proposals, companies will move to distributor business models in order to have certainty and to mitigate the risk of double taxation, or close down rep offices for the fear of challenge, which could have a negative impact on cross-border trade. To mitigate this risk, we believe that greater clarity is required over the specific arrangements or structures that are being targeted.

8. When MNEs own local facilities, particularly in developing countries, there are benefits to the local economy. MNEs are more likely to pay higher wages, provide better benefits and apply tougher safety and environmental standards. This has been evidenced as being achieved through rises in productivity as a result of restructuring, where acquired plants increase investment outlays, employment and wages. Creating effective tax penalties for MNE ownership of local facilities will discourage such ownership.

9. The Discussion Draft dismisses, as insubstantial, the issues relating to attributing profits to the newly created PEs. To the contrary, BIAC believes that profit attribution is the most significant issue in a PE controversy, and also, that the attribution of losses to newly created PEs will also need detailed consideration. Countries are often motivated to create more PEs in order to attribute profits to them - There would be little point in creating the additional compliance burden for both taxpayers and tax administrations if there was little expectation of a related shift in the attribution of profits. We also note that the practical application of the Authorized OECD Approach (AOA) for the attribution of profits to dependent agent PEs for industrial business is already extremely challenging, with the result that arbitrary formulary apportionment methods continue to be the norm where PEs are determined to exist. In the Financial Services sector, the practical difficulties of attribution where an asset of an enterprise is considered to be split between two (or more) jurisdictions are already substantial, and will increase if the proposed changes are made. Many tax administrations will recognize that even in sophisticated financial businesses, it is too complex to expect systems to accurately allocate profit in the event of “split” assets. Such existing difficulties highlight the importance of addressing attribution issues.

10. To the extent that a PE is “virtual,” or essentially “virtual,” because functions, assets and risks of that PE are minimal, no significant profits should be attributed to that PE. Countries may, however, attempt to use such ‘marginal PEs’ to attribute significant profits based on the value of the market or some other attribution theory. The Discussion Draft notes that “these actions are not directly aimed at changing the existing international standards on the


3 Whilst the preliminary work has identified a few areas where (sic) additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in this note were adopted. Paragraph 45 of the Discussion Draft.
allocation of taxing rights on cross-border income.” Broad PE rules, combined with a lack of clear guidance on profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed. Other countries may not share this view and the lack of clarity may cause companies to be caught in the middle with profits attributed to both jurisdictions, resulting in double taxation. Even where there is no assertion of a fundamental change in international standards, double taxation is a real risk as new PEs are determined and MAP processes are required to resolve disputes. This will result in significant additional compliance burdens for both taxpayers and tax administrations.

11. There are many function-specific profit attribution questions. For example, some assert that warehouses generate significant profits, even though warehousing and delivery functions are routinely outsourced and third party comparables demonstrating low profit margins may be readily available. It is not difficult to imagine disputes on the value of this function.

12. BIAC expects that the value of raw data to be very controversial. As BIAC pointed out in its comments on the Discussion Draft on the Digital Economy:

   The Discussion Draft provides that data gathered from various sources is a primary input into the process of value creation in the digital economy. (Paragraph. 183) A key challenge is the attribution of value to this data and the extent of value relative to other sources of value – systems, software and people. It may be challenging to assign an objective value to raw data (Paragraph. 183) and determine the ownership of that data. Personal data is generally considered to be owned by the individual to whom it relates, rather than by a company. (Paragraph. 183)

   BIAC believes that raw data has little or no intrinsic value, especially generally available raw materials such as usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources.

13. The amount of raw data is exploding, particularly in connection with the internet of things. If countries take significantly different views on value of data that is collected, then the likely outcome is increased disputes and double taxation.

14. Another area of likely contention and likely dispute relates to the customer support functions. Countries take substantially different views as to whether such activities add significant value to marketing arrangements.

15. The Discussion Draft does not address the potential interaction of these rules with the limited force of attraction principle that forms part of the UN Model - The proposed rules are intended to only affect the OECD Model. However, if the proposals are implemented through the adoption of a multilateral instrument that would amend bilateral treaties that contain both OECD-based business profits articles and UN-based business profits articles, then it is necessary to consider the impact of the force of attraction principles on profit attribution. Significantly expanding the PE rules has the potential to also significantly expand the application of the force of attraction rules.

16. The PE proposals also do not fully recognize the bilateral nature of tax treaties. PE rules that restrict the ability of a “source” country to impose tax are particularly appropriate in the

4 Discussion Draft, paragraph 3, page 10.
context of trade relationships where the flow of foreign direct investment goes both ways. The source and residence country would be both benefitted and burdened by rules restricting the creation of PEs. The proposed rules therefore create significant burdens with no likely significant net tax impact between treaty partners. The proposals are, therefore, particularly inappropriate in the context of economies where FDI is reciprocal. Countries may be willing to agree to a PE provision that permits more “source” country taxation in the context of a relationship where the FDI is more one-way, or in exchange for other concessions by the “source” country in the bilateral relationship, but that should not become the benchmark model. The PE proposals would be better focused on tightening and clarifying the PE threshold in order to prevent abuse, rather than the simply lowering the threshold across the board. Lowering the threshold could have the perverse effect of increasing the prevalence of activities designed to avoid PE status, particularly if the thresholds involve subjective criteria.

A. Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

General Considerations

17. BIAC firmly believes that any review of the Permanent Establishment (PE) definition designed to prevent abuse should be carefully considered in order to avoid any unnecessary burdens, further complexity and uncertainty for taxpayers and tax administrations. The creation of new PEs will likewise place additional burdens on tax administrations, which will also need to manage the compliance, audits and MAP processes. If complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

18. In addition, tax administrations are carrying out more stringent audits and implementing tighter controls, often targeting PEs more frequently (and challenging the taxpayers PE determination). As such, extra provisions and clear guidance are needed, so as to create greater certainty and reduce the potential for disputes between taxpayers and tax administrations.

19. It is our concern that the suggested changes will not contribute to achieve the desired clarity, but instead, will lead to more uncertainty and disputes, due to the increased use of subjective tests. Without useful dispute resolution tools, like mandatory binding arbitration, MNEs will face protracted disputes, uncertainty, and no recourse to resolve such disputes.

20. BIAC understands that some Governments believe that the PE threshold must be lowered to tackle cases of abuse. We agree that real cases of abuse do exist and should be targeted, but we also believe that any amendments to the existing framework require careful assessment and analysis, so as to not jeopardize one of the very important building blocks of the international tax system. This can only be achieved in the time available with a very targeted

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7 To the extent that countries might agree to a more expansive PE rule in a bilateral agreement based on the one-way nature of FDI or in exchange for other concessions, addressing the PE rules in the MLI will be extremely difficult because taking these bilateral aspects into account will be difficult.
scope, and the use of objective criteria and agreed legal terms wherever possible. Limiting the scope to clear cases of abuse will avoid inadvertently penalizing perfectly legitimate business practices.

21. We believe that the emphasis of the Discussion Draft should be to tighten the PE threshold to prevent abuse (i.e. “artificial avoidance” as noted in the BEPS Action Plan), but we note that the lowering of the threshold in so many areas may not prevent abuse. Such a broad lowering of the threshold may arguably increase the prevalence of activities designed to circumvent the finding of a PE, particularly where the thresholds applied involve subjective criteria. Tightening or targeting is the key.

Paragraph 6 – 11 of the Discussion Draft – Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies

22. The Discussion Draft broadly defines a commissionaire arrangement as:

...“an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such arrangement, a foreign enterprise is able to sell its products in a State without having a PE to which such sales may be attributed for tax purposes; since the person that concludes the sales does not own the product that sells, it cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission)\(^8\)

23. The main tax issues arising in connection with such agreements are due, mainly, to the differences in their treatment among between and civil law countries.

24. As noted above, the differences in interpretation by tax administrations or case-law can result in interpretations that span legal and economic issues. Moreover, the guidance included in the Commentary does not provide much clarity as to how to best address the issue of dependent versus independent agents.

Proposed options for changes to Art. 5 of the OECD Model included in the Discussion Draft

25. The Discussion Draft, in paragraph 10, states that:

“as a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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.”

26. In our opinion, this policy statement is overly broad and clearly goes beyond the intended target of commissionaire arrangements or other arrangements that are designed to artificially avoid the creation of a PE. Based on such subjective principles, activities across the full spectrum of functions (including high and low value activities) could be considered to ultimately result in the regular conclusion of contracts. Indeed, for what purpose is any activity of an MNE undertaken, even the most routine, if not to indirectly or directly contribute to a broader process that will result in the conclusion of a contract?

27. We note in this regard that the financial services sector has particular concerns. Parts of financial services regulations are restrictions that directly affect the chain of distribution of

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\(^8\) OECD Discussion Draft on BEPS Action 7, Sep. 2014, Page 10-11
services and products across borders. Active distribution (soliciting) of products and services is, in most countries, only possible with an authorization from the competent authority at the place of distribution. This refers, in particular, to the financial products that are not traded on a stock exchange, to mutual funds and to insurance policies. Therefore, most of the activities performed are based on a concept of remote solicitation i.e. customers seek contact and ask for services. Remote solicitation of financial services products should not fall under the concept of a PE.

28. Businesses require certainty over tax issues, and that certainty is best achieved when principles and guidance are developed in an objective, rather than subjective way. BIAC believes that the high level and unclear nature of the OECD’s proposals under Options A-D will introduce significantly more subjectivity into the PE test. Due to the consequences of “triggering” a PE (including compliance requirements and potential for penalties for inadvertent failure to file), it is important for business to understand as clearly as possible with sufficiently “bright line” tests when a PE might arise.

29. The Discussion Draft identifies commissionaire structures and “similar arrangements” as one of the causes of BEPS in a State where sales take place. To improve the clarity of the proposals, examples should be provided to objectively identify the “similar arrangements” that the OECD is targeting. There are a number of legitimate commercial arrangements that could not considered “similar” to commissionaire arrangements but the target is not clear from the text. It is our understanding that the intent of the OECD is not to bring limited risk distributors into the scope. It would be helpful for the Discussion Draft to clarify that understanding.

30. In relation to Options A and C, the Discussion Draft proposes to replace “conclude contracts” with the wording “engages with specific persons in a way that results in the conclusion of contracts.”

31. BIAC believes that to improve the clarity of this proposal, the existing guidance in the Commentary (Paragraph 33) to the OECD Model should be developed, to add additional guidance to clearly identify the necessary elements to assess whether there has been engagement with specific persons “in a way that results in the conclusion of contracts.” It should also be clarified whether the circumstances should be assessed internally (i.e. whether authorization formally granted by the enterprise to an intermediary is assessed internally and is decisive to bind the enterprise) or externally (i.e. such authority of the intermediary to conclude contracts is assessed externally, based on what a bona fide third party would presume to exist).

32. The OECD Discussion Draft states on page 12 that:

“the determination of whether the intermediary’s interaction with specific persons results in the conclusion of a contract would require a direct causal connection between that interaction and the conclusion of the contract. It would not, however, require that the contract be formally concluded by the intermediary”.

33. BIAC believes that the wording of Options A and C goes far beyond directly binding the principal. The proposed wording seems to target all sales arrangements where a local entity provides support services to a foreign sales entity that directly concludes contracts with local

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9 ‘Internal assessment’ and ‘external assessment’ correspond to the recognized U.S. legal concepts of ‘actual authority’ and ‘apparent authority.’
customers. Such support services could include marketing, customer relationship management or negotiating certain limited contract terms etc. It would seem that such services are targeted, even if the service provider is already properly compensated for its services in accordance with the Arm’s Length Principle. We are concerned that any such services, regardless of how routine they are, may be seen, under the proposals, as having a direct causal connection to the conclusion of a contract. This could substantially increase the number of disputes between states, and substantially increase the cost to taxpayers tax administrations.

34. BIAC is concerned that without clear limitation, almost any local support activities in a sales transaction would lead to a PE exposure. The proposed amendments to Art. 5 (5), extending the test beyond the conclusion of contracts in the name of the principal, could also lead to risk for shared service companies, particularly as they may not be able to continue to rely on the independent status exemption based on other proposals in the Discussion Draft. We also note that the preamble to options A-D states that, “activities that …[… are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise” should provide a sufficient taxable nexus. We believe that the phrase “performed by a foreign enterprise” is ambiguous, and that further clarity should be provided as to what this means. In addition, we do not believe that a mere offering over the internet should automatically be considered as an activity that results in the conclusion of contracts.

35. Options A and C do not require any level of authority from the intermediary to bind the Principal, but only that the activity in question merely contributes to the circumstances which result in the conclusion of the contract. It could be interpreted that the mere existence of any relationship between an intermediary and a customer could be considered to result in a PE where a particular country is of the view that any customer relationship is a key component of the contractual negotiation. These proposals are a significant concern for BIAC.

36. Paragraph 33 of the 2010 OECD Commentary on Art. 5 provides that: all elements and details of a contract must be negotiated by the intermediary, in a way binding on the enterprise in order to create a PE. Notwithstanding this provision, Courts have not always followed this principle, as is illustrated by an Italian decision relating the Philip Morris case: The Italian Supreme Court held that the simple attendance of representatives of an Italian enterprise at some stages of the negotiation, or closing of contracts, with no power of representation, should be sufficient evidence of the authority to conclude contracts in the name of a foreign enterprise, so as to assess the existence of an agency PE in Italy. BIAC disagrees with this decision and has identified this case as an example of where the current rules have led to differing interpretations. It is very important that the language of the OECD’s proposals be as clear and specific as possible to avoid such conflicting interpretations to the greatest extent possible in the future.

37. We do not favor options A and C due to the vagueness of the notions that they include, for example, “in a way” and “results”, but if such options are to be pursued, their legal certainty should be improved by expanding the Commentary to include further examples and to address specific situations such as:

- What does the phrase “engages with specific persons in a way that results in the conclusion of contracts” imply? Is it restricted to engagement that results in the conclusion of a binding contract by the intermediary, or is it broad enough to cover any engagement (e.g. participating in negotiations without exercising decision-making authority) by an intermediary, while not binding, could arguably contribute to the
conclusion of contract by the foreign company? In our opinion, the latter engagement may, in some circumstances, to fall short of the “engaging with specific persons in a way that results in the conclusion of contracts” threshold, and should therefore not constitute a PE.

- What would be the outcome for PE purposes if a contract negotiated by an intermediary explicitly includes a clause subjecting acceptance of the contract to further approval by the Principal (and where that requirement is specifically explained and communicated to the client)? In our opinion, we believe that such activity should also not breach the “engaging with specific persons in a way that results in the conclusion of contracts” threshold, and should therefore not constitute a PE of the foreign enterprise.

- What would be the outcome for PE purposes, if an intermediary received specific and detailed instructions from a foreign company to negotiate a contract and assumed a role of a mere “spokesperson” (and actually has no “authority”)? In our opinion, this should not constitute a PE.

- What would be the outcome for PE purposes, if an intermediary has been delegated a narrow band of authority by the foreign company for a small number of contract terms? As an example, what if an intermediary is delegated the authority to negotiate and agree only price discount within a specified percentage range of the List Price on behalf of the foreign company, and the foreign company retains the authority for Price discount beyond the specified range and for all other critical terms and conditions of the contract e.g. delivery schedule, payment security, performance guarantee, liquidated damages, etc.? In our opinion, this should not constitute a PE.

38. Options B and D of the Discussion Draft propose to replace “conclude contracts” with the wording “concludes contracts or negotiates the material elements of contracts”. In our opinion, it is essential to include a clear definition of the “material elements” of a contract to allow a better assessment by taxpayers and tax administrations, and to avoid increased uncertainty and subjectivity. Paragraph 33 of the 2010 OECD Commentary on Art. 5 clearly sets out that mere participation in negotiations, without the authority to conclude contracts binding on a foreign company, will not be sufficient, by itself, to trigger a PE. We suggest that the mere participation in negotiations, without the exercise of decision making authority, or negotiation and conclusion of a “few” material elements should not be sufficient to trigger a PE. If option B or D is to be adopted, then very clear rules are needed on what is necessary to be considered to have concluded or negotiated the material elements of a contract.

39. In addition, Options A and B propose to add the language; “to contracts for the provision of property or services by the enterprise”. The Discussion Draft does not limit the article to the conclusion of contracts for the sale of goods (such as commissionaire agreements), but goes substantially beyond that to include the conclusion of leasing contracts or the provisions of services.

40. In addition, the Discussion Draft also proposes to add some clarity to the meaning of “(…) in the name of the enterprise”. In our opinion, the most appropriate solution to reduce the controversy surrounding the interpretation of “(…) in the name of the enterprise” would be subjecting the intermediary to the condition that it must have authority to conclude contracts that are legally binding on the enterprise. The fact of whether a contract is legally binding or not should be examined under the law ruling the contract. This solution would reflect the original intent of the OECD Model Convention on this matter, also supported in
leading case-law such as the Zimmer Ltd. or Dell (Norway) cases. The latter solution would allow for a more effective application of the wording “(...) in the name of the enterprise” and would reduce the probability of disputes.

41. **Options C and D** propose to replace the expression “contracts in the name of the enterprise” with the wording “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”. BIAC believes that these proposals will add excessive complexity and subjectivity to the PE test for both businesses and tax administrations, and are, therefore, not desirable.

42. We are also concerned that the wording "contracts which [....] are on the account and risk of the enterprise" included in Section A, paragraph 11, page 13 of the OECD Discussion Draft will not only lead to commissionaires becoming PEs in source countries, but will also increase the PE risks for other limited risk activities, including limited risk distributors (“LRDs”), toll and contract manufacturers, contract R&D providers, service providers etc. which would go substantially beyond the scope of the BEPS Action Plan.

43. Moreover, the Discussion Draft also strengthens the requirement of “independence”, proposing to remove the possibility that an agent can still be considered to be independent, even though it acts exclusively on behalf of one party, as long as specific requirements are met. In this regard, we note that Paragraph 38.6 of the OECD Commentary to the OECD Model states:

   “Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent’s activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.”

44. BIAC believes that, although “independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise”, as expressed in Paragraph 38.6 above, this fact is not “by itself determinative”, and all facts and circumstances of the case at hand should be taken into consideration.

45. Automatic denial of independent agent status where an enterprise works exclusively or almost exclusively for associated enterprises disregards the fundamental concept of independence of legal entities and is not warranted, especially where the agent is remunerated at arm’s length, and economic and legal independence can otherwise be demonstrated.

**Simplification**

46. Complexity in international tax rules continues to increase and compliance with those rules becomes ever more difficult. BIAC is hopeful for clarity and simplicity in new principles and rules being developed by the OECD. In addition to tackling legitimate abuse, one of businesses’ primary concern is that double taxation is avoided, and that Governments can agree to consistent international principles as to what profits should be subject to tax and where. The lowering of the PE threshold will significantly increase red tape for companies
and tax administrations. The mere creation of a PE leads to considerable administrative burdens on both sides.

Preliminary Conclusions on Section A of the Discussion Draft

47. BIAC believes that a balanced approach should be favored by the OECD. In this regard, the least damaging proposal identified in the Discussion Draft is likely Option B.

48. Nevertheless, in our opinion, all of the suggested proposals seem to go substantially beyond commissionaire arrangements and similar structures and they are likely to impact other fact patterns that may not have been envisaged. If it is the intention of the OECD to implement such broad proposals, a clear articulation is required that sets out what abusive transactions or structures are being targeted.

49. Option B, if developed appropriately, does have the potential to provide some certainty and clarity, while limiting the risk of inconsistent application and creating significant double taxation and the artificial avoidance of PE status. In any case, further clear and objective guidance should be provided in the OECD Model Commentary on Option B.

50. Although we do not favor Options A or C, if they are to be pursued then further guidance should be provided in the Commentary (Paragraph 33) to the OECD Model to clarify what are the necessary elements to determine when there has been engagement with specific persons in a way that results in the conclusion of contracts. This should include whether it should be assessed internally or externally (depending on what a bona fide third party would consider to exist whenever it is concluding a contract, which creates an obligation vis-à-vis a foreign enterprise). BIAC is concerned that even with additional guidance, such options will likely create great uncertainty which will, in turn, lead to an increasing number of disputes between the States and increasing costs for solving such disputes.

51. For Options B and D, it would be essential to include a clear definition of the “material elements” of a contract in order to allow a better assessment by taxpayers and tax administrations, and avoid a further increase in legal uncertainty.

52. In determining whether independent status exists, we continue to support the ‘all facts and circumstances’ test, as expressed in Paragraph 38.6 of the Commentary to the OECD Model.

53. Finally, any changes to be made to the existing rules on PE status should take into consideration that simplification and objectivity are helpful for businesses and tax administrations alike, that excessive burdens for both parties should be avoided, and that effective dispute resolution mechanisms should be available. As the creation of a PE leads to significant consequences for enterprises, it is desirable that it should be as clear as possible when such consequences arise.

B. Artificial avoidance of PE status through the specific activity exemptions

54. The purpose of the specific activity exemptions in Art 5 (4) of the OECD Model Convention is to provide relief from filing and tax payment obligations for activities that are generally preparatory or auxiliary in nature, and that do not contribute significantly to the profits of an enterprise. Filing and payment obligations can create significant cost for a non-resident enterprise, and can discourage investment in smaller and emerging markets. In revising the
exceptions, the OECD and member countries should keep these fundamental principles in mind.\footnote{Please see the appendix for some examples of costs associated with this. If the costs associated with setting up financial systems and annual accounting exceed the profit that would be attributable to the PE, then the business will find another way to accomplish this function.}

**The exceptions are not restricted to preparatory or auxiliary activities**

55. **Option E** of the Discussion Draft would not delete any of the activities from the list, but would make all of the activities subject to the condition that the activity is preparatory or auxiliary in nature.

56. Business believes that activities that are not preparatory or auxiliary in nature should indeed be considered to possibly create a PE, and we can understand the principled intentions of the OECD in proposing the preparatory or auxiliary override to the exemptions. However, as set out below, we have substantial concerns about the practical impact of such an override, and the likelihood of being able to develop clear and objective rules that do not create substantial additional burdens and/or disputes. On balance, we believe, at this stage, and with the tight time constraints of the BEPS process, that it would not be possible to develop a sufficiently robust framework to implement this proposal on an internationally consistent basis.

57. We do recognize that this option may have the advantage of recognizing that all of the items on the list can, in many circumstances, be preparatory or auxiliary in nature, and would leave the delivery, purchasing and data collection exemptions partially intact. If this option is developed further, it would be essential for all countries to clearly accept and state that all of the activities on the list are still capable of being preparatory or auxiliary in nature. Otherwise, the proposal will likely confuse and mislead taxpayers and tax administrations. Also, if pursued, further detailed practical guidance and examples would be needed to assist taxpayers and governments to identify which activities are and are not preparatory or auxiliary in nature. Such guidance would have to be as objective as possible and take into account the wide spectrum of functional fact patterns that exist across the different activities. This would seem to be a very difficult task to undertake. We note in this regard that paragraph 24 of the Commentary on article 5 states that “It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.” We encourage the OECD to further clarify this concept if all the activities are to be subject to this condition.

58. As suggested already, the primary disadvantage of this option related to the practical challenge of subjecting all of the listed activities to possible challenge. Certainty of outcome is critically important for business. Subjecting all the items on the list to potentially subjective tests would increase uncertainty. We also strongly believe that the preparatory or auxiliary override would impact the majority of situations where the preparatory or auxiliary test is legitimately relied upon, increasing the burden faced by compliant taxpayers.

**The word “delivery” in subparagraphs a) and b) of paragraphs 4 of Article 5**

59. **Option F** would delete delivery from subparagraph a) and b) of paragraphs 4 of Article 5. Whilst we do not favor this deletion, this option would be more appropriate if countries believe that maintaining a fixed place of business through which delivery activities are conducted cannot be preparatory or auxiliary. If this option is adopted, then it is important
to be clear about a number of points. First, a shipper of goods using an unrelated shipping company to deliver goods from a warehouse controlled by the unrelated company would not create a PE. This would be the result because the enterprise would not have a place of business in the “source” country. The unrelated company’s warehouse would not be a place of business of an unrelated shipper.

Second, on determining profit attributable to a warehouse that would be a PE under the proposed rules, the OECD should make it clear that the only profits that are attributable to the PE are those relating to sales into that country. For example, assume that an MNE makes sales into countries A, B, and C, that a warehouse is located in country A, and that products are delivered from that warehouse to purchasers in countries A, B, and C. Assuming no other presence in country B or C, there would be no PE in Countries B and C and those sales could not be attributed to the PE in country A. If there is otherwise a PE in B and C, is there a service fee attributable to the PE in Country A that should be deductible by the PEs in countries B and C?

Third, countries should recognize that these new PEs ought to share in the expenses of the enterprise. For example, PEs arising from warehouse activity should bear a share of management costs and a share of interest expense among others.

In addition to the above, we are concerned that the focus of countries in examining the delivery exception has been on marketing to ultimate consumers and that not enough thought has been given to the exception in the context of business-to-business transactions where BEPS concerns would be significantly less. For example, it might continue to be the case that maintaining a warehouse for the ultimate delivery of heavy equipment should be preparatory or auxiliary to the manufacture and sale of such equipment. In the oil and gas industry, storage and distribution raises special issues that are described in detail in the appendix to this submission. These issues ought to be explicitly considered before substantial changes are adopted. If, after such consideration, it is concluded that these business-to-business transactions do not raise BEPS concerns, we would encourage the OECD to include examples in the Commentary that make it clear that the delivery exception remains available under Article 5(4)(e) in these cases. Since the UN Model does not contain an explicit exception for delivery, it should be considered what impact the absence of this exception has had on the jurisdictions that have adopted the UN Model on this point and on the MNEs doing business in those jurisdictions.

If the word “delivery” is removed from paragraph 4 of Article 5, the OECD should provide clear guidance as to when “storage” and “display” end, and “delivery” begins in order for consistent approaches to be taken by Tax Authorities.

The exception for purchasing offices

Option G would eliminate the preparatory or auxiliary exception for purchasing goods. BIAC believes that the exception for purchasing should be retained. Narrower solutions are available for cases that are considered problematic. In most cases the mere purchasing of goods is too attenuated from the earning of profit to justify the creation of a PE. The PE rules are attempting to find a balance between:

11 It would probably also be necessary to provide this guidance even if Option E is adopted, if countries intend that the delivery would rarely be preparatory or auxiliary.

12 Companies sometimes maintain regional warehouses from which delivery is made to multiple countries. It does not seem inappropriate to treat all the deliveries to all the countries the same, that is, there would not be a PE in any of the countries regardless of the location of the warehouse.
a. the activity threshold that ought to require a non-resident enterprise to comply with the tax burdens imposed by the state; and

b. the revenue implications of foregoing that revenue by the taxing jurisdiction.

No business can function without purchasing goods, whether for internal consumption or processing and ultimate resale. The issue is not whether a purchasing function does or does not contribute to profit or loss; it clearly will. The issue is whether that contribution is sufficient to justify the creation of a PE? BIAC believes it is not.

65. The reason for this is that generally, the tax and compliance burdens to business and potential negative impact on cross border trade will likely outweigh the tax benefit to Governments. As pointed out above, the costs of setting up the structure to collect data to implement PE reporting can be multiple millions of dollars. If the profit attributable to the purchasing of goods is minimal, then the cost of implementing the PE structure could eliminate all of this profit, resulting in no benefit for the taxing jurisdiction to justify the time and expense of finding a PE, attributing profit to the PE, and auditing the result. Given that possibility, businesses may restructure their purchasing functions to minimize PE risk. Purchasing will become even more centralized than it already is and purchasing offices may be closed.

66. Countries should also consider this burden in light of the reciprocal nature of these rules. That is, if purchasing is ordinarily an activity that generates little profit, the balance between administrative burdens on taxpayers versus revenue concerns of the countries should be resolved in favor of minimizing the burden created. In cases of reciprocal trade, goods will be purchased in all countries, so exempting purchasing activity will continue to benefit cross-border trade.

67. Local purchasing activities are mainly driven by businesses desire to be closer to their sources of supply, and therefore to optimize procurement activities (supply and quality) within the MNE. Most local activities will be preparatory or auxiliary in nature and the profit attributable to such activities would be minimal. If the exemption is not retained, business might adopt inefficient procurement structures to avoid PE status.

68. If countries intend for purchasing activities to create PEs, it should be accepted that purchasing can, in addition to contributing to profits, also contribute to losses. Sometimes, this contribution may be direct: a company may overpay for its inputs, and therefore would not be able to sell its products at competitive prices, ultimately suffering losses. Alternatively, companies may misjudge the demand for a particular product and purchase too much, ultimately not being able to resell the product at a profit.

69. The three examples in the Discussion Draft seem to ignore that the fact patterns arise in the context of a bilateral treaty relationship. That is, the “source” country is giving up its right to tax based on negotiations that allocate taxing jurisdiction to the other state. As part of such bilateral negotiations, the two countries determine whether the other state will impose tax. Residence countries frequently condition exemptions for business profits on the existence of a PE in the source jurisdiction. So, this interaction between the “source” and “residence” country goes directly to the issue of conflicts of qualification (i.e. where the

13 This is one of the difficulties inherent in the MLI approach. Income tax treaties should reflect the bilateral relationship between the countries negotiating the agreement and the MLI will complicate this, if it does not make it impossible.
source country exempts income, but that income is not taxed in the corresponding residence country). Business does not object to rules that resolve the issue of conflicts of qualification where the territorial or exemption system is only applied in cases where the “source” state imposes tax. Encouraging states to clarify their intentions with respect to the imposition of taxation in bilateral treaty relationships would be a narrower and more appropriate solution to address any unintended double non-taxation arising in the first example.  

70. Eliminating double non-taxation through the proper resolution of the conflicts of qualification would, consistent with current norms, eliminate double non-taxation by ensuring that the country of residence imposes tax. This narrower solution is therefore consistent with the BEPS Action Plan and the Discussion Draft which state “these actions are not directly aimed at changing the international standards on allocation of taxing rights on cross-border income.”

71. In recent UN discussions some delegates have objected to rules implementing the proper resolution of the conflicts of qualification, despite the fact that it would only limit unintended double non-taxation and would not limit the ability of a country to adopt tax incentive legislation. The only reason to object to the principles set forth on conflicts of qualification would be that such principles are inconsistent with more “source” taxation (even if it is not exercised). As part of the OECD’s proposals we believe further consideration should be given to this potential solution.

72. Another narrower solution to the problem posed by the first example would be to adopt appropriate Controlled Foreign Company (CFC) rules dealing with foreign base company sales transactions. Again this would preserve the current allocation of taxing rights between source and residence states.

73. In the second example, it is not clear why SCO is not also considered to be selling in State S. A more appropriate solution might be to make clear that SCO is both purchasing and selling, that is to say that the buyers are also conducting selling activity in State S, so that the PE is not merely purchasing goods but also is considered by the authors to be substantially participating in the sale of those goods.

74. BIAC agrees with the conclusion of the third example.

75. In most cases, purchasing will make only a minor contribution to the overall profitability of the enterprise. The profits attributable and the corresponding amount of tax due in relation to these minor contributions will not justify the cost of establishing the structure necessary to produce the financial information to comply with PE rules, or the annual compliance burden. It may well therefore cause MNEs to consider closing purchasing offices. We believe that simpler solutions for abusive cases should be pursued and the exception for purchasing should be retained.

76. **Option H** would delete subparagraph d) of paragraph 4 of Article 5. The proposal would delete both the exception for purchasing and the exception for data collection. The only justification offered for deletion of the data collection exception is that

“**concerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information**

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14 See the OECD commentary on Article 23 A and 23 B paragraph 32.1 et seq.

15 Action Plan page 11 and Discussion Draft paragraph. 3 page 10.
Before considering adopting changes that would have a significant impact on taxpayers and tax administrations, we encourage the OECD to first confirm that the above concerns are well-founded. As an initial matter, we are not sure what the term ‘repackaging’ means’. If it is intended to simply mean the collection of data and the forwarding of that data, then we believe that this has no intrinsic value (and such activities should not be considered to breach the PE threshold). If, however, ‘repackaging’ is intended to mean the sifting, analysis and interpretation of enormous quantities of data into something that is commercially useful, then that is a different issue. We believe, in the latter case, that traditional transfer pricing guidelines should be sufficient to price such services.

BIAC believes that the exception for data collection should be retained.

Fragmentation of activities between related parties

Options I and J propose to address fragmentation of activities among associated enterprises, rather than among separate parts of the same enterprise. Most of our concerns in relation to these rules apply equally to both options, since our concerns relate to the basic application of the anti-fragmentation rule. Both options would significantly undermine the concept of separate entity reporting. As discussed in the general comments section of this letter, this may cause some unintended consequences, with companies reconfiguring their operations in ways that might be inefficient, therefore potentially harming global trade and investment.

The proposed rule seems to be limited to activities that would otherwise be within the scope of Article 5, paragraph 4, and does not seem to cover other activities that would not create a PE. If, for example, an MNE owns an affiliate established in country A that operates a contract manufacturing facility in country B and another affiliate maintains a stock of goods at that manufacturing facility in country B, solely for the purpose of processing by that the first affiliate, it would seem, under the proposed rules, that the second enterprise would now have a PE in country B. If, however, the two entities were unrelated, no PE would exist. If the contract manufacturer is a low-value activity, this may discourage the MNE from maintaining ownership of that manufacturing operation. The only activity that the second affiliate is engaging in is “maintaining a stock of goods for purposes of processing by another enterprise.” We question how much profit should be attributable to that PE? What are the functions, assets and risks that will be analyzed in determining the amount of that profit? And is the attributable profit, and associated tax revenue, greater than the costs faced by both taxpayer and tax administration?

Assuming that the purchasing exception is retained, if a State R enterprise purchases goods through a local purchasing office established in State S on behalf of many of the associated enterprises in the affiliated group, and any of the goods purchased by the State R enterprise through that purchasing office were used by an affiliated enterprise with a PE in State S, the State R enterprise would have a PE in State S. What profit would be attributed to that PE? Would it only be profit attributable to the goods sold to State S customers or also a portion of the profits of the State R enterprise on resale to all customers of products purchased in State S? How would the UN force of attraction principle apply? As we understand the proposal, there would be a PE of the State R enterprise in State S. We believe this result is

16 Discussion Draft paragraph 28.
inappropriate given the difficulty of attributing any profit to this activity. The tax gained would very likely not justify the burden.

82. As another example, if a nonresident enterprise of an MNE group purchases the output of a local manufacturing affiliate, and does not maintain a stock of goods at the affiliate's premises (the affiliate owns its own inventory), but the nonresident enterprise sends an employee to the manufacturing facility to inspect and perform quality control functions, is the anti-fragmentation rule applicable? As we read the proposed rule, it should not apply because there is no fixed place of business that is maintained by the nonresident solely for the purpose of carrying on an activity of a preparatory or auxiliary character. That is, the fixed place of business (the manufacturing facility) is maintained by the local manufacturing affiliate, so the nonresident member of the MNE group would not have a PE because it does not have a fixed place of business to begin with, and therefore, the exceptions of paragraph 4 do not apply. If the proposed rule is intended to apply in such a case, then we believe that the rule would be unadministrable, especially in today’s business environment where employees are globally mobile. Virtually any time an employee of one company visited the offices of another associated enterprise, it would at least create the possibility that a PE would be created.

83. BIAC does not believe that either option I or J ought to be adopted as they will both pose issues where MNEs have existing companies in countries where preparatory or auxiliary activities are undertaken. Option I is, however, narrower than option J, so between the two it is the less objectionable version.

C. Splitting-up of contracts

84. Article 5(3) of the OECD Model Convention provides that building sites give rise to a PE if they last for more than a 12 month period. The Discussion Draft raises a concern that is already adequately considered in existing Commentary to Article 5 of the OECD Model Tax Convention: that is, companies could divide up contracts in order to avoid a PE. This could happen in the case of Article 5(3), by dividing up contracts into several construction phases, each covering a period shorter than 12 months, and each of those phases being performed by a different legal entity.

85. Furthermore, the Discussion Draft identifies a similar concern regarding the application of the provision for service PEs as described in the Commentary to Article 5.

General comments on the “automatic rule” and the general anti-abuse rule

86. A general anti-abuse rule (page 23, box L of the Discussion Draft) intends to address only 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. Although there is a suggestion is to insert a (specific) example in the Commentary, we are concerned that the consequence may be that tax administrations will be encouraged to generally make use of the new Principal Purpose Test. This would further reduce any certainty remaining in the PE rules.

87. On the contrary, the Discussion Draft itself mentions that the “automatic rule” (page 22, box K), which adds up the activities performed by associated enterprises, may be too broad. We indeed believe it would catch legitimate cases where there is no tax avoidance motive.

Narrowing down the “automatic rule”

88. The Discussion Draft therefore proposes two solutions to narrow the very broad “automatic rule” (page 22, box K).
89. One approach is to require, for each company, a minimum presence of 30 days. In our view, this period of time would be much too short. Considering the case of a diversified and decentralized MNE, undertaking international outbound business not only from the headquarters but also from subsidiaries; the proposals would be very difficult to administer and to monitor, as all parts of an MNE may not be fully aware of all the activities of the group as a whole.

90. Furthermore, it should be clarified in b) which “activities” are intended to trigger the creation of a PE. In our view, this should only be substantially similar activities related to the construction site, and not any other activities – this would be consistent with the language in the provision suggested in Paragraph 42.45 of the 2010 OECD Commentary on Article 5. Paragraph 33 of the Discussion Draft, in fact, makes a reference to Paragraph 42.45 of the OECD Commentary on Article 5 as justification for considering an anti-abuse provision to address splitting-up of contracts. However, the “substantially similar” criteria appearing in the provision suggested in the OECD Commentary is not incorporated in the proposal (box K of the Discussion Draft). The alternative proposed approach would allow a taxpayer to demonstrate that avoiding the 12 months presence of one single enterprise was not the principal purpose of using more than one enterprise. We believe that for day to day practical application, it will be very difficult to rebut the assumption of abuse, which would derive from fulfilling the “automatic rule”. We believe that the “automatic rule” should be further narrowed to only permit that one PE would be created per country through aggregation (i.e. in the event that more than one entity fails the 30 day test).

Service PE

91. The Discussion Draft only notes that it would be necessary to provide a similar rule for treaties that contain the service PE concept. A discussion of how such a rule would work is not included. We believe that this would be a much more difficult rule to implement, because there is no obvious way in which services would be connected. The rules applying for construction sites (which are fixed places) cannot be compared/adapted to the offering of services without any fixed presence in a country if the rule simply aggregated all the days of services provided in a country by the worldwide group, this might create many PEs that would be extremely hard, if not impossible to monitor. Therefore, we strongly advise against the application of any such rule to service PEs.

Conclusions on Section C of the Discussion Draft

92. Careful consideration will be necessary, taking into account the above mentioned concerns. Any solution should be balanced in the way that it:

- Effectively deals with legitimate concerns of tax administrations; and
- Is practically feasible and provides legal certainty for businesses.

93. On the basis of these criteria, the proposals provided in the Discussion Draft do not appear to be sufficiently balanced. The “automatic rule” seems to be very hard to monitor, and, therefore, it is not practically feasible. On the other hand, the Principal Purpose Test would lead to an increase in legal uncertainty. If the OECD does pursue a purpose based test, clear guidance will be necessary so that taxpayers can understand what documentary evidence is needed to meet the purpose threshold. We believe that the extension of service PEs should not be pursued, as it would present substantial practical difficulties, and at the same time, it would substantially increase legal uncertainty.
D. Insurance

94. With regard to related party cross border insurance transactions, we do not believe that the Discussion Draft provides any rationale as to why additional special treatment is needed for this sector of the economy. It should be clearly articulated as to why insurance should be considered a ‘special case’ before any proposals can be considered in detail.

95. The non-tax regulatory rules associated with how agents may interact with principles, provides the basis for tax purposes as to whether such agents are of independent status. Adding additional tax considerations is unnecessary. The current definition of a PE in Article 5 of the OECD’s Model Tax Convention correlates well with the definition of PE for regulatory purposes. This ensures that the tax and regulatory definitions of the term "Permanent Establishment" are broadly consistent, which has clear benefits, e.g. accounting information reported for regulatory purposes can also be used to determine taxable profits. The applicable regulations concerning PEs in tax and regulatory matters should continue to be as closely aligned as possible. If this is not the case, a substantial number of tax PEs will likely be created, without a corresponding regulatory PE, generating additional compliance burdens and the potential for double taxation.

96. The taxation of insurance PEs is considered in detail in Part IV of the OECD Report on the Attribution of Profits to Permanent Establishments. This has provided a framework that is generally considered to work by both tax administrations and taxpayers. Therefore, anything that substantially changes the application and effectiveness of Part IV should be approached with caution.

97. The Key Entrepreneurial Risk-Taking (KERT) functions (e.g. assessment, assumption and management of risk) are generally undertaken in the underwriting location. The agent will generally act as the contact point for the customer but will not manage the risk associated with the insurance. Article 5 of the OECD Model Tax Convention, as it is currently written, does not require a tax PE if the agent is active in another state or the risks are situated in another state. The agent receives an arm’s length fee for its services, and the profit associated with that fee should be taxed accordingly. The profit associated with the KERT function (the acceptance and management of risk) will be taxed in the underwriter jurisdiction.

98. Since the income of the underwriter is already subject to tax in its home country, double taxation would be likely under option M unless the home country offers appropriate relief.

99. Based on the above, we do not believe there is need for an insurance-specific provision as proposed under option M. We believe that Option M would require that overseas dependent agents would create tax PEs whilst performing no KERT functions. This would result in minimal, if any, additional profit to tax, but would create substantial risk of double taxation, in addition to an increased compliance burden. This may increase the cost and/or reduce the availability of insurance products.

100. Considering the proposals within the Discussion Draft, Option N should be preferred over Option M as it would place the insurance industry on the same footing as other sectors.

101. Insurance (or any other sector) specific proposals should only be made where they provide greater legal certainty to taxpayers and tax administrations to determine when a PE is and is not created.
E. Profit attribution to PEs and interaction with action points on transfer pricing

102. The Discussion Draft recognizes (paragraph 45) that the question of the attribution of profits must be a key consideration in determining which changes should be made to the definition of PE, and also states that no significant changes to the attribution rules have been identified as necessary if the proposals are adopted, though it notes that some additions or clarifications to the attribution rules would be useful. However, the Discussion Draft makes clear that the work on risk and capital in particular may lead to a further ‘reconsideration’ of some aspects of the existing attribution rules and guidance.

103. The discussion in the PE paper seems to imply, without any analysis, that the measure of profit attributable to a PE would typically be greater than the corresponding result under the TP rules (see for example the specific example in paragraph 7) when applied to determine the income of the source country entity whose activities created the deemed PE. We are also concerned that, as a practical matter, the Discussion Drafts raises an expectation on the part of tax administrations that there are greater profits to be attributed to a PE (since it is otherwise hard to explain why the OECD has gone to such trouble to change the relevant PE definition) in addition to the profits recognized by the source state dependent person. However, whilst we would recognize that there will be some situations where the relevant profit attribution to a PE is greater than the measure of profits that would be achieved by the application of the TP rules, in very many cases, this result would not be obtained. Rather, there would be no additional profit attributable to a PE beyond what is reported by the local dependent person under Article 9. Based on these comments, we would encourage an exploration of whether a rule or exception could be developed so that a PE would not be created if such a PE would not lead to an increase in overall attributable profits. This could assist in mitigating some of the administrative burden and double taxation that will accompany the proposals.

104. On the basis of the above, we consider it important for the OECD to explain and clarify the factors that lead to profit attribution to a PE in excess of the arm’s length payment to the source state dependent person.

105. There is also a more fundamental point. Experience of business in dealing with the attribution rules (including in the financial services sector, where the rules should be materially easier to apply given that they were initially developed with that sector in mind) is that the application of the rules, in practice, is very often subjective and uncertain. Coupled with the proposals in the Discussion Draft which have the practical effect of significantly lowering the PE threshold in many situations, this inevitably means that there will be significantly more cases where attribution issues arise and where uncertainty may therefore arise. It is therefore inevitable that further material areas of dispute will be opened up by these PE proposals and in turn re-emphasizes the very significant need for the BEPS work to deliver materially improved dispute resolution practices. We are also concerned that the subjectivity arising as a result of the application of the attribution rules will continue to lead to formulaic apportionment approaches by the back door as the only means to settle these disputes.

106. The Action Plan identifies BEPS concerns in the context of sales attributable to a Dependent Agent PE by comparing the taxable profits from these sales with the profits that would have been taxable had the sales been made by a Distributor, and not a foreign enterprise. The AOA for profit attribution to Dependent Agent PEs does not, however, mention profits made by a distributor as any benchmark relevant for determining profit attribution to a Dependent Agent PE.
Agent PE. As a result, in practice, in the industrial sector, MNEs sometimes encounter examples where Tax Authorities use formulary apportionment type approaches to determine profit attribution to Dependent Agent PEs. The use of such approaches could be mitigated by providing further practical guidance for the application the AOA for profit attribution to Dependent Agent PEs in the industrial sector. An approach similar to that laid out in guidance issued by the Australian Tax Office and by HMRC in the UK, should be incorporated in the practical guidance on profit attribution. This would include that

a. Profits made by Comparable Distributors in the Source Country encompass the maximum profit which can be attributed for sales related activities in the combined hands of the intermediary, the Dependent Agent PE and the foreign enterprise.

b. Profits made by Comparable Distributors should be allocated between the intermediary, the Dependent Agent PE and the foreign enterprise using appropriate transfer pricing methods, considering the functions, assets and risk profiles of each of these taxable units.

Other Comments

107. Many of the comments made within this document refer to the additional difficulties that will be faced by MNEs in cross-border situations if the threshold for PE status is substantially lowered. We are concerned that the additional burdens and likelihood of disputes could have a negative impact on cross-border trade.

108. An area, perhaps outside the direct scope of the OECD’s Discussion Draft that causes MNEs great difficulty, is the interaction between VAT and PE status.

109. As indicated above, one impact of businesses having PEs where previously they did not exist is the likelihood of additional VAT registrations. In some countries, the two go hand in hand (i.e., an MNE will be automatically registered for both corporate tax and VAT together), whilst other countries might increasingly seek to argue that a VAT registration is required if there is a PE.

110. In addition to these extra compliance burdens, there is also the risk that such an approach might lead to further complexities for both business and governments through the increased use of force of attraction rules. For example, many countries deem that if there is a PE then all charges to local customers must be subject to local VAT and reported in the local VAT return, even where the local PE does not intervene in the transaction. Such treatment leads to costly ERP systems changes for VAT accounting and invoicing purposes and, moreover, being obliged to report these transactions through the local VAT return also leads to mismatches with the PE’s corporate tax return – i.e., the VAT return would almost certainly contain higher transaction volumes than the corporate tax return, and this fact alone can lead to challenges from the tax administrations as to whether the amount of corporate tax payable should also be increased.

111. Additionally, there is also an increased risk that conflicting ‘establishment’ definitions for VAT purposes may create instances of unintended double taxation and double non-taxation, particularly if the International VAT/GST Guidelines are not implemented and applied consistently (i.e., the general rule and specific rules) across the world.

112. Although it may be considered that these issues are only indirectly related to PE status, we would welcome further consideration from the OECD on the interaction with VAT and other compliance issues.
Appendix A: Cost of compliance

In this appendix we set out a number of comments from BIAC members in relation to the cost and burden of complying with the OECD’s proposals.

Profit Attribution and Transfer Pricing

One of the key burdens associated with the proposals will be the compliance cost associated with determining the profit attributable to the PE – there will likely be a multiplier effect with the action items on TP, in that the proliferation of PEs will result in the proliferation of additional TP exercises, the associated documentation and analysis required and the resulting liaison between both the country in which the newly created PE arises and the country in which the profits on the relevant transactions have historically been reported. This is likely to be extensive in order to mitigate the anticipated risk of double taxation that could arise from these new PEs

Artificial avoidance of PE status through commissionaire arrangements.

The OECD proposed options to address commissionaire structures as laid out in options A to D will have an adverse impact on international business models. To use an aviation fuel supply business as an example, Group X operates through 50 entities (at 50 airports) in 50 countries around the world. The UK company (operating out of a UK airport) negotiates a global contract to provide fuel to a UK headquartered airline, at whichever of the 50 airports it is needed. The benefit of this type of contract is that the fuel supplier and airline do not have to enter into separate contracts in each country that there is a refueling need.

In the example, when the UK airline is refueled by the Group X entity the UK, the profit or loss of delivering jet fuel to the customer is taxable income of the UK company. Similarly, when the UK airline is refueled in another jurisdiction, it is the affiliate established in that country that enjoys the taxable profit between the cost of fuel and the price earned with the customer. This is because the non-UK delivery rights of the sales contract is assigned to the supply companies around the world in return for an arm’s length marketing fee.

Under OECD options A to D the model described above will mean that every supply company will have a PE in the country where the umbrella sales contract is negotiated. This could lead to a substantial number of PEs. Based on the above example, assuming that the UK headquartered customer uses all of the Group X’s 50 refueling locations, 49 PEs would be created in the UK. This situation would be multiplied to the extent that other Group X entities negotiated similar umbrella contracts with other airline groups (e.g. the French entity negotiating with a French airline etc.). Each other entity negotiating each umbrella contract could create 49 additional PEs.

We have estimated that the initial set up costs for each new PE would be $350k – this includes systems and legal fees and, although there will be systems savings for each new PE, a complete redesign could still run into tens of millions of dollars, plus there are ongoing annual compliance costs in the region of $30k - $60k per PE, covering the costs of retaining a third party to file returns, creating the necessary TP documentation and employing control function staff. In aggregate these costs would be unsustainable and therefore, a fundamental re-work of the model would be required, possibly towards more of a central trading model.

The above example is a common way in which such contracts are structured, and is not limited to and particular sector or even airline contracts. The new PEs will not be as a result of people
activities of overseas companies. For example, Chinese employees involved in marketing to Chinese airlines and delivering fuel at Chinese airports are not working in the UK, yet the Chinese company would have a UK PE.

**Removal of “delivery” from subparagraphs a) and b) of paragraph 4 of Article 5**

Oil and oil products are sold through an international trading business. A typical trading operation will have a small number of companies that enter into trades of oil, oil products or gas with third parties around the world. Negotiations are carried out by employees of these companies in the jurisdiction in which they are resident and contracts are concluded either by telephone or followed up by written confirmation or online. The trading company has no economic substance (people activity) in the vast majority of countries with which it trades oil and gas. For an integrated oil company, any physical substance will be in an unrelated business such as oil and gas exploration.

In order to satisfy the delivery of a product to a customer, the trading company may rent tanks to store oil products which are then used to deliver to local markets. The tanks are operated and maintained by third parties. The oil/gas that is stored in the tanks is “maintenance of stock”. The cost to rent the storage is taxed locally. The margin earned on selling to customers is taxed in the country of residence of the trading company where all the economic activity takes place – negotiations and conclusion of contracts.

The trading company has to be able to provide the oil or gas to meet its contractual obligations and shipping and transportation of such commodities is not always as straightforward as it is in some other sectors that may utilize the exemptions under paragraph (5). The oil, gas or product cannot be guaranteed to arrive in a given port at a specified date and time to suit the customer needs. The creation of a PE through the mere holding of hydrocarbons in storage will increase compliance burdens, adding much complexity. It is also unclear what income would be attributable to a PE created in these circumstances, given all the economic activity is carried out in the location of the trading company. This will increase the risk of cross border tax disputes between tax administrations.

For one BIAC member, it has been estimated that additional direct tax registrations will be required in up to approximately 40 jurisdictions, with knock-on effects for indirect taxes. The resulting compliance burden would add to costs of such transactions that could make them uneconomic. It is estimated that this would result in an additional up front compliance cost of $14 million, with annual additional compliance costs of $2.4 million.

The nature of this industry often means that the supply of oil and gas results in slim margins. Opening up new markets, often in developing economies are challenging projects. The proposed changes to the definition of a PE will create further uncertainty and risk. In the competition for capital, these projects will compare less favorably than other ventures if these changes are made, with the potential knock on effect that the lack of energy will have on developing countries own economies.
Montreal, 9 January 2015

Ms. Marlies De Ruiter,
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
Organisation for Economic Co-operation and Development
2, rue André Pascal
Paris, France
75116

Dear Ms. De Ruiter,

Re: Comments on the OECD Discussion Draft with respect to BEPS Action 7: Preventing the Artificial Avoidance of PE status ("Discussion Draft")

Please find enclosed Bombardier’s response to the OECD’s Invitation to Comment on the Discussion Draft relating to Action 7 on preventing the artificial avoidance of PE status.

We welcome the opportunity to provide our experiences and share specific examples regarding this relevant issue. We would also welcome the opportunity to provide further insight on these issues at your request. For sake of clarity, we have replicated the OECD’s specific commentary and/or questions in italic font. Our comments follow each inquiry.

By way of background, Bombardier is the world’s largest manufacturer of both planes and trains. Looking far ahead while delivering today, Bombardier is evolving mobility worldwide by answering the call for more efficient, sustainable and enjoyable modes of transportation everywhere. Our vehicles, services and, most of all, our employees are what make us a global leader in transportation. Bombardier is headquartered in Montréal, Canada. Our shares are traded on the Toronto Stock Exchange (BBD) and we are listed on the Dow Jones Sustainability World and North America Indexes. In the fiscal year ended December 31, 2013, we generated aggregate gross revenues of $18 billion US.

Executive Summary

Worldwide trade has evolved significantly since the early part of the 20th century, when tax work sponsored by the League of Nations established the cornerstone of tax treaties’ distributive rules associated with source and residence. Being that there is no natural law of source, the OECD’s work on
Action 7 is of great importance, to pave the way to fairer rules on which tax systems may effectively rely to determine where income is earned and by default where such income should be taxed. We agree with the fundamental principle that profits should be taxed where functions deriving the profits are performed, where value is created and where the risk associated with a particular transaction is borne. Accordingly, we are of the view that broadly speaking, certain changes to the definition of PE to prevent the artificial avoidance of PE status are most welcome, especially to counter transactions subject to double non-taxation.

However, we are also of the view that the proposed changes outlined as part of the Discussion Draft are very broad in nature, and are likely to result in an unjustified layer of additional tax burden on certain multinationals that are operating on a global scale, further increasing the tax filing obligations of such multinationals. In particular, the Discussion Draft also appears to effectively pre-suppose that in most instances, the income earned by the resident of the other contracting state is insufficient (and not necessarily supported by any underlying transfer pricing documentation), without necessarily taking into account the substance of, the roles undertaken, the tasks performed and the risks borne by each of the enterprises in the chain.

As you are aware, the global economy and the legislative tax landscape (both domestically and internationally) have changed considerably in the past decade. With the supply chain of multinationals becoming increasingly global and complex, a key element of remaining globally competitive is to not only expand into new markets, but also to source goods and services worldwide, in the most efficient fashion possible. For example, a Canadian manufacturer may want to use the services of a foreign subsidiary (for example, one that would not be viewed as carrying on an independent business as it carries other activities, but performs certain other activities only for the benefit of a related non-resident company of the broader organization) to support its sales activities in a particular geographic region, as the foreign subsidiary has the capacity to deliver such services in a timely and cost-efficient manner. More importantly, this subsidiary is best equipped to provide such services, given its expertise in a particular domain, or its proximity to foreign customers (even outside of its country of establishment).

In the current highly globalized economy, the location of such services is generally not driven by base erosion considerations, but rather by considerations of international competitiveness, including developing and maintaining cost-efficient supply chains. If a foreign subsidiary is to be fairly compensated for its activities, and the activities are limited to those identified in Paragraph 4 of Article 5 of the OECD Model Treaty (or are similar in nature), then we are of the view that such activities (performed for an enterprise that is a resident of a contracting state) should not automatically give rise to a PE in the other contracting state.

Our specific concerns are as follows:

**Issue 1 – Artificial avoidance of PE status through commissionnaire arrangements and similar strategies**

*It is clear that in many cases commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place. Changes are therefore proposed to the wording of paragraphs 5 and/or 6 of Article 5 in order to address such strategies. As a*
matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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.

The OECD is considering four proposals, all of which are essentially focused on strengthening the requirements regarding independence. It states within this paragraph 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 Bombardier's aerospace activities, the relationship with third party suppliers that act as independent providers of services to our worldwide parts warehouses are generally not viewed as giving rise to a commissioneer or agency type relationship with such suppliers. However, in light of the proposals put forth by the OECD, consideration should be given as to whether some of the existing activities being performed for and on behalf of other Bombardier entities would be viewed as being performed by a dependent agent in a manner that gives rise to a PE for the enterprise who benefits from such activities.

Bombardier Inc. ("BI"), a resident of Canada, parent entity of the Bombardier group and operating entity of the aerospace segments, may be viewed has having a dependant relationship with many of its wholly-owned subsidiaries that operate regional services offices (commonly referred to as "RSOs"). Such RSOs are located worldwide and perform field service representation and liaison services to customers worldwide as part of the contracts between customers with their aircraft's Original Equipment Manufacturer or "OEM", such as Bi and Learjet Inc., a corporation resident of the United States. The geographic location and residency of such RSOs is solely a function of the commercial needs in a particular geography and not in any way tax motivated. Services performed locally are almost entirely charged intra-group to the OEM. RSOs may occasionally employ a sales director, in charge of business development opportunities. Despite the fact that all of the key elements regarding the aircraft purchase and sale agreements would be negotiated by the OEM in its country of residency, a concern may still exist as to whether or not the RSO should be considered "acting on behalf" of the OEM. For example, alternative formulation "A" on page 11 would go as far as to automatically create a PE where a person acting in a Contracting State "on behalf" of an enterprise habitually engages with specific persons in a way that results in, inter alia, the conclusion of contracts in the name of the enterprise. Similarly, alternative formulation "C" on page 13 would go as far as to automatically create a PE where a person acting in a Contracting State "on behalf" of an enterprise habitually engages with specific persons in a way that results in the conclusion of contracts which by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise. In both instances, the unintended effect would be potential double-taxation, as a person would essentially be considered to automatically have a PE in the country where the activities of the stand-alone established enterprise take place, while at the same time, such stand-alone enterprise would have
already been subject to tax in that same country based on the profits earned on such activities (computed in an arm's length fashion and supported by appropriate transfer pricing documentation).

In conclusion, we are in the view that the proposed wording regarding alternative formulations "A" to "D" and the extremely low threshold regarding when a person could potentially be viewed as "acting on behalf" of an enterprise in a Contracting State is simply too broadly worded and could inadvertently give rise to a PE in a situations that have absolutely nothing to do with the broader BEPS initiative. It is our view that in order to avoid double taxation and to further increase the tax filing obligations of multinationals, more work needs to be done to more clearly identify and distinguish those situations that should give rise to a PE.

**Issue 2 – Artificial avoidance of PE status through the specific activity exemptions**

The reference to the negative list refers to the list of exceptions included in Art. 5(4) of the OECD Model Tax Convention pursuant to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph.

**The exceptions are not restricted to preparatory or auxiliary activities**

The approach at Option E proposes to Amend Art. 5(4) so that all its subparagraphs are subject to a "preparatory or auxiliary" condition, in order to make all the activities currently listed in paragraph 4 of Article 5 subject to the condition of being preparatory or auxiliary. This would seemingly be in line with the original purpose of the exceptions included in subparagraphs a) to d).

[Amend paragraph 4 of Article 5 as follows]:

4. notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
   a. the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
   b. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
   c. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   d. the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
   e. the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
   f. the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
Provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, f of a preparatory or auxiliary character.

It is our view that adding such a “catch-all” condition would not be in line with the original purpose of the negative list of activities referred to in paragraph 4. In fact, this approach would be even more restrictive than the current negative list under the UN Model Tax Convention, which states that in instances where a combination of activities mentioned in subparagraphs (a) to (e) exists, only the overall activity of the fixed place of business resulting from this combination must be of a preparatory or auxiliary character. It is troublesome that under the proposed formulation “E”, each activity, or in the case of subparagraph f), the overall activity of the fixed place of business, must be of a preparatory or auxiliary character. Adding the requirement that all exceptions are subject to the “preparatory or auxiliary” condition significantly reduces certainty for taxpayers by subjecting the existing exceptions that currently apply automatically, thus providing a bright line test to a condition that would be inherently more subjective. As each activity is considered, in and of itself (by both the OECD and the UN) to be too remotely connected to income generating activities, we are of the view that they should continue to remain automatic exceptions.

In Bombardier’s specific instance, a highly regulated spare parts business is usually operated by spare parts hubs that act as a distributor for an entire spare parts network (typically organized by geography). It is not uncommon for such hubs to lease premises in another country (with, therefore, no Bombardier employees present) where the location is merely used for the storage and delivery of the parts, while all functions that derive profits are performed in the country of residency of the spare parts hub. In such a situation, it is our view that there is clearly no artificial scheme at play, since the spare parts business model is built in such a way that the delivery locations must sometimes be closer to the aircraft operators, in order to address faster turn-around time in the case of “aircraft on ground” situations and/or for warranty purposes. The proposed changes in formulation “E” would be prejudicial to the spare parts distribution network and create significant uncertainty on a global scale, ultimately resulting in increased costs within the global supply chain while reducing its agility and flexibility in serving customers.

Moreover, the changes could increase disputes with foreign tax authorities, becoming administratively costly for all involved and reducing fairness and certainty of our international tax position. In summary, it is our view that in order to have a fairer and less burdensome tax system, subparagraphs a) to d) should not be subject to an added condition that the activities referred to therein be of a preparatory or auxiliary nature. We respectfully request that the OECD reconsiders the proposed formulation “E” in light of the above.

The word “delivery” in subparagraph a) and b) of paragraph 4

The OECD mentions that if Option E (under which activities listed in subparagraphs a) to d) would be subject to the condition of being of a “preparatory or auxiliary” character) is not adopted, it would be possible to address BEPS concerns specifically related to subparagraphs a), b) and d) of paragraph 4, through the following three options.
It is important to note that the term "delivery" is absent from the UN Model Convention, in subparagraphs a) or b), and such departure has its raison d'être in the mindset of most OECD members which were historically of the opinion that the mere delivery in a State should not be sufficient in and of itself to earn profit in the country where such goods are being delivered. In fact, a 1997 study revealed that almost 75% of the tax treaties of developing countries, included the "delivery of goods" in the list of exceptions in subparagraphs a) and b) of paragraph 4, meaning that the mere delivery of product was considered in and of itself to be too remotely connected to be considered income producing. This was and remains a widely accepted principle.

For the same reasons as described above under formulation "E", we are of the view that the proposed change provided under formulation "F", specifically the removal of the word "delivery" in subparagraphs a) and b) of paragraph 4, is inappropriate. The aerospace industry's highly regulated spare parts business is dependent on a sophisticated supply chain model where the sole delivery (handling and shipping, performed primarily by third party logistics suppliers of spare parts in a particular country) is not at all connected to the true value drivers of the broader spare parts supply chain. The OEM does not have control over the delivery location of spare parts. The ordering customer may, in limited circumstances, be local (i.e. based in the same country as the spare parts hub/depot), or, as it is usually the case, be located in a foreign jurisdiction. In our view, this differs greatly from an online retailer, for example, which will often keep storage of goods in a large warehouse aimed at delivery in a particular local market, with significant employees physically located therein.

In conclusion, a business distribution model built for bona fide business purposes, rather than for avoidance purposes, is typically aligned with source countries right to tax pursuant to transfer pricing principles. It is beneficial to consider the nature of the business model, including how and where value is created in the supply chain, due to the fact that in a traditional manufacturing industry, delivery is usually of ancillary nature. Accordingly, we respectfully request that the OECD reconsiders removing the reference to "delivery" from subparagraphs a) and b).

As such, we hope the OECD will consider the above comments, which are aimed at helping the OECD, tax authorities and other stakeholders tailor the recommendations in development under Action 7 to the BEPS objectives targeted within the overall OECD project.

Best Regards,

Pierre Lafontaine
Vice President, Taxation
Bombardier Inc.
Dear Ms de Ruiter

Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE status

We are writing in response to the OECD’s Public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status, and in particular the potential impact that the OECD proposed changes to the wording in Article 5 of the OECD Model Tax Convention on commercial transactions.

In summary, the proposals as currently drafted will have a material impact on the compliance obligations of our business by imposing many additional international tax registration requirements [permanent establishments (PEs)]. It is our view that the new PEs created are unnecessary and would neither bring into the charge to tax profits that are not currently subject to tax or alter the distribution of taxable profits between countries. BP adopts a policy that intra-group transactions are carried out on arm’s length terms that correctly reward economic activities. If countries insist on attributing profits to the newly created PEs, BP will be exposed to an increased level of double taxation. This will be a significant compliance obligation not only on BP but also on Tax Administrations to process the additional tax returns and resolve instances of double taxation through international tax treaties.

This letter seeks to provide some examples of these practical issues.

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The objective of the OECD proposals is to tackle structures that have been designed to erode the taxable base of a state in which sales are taking place. However as currently drafted the suggested changes to paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention go much wider than the intended scope and impact commercially negotiated international business models that are taxed in the appropriate countries.
This can be demonstrated by explaining the business model in the International Aviation and Marine fuel businesses. These business activities are undertaken by incorporated entities, the profits of which are included in the statutory accounts and tax computations of the companies that undertake the economic activities. These business activities are not driven by tax avoidance but the need to deliver oil and hydrocarbon products to our customers around the world. We are concerned that the proposals outlined in the discussion draft to address avoidance from the use of commissionaire structures and the overreliance on exemptions in paragraph 5 of Article 5 of the OECD model convention will result in the creation of PE’s of companies that are not the target of the proposed changes.

The OECD’s proposals to address commissionaire structures as laid out in options A to D will have an adverse impact on international fuel delivery models similar to those operated by BP. Using the Aviation business as an example, a company (say UK) may negotiate a global contract to provide fuel to a global UK airline at whichever airport it is needed. The benefit of this type of contract is that the fuel supplier and airline does not have to enter into separate contracts in each country where there is a refuelling need.

In these circumstances, when a UK airline is refuelled in the UK the profit or loss of delivering jet fuel to the customer is taxed by the UK company. Similarly, when the UK airline is refuelled in another jurisdiction (say Germany) it is that country which taxes the profits arising from the difference between the cost of fuel and the price earned with the customer. This is because the non-UK delivery rights of the sales contract is assigned to the supply companies around the world in return for an arm’s length marketing fee. This fee is subject to transfer pricing review. This is a common way in which such global contracts are structured and is not limited to the oil and gas sector or even airline contracts.

Under OECD options A to D, the model described above will mean that each of the supply companies will have a PE in the country which negotiated the sales contract. A business model that has airports in 50 countries would create 49 PEs in each country, plus the tax registration of the original company; or in other words 2,500 taxable entities (50 times 50).

The creation of PEs in these situations will not result in additional profits being taxed globally but will result in additional disputes between the two countries on the allocation of profit between the country of incorporation and that of the PE.

It is also necessary that the OECD considers the indirect tax consequences and impacts of any changes to the definition of PEs. There is a lack of clarity between the definition of PE for corporate tax purposes and that of fixed establishment for indirect tax and in many countries a PE for corporate tax triggers indirect tax registrations.

In addition to the additional compliance burden, creation of new PEs will add significant confusion around supply chains for indirect tax purposes creating operational complexity as well as increased risk of disputes. Where a UK trading company has an indirect tax registration in an overseas country, a new corporation tax PE may impact its existing local indirect tax status e.g. becoming resident from non-resident, impacting taxability of transactions and its working capital requirements.
We have not estimated the costs of operating under such a model but have concluded that to address the increased compliance burden a fundamental rework would be required possibly towards more of a central single trading model.

B. Artificial avoidance of PE status through the specific activity exemptions

1. The exceptions are not restricted to preparatory and auxiliary activities

BP has no comments to make on the proposal in E to extend ‘preparatory and auxiliary’ to each of sub paragraphs a-f in paragraph 4 of Article 5.

2. The word of "delivery" in subparagraphs a) and b) of paragraph 4

Whist the intention of the OECD is to address concerns that large warehouses may be maintained with significant employees supporting on-line sales that may be designed to erode the tax base of a county, this exception goes much further that the stated objective. Not only will it address the large dedicated distribution facilities that are core to on lines sales businesses the changes as drafted will also apply to any business that uses storage facilities to access global markets. The delivery exception is relied upon by BP’s integrated supply and trading business through which BP markets oil and gas.

A typical trading operation will have a small number of companies which enter into trades of oil, oil products or gas with third parties around the world. Negotiations are carried out by employees of these companies in the jurisdiction in which they are resident and contracts are concluded either by telephone or followed up by written confirmation or online.

The trading company has no economic substance (people activity) in the majority of countries with which it trades oil and gas. For an integrated oil company such as ours any physical presence in these countries will often be in an unrelated business such as oil and gas exploration and production. In order to satisfy the delivery of hydrocarbon products to a customer the trading company may rent tanks to store the products prior to delivery to local markets. The tanks are usually operated and maintained by third parties, and a commercial rent is paid to that entity. The oil/gas that is stored in the tanks is "maintenance of stock". The margin earned from selling to customers is taxed in the country of residence of the trading company where all the economic activity takes place – i.e. where the negotiations and conclusion of contracts takes place, and where the employees are located.

Often hydrocarbons cannot be guaranteed to arrive in a given port at a specified date and time to suit the customer needs. The creation of a PE through the mere holding and storage of hydrocarbons will clearly increase the compliance burden adding much complexity. It is also unclear what income would be attributable to a PE created in these circumstances. Given that all the economic activity is carried out in the location of the trading company. It is our belief that this will significantly increase the risk of cross border tax disputes between tax authorities.
In terms of scale BP estimates that additional direct tax registrations may be required in up to 20-30 jurisdictions, with similar effects for indirect taxes that were raised in comments on commissionaire arrangements. The resulting compliance burden would add significantly to the costs of such transactions and may well make many of them uneconomic.

We broadly estimate that this would incur additional up front compliance costs of c.$20 million, with annual additional compliance costs of c.$3 million pa. The nature of the industry often means that the supply of oil and gas results involves very slim margins. Opening up new markets, often in developing economies, is challenging and the proposed changes to the definition of a PE will create further uncertainty and risk. In the competition for capital these projects will compare less favourably than other ventures if these changes are made.

3. The exception for purchasing goods or merchandise or collecting information

No comment

4. Fragmentation of activities between related parties

No comment

C. Splitting-up of contracts

No comment

D. Insurance

No comment

We would be happy to provide further information on the impact of these proposals to the OECD should there be any questions on the above.

Yours sincerely

John Bartlett
Comments on the OECD Public Discussion Draft entitled “BEPS Action 7: Preventing the Artificial Avoidance of PE Status 31 October 2014 to 9 January 2015”

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled BEPS Action 7: Preventing the Artificial Avoidance of PE Status 31 October 2014 to 9 January 2015” (hereinafter referred to as the Draft).

BUSINESSEUROPE acknowledges the fact that there is a BEPS concern in this area. However, we are concerned that the proposals in the Draft will result in a lowering of the PE threshold that goes far beyond the specific problems related to the digital economy. The current draft does not sufficiently distinguish between BEPS and the allocation of taxing rights between the source state and the residence state. Under the mandate of the BEPS-project, any new standards should in our view be limited to addressing only the former topic. Where a taxpayer is appropriately taxed in the state of residence, it is typically not a matter of BEPS but one of allocating taxing rights.

PE issues often result in double taxation and all efforts to provide additional clarity to the OECD Model Tax Convention are naturally of interest to business. Unfortunately, we believe that the proposals are likely to induce additional ambiguity into an already
complex area resulting in a dramatic increase in PEs with conflicting claims of tax jurisdiction, allocation disputes and double taxation.

Although companies face many challenges in relation to PE issues, the list in Article 5.4 still mitigates administrative costs and facilitates the determination of when a PE is at hand. Compliance costs in relation to PEs are significant and increased uncertainty in this area is likely to have a negative impact on cross border trade and investment.

In addition, and as acknowledged in the UN Model, some of the activities may generate little income and due to divergent treaty application lead to prolonged litigation regarding how much income should be attributed to the PE. Therefore, the end result could be a significant increase in the number of PEs that no actual profit can be attributed to. This is neither helpful regarding the complexity in this area nor to effectively solving BEPS concerns.

Overall BUSINESSEUROPE supports the comments made by BIAC but would also like to provide some additional comments.

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The Draft proposes the following four alternatives to address abuse in relation to commissionaire structures and similar arrangements:

A. (Para 5.5): Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”;

(Para 5.6): strengthen the requirement of “independence”

B. (Para 5.5): Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”;

(Para 5.6): strengthen the requirement of “independence”

C. (Para 5.5): Replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”;
(Para 5.6): strengthen the requirement of “independence”

D. (Para 5.5): Replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”;

(Para 5.6): strengthen the requirement of “independence”

As a starting point it is essential that any initiative to counter abusive cases is targeted and provides clear guidance so as to avoid application also in relation to non-abusive cases or cases involving allocation of taxing rights rather than BEPS. In general, tests based on objectivity provide far more certainty and predictability than those based on subjectivity. Regrettably, a common feature of all four proposals seems to be that they all add additional subjectivity into the PE test.

All four proposals entail a more restrictive interpretation of the independent agent concept by basically disqualifying the use of associated enterprises in commissionaire arrangements and also by removing the possibility to be an independent agent if acting exclusively or almost exclusively on behalf of an enterprise. In relation to the proposed changes in the dependent agent test we are concerned that the proposals may affect not only commissionaire arrangements but also other principal sales structures.

Additional clarity on the wording “engages with specific persons in a way that results in the conclusion of contracts”, “material elements of contracts” as well as examples on what is to be considered as “similar arrangements” is necessary. As previously indicated we find the proposed options too far-reaching since they go beyond the commissionaire structures and can involve buy-sell distributors and/or even pure marketing activities.

B. Artificial avoidance of PE status through the specific activity exemptions

BUSINESSEUROPE acknowledges the fact that it is possible to be heavily involved in the economic life of another country by doing business via the internet and that this may open up for potential abusive cases. However, when targeting this particular area it is of utmost importance not to lower the PE threshold for traditional business engaged in non-abusive situations.
Although it might be desirable to address situations of artificial avoidance of PE status it needs to be acknowledged that there are still valid and perfectly legitimate reasons for the exceptions that are currently found in Article 5.4 of the Model Tax Convention.

For a great number of MNEs the exceptions in Article 5.4 facilitate less administration and cost by enabling a relatively simple and consistent approach to the determination of whether or not a PE exists. Companies report that whenever they are considered to have a PE, there is the inevitable dispute on how much income should be attributed to that PE. On many occasions this results in long litigations and high costs.

Since the kinds of activities mentioned under 5.4 normally are not by themselves income generating, it will be quite difficult to allocate income to such a PE and disputes in this area are likely to increase significantly.

**The exceptions are not restricted to preparatory or auxiliary activities**

In option E in the Draft it is suggested to make all of the activities in para 5.4 subject to a preparatory or auxiliary condition.

Although the activities listed in 5.4 in many cases are of a preparatory or auxiliary character, it is acknowledged in para 21 in the Commentary to Article 5 that this is not always the case. To introduce an explicit reference to "preparatory or auxiliary activity" will affect traditional businesses and the number of PEs would no doubt increase dramatically.

In addition, the concept of "preparatory or auxiliary activity" is vague and opens up for ambiguity and divergent interpretation. Para 24 in the Commentary to Article 5 also states that "it is often difficult to distinguish between activities which have a preparatory or auxiliary activity and those which have not".

Compared to options F, G and H option E has the advantage that it would at least still be possible to get a PE exception from activities such as delivery, purchasing and collecting information.

However, if all activities are subject to the condition that they have to be preparatory or auxiliary, why do we need such a list at all? Another way to deal with this issue would be to leave para 5.4 as it is and provide for a PE exception unless the tax authority can show that the activity is not of a preparatory or auxiliary nature.
Although the intention may be to target companies with a large warehouse in which a significant number of employees work, we are concerned that many industrial companies with warehouses will be challenged by tax authorities.

If option E is adopted, the new commentaries need to clarify and give examples of situations in which the activities would qualify as "of preparatory or auxiliary nature". A situation in which a company in state A sells products in state B solely on the Internet and with no presence in state B, other than a warehouse, is clearly different from a situation in which a company in state A uses a warehouse in state B, used for delivery of products sold by an affiliate in state B (or sold by other affiliates in third states, e.g. central warehouse situations).

Although the intention may be to target the first case, tax authorities could argue that the company in state A would have a PE in state B in both described situations. In the latter case, a local sales profit resulting from sales activities will be duly taxed in state B and a PE for company A would only add administrative burden and risk of additional disputes for allocation of PE profits (if any). As noted above, for the purpose of amending the current guidelines, it is important to distinguish between situations which create BEPS and those that merely refer to the allocation of taxing rights between the source and the residence state.

The word "delivery" in subparagraphs a) and b) of paragraph 4

In option F the Draft proposes deleting the word "delivery" from subparagraphs a) and b) of paragraph 5.4.

BUSINESSEUROPE strongly objects to the deletion of the word "delivery". Many companies report an increasing trend and need of having warehouses closer to their customers. It is difficult to understand the purpose of having the exception for storage when deleting the exception for delivery. Having a warehouse for storage without the possibility of delivery makes little sense and would have significant consequences for their business operations. Excluding delivery from the PE exception would also have a much wider impact than on cases where there is a BEPS related concern.

Deleting delivery from subparagraphs a) and b) of paragraph 5.4 would, as far as we can tell, effectively put an end to long established and well accepted principal structures maintaining central warehouses in geographically strategic locations for the delivery of goods using local low risk distributors for their sales operation. It would also affect companies maintaining a warehouse for the delivery of spare parts to customers...
for machinery supplied to those customers even where it does not maintain or repair such machinery (see para 25 of the Commentary to Article 5). The effect on businesses and trade/investments decisions is unacceptable.

The Draft also explains that the omission of the word “delivery” is a departure from the OECD Model Convention, reflecting the view that a stock of goods for prompt delivery facilitates sales of product and thereby the earning of income in the host country. We acknowledge the fact that there could be a BEPS concern if the goods or the merchandise are delivered to customers in the same country where the goods or merchandise are stored. If, however, the delivery is made in a cross-border circumstance, it is difficult to understand such concern. There may be situations in which a company has a central warehouse from which no deliveries are made to the host country but only to third countries. It needs to be clarified that such a situation should not constitute a PE.

If deliveries are made to the host country as well as to third countries the company would have a PE in the host country. However, it needs to be clarified that only profits from sales to the host country could be attributed to the PE.

BUSINESSEUROPE fully agrees with the word of caution in the UN Model that “…even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into attributing too much income to this activity if they do not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties”.

From this perspective option E would, as indicated earlier, be preferable.

**The exception for purchasing goods or merchandise or collecting information**

Option G proposes the deletion of “purchasing goods” from subparagraph d) and option H proposes to delete the entire subparagraph, thus both the exception for purchasing goods and collection of information.

BUSINESSEUROPE does not support either of these two options. These exceptions are very important for companies and the deletion of these activities would no doubt increase the number of PEs dramatically. Before deciding whether to invest in a new market companies need to be able to examine and “scan” the market. In this respect
purchasing and data collection is necessary. In addition, raw data by itself has limited value. Value is created only by the process and interpretation of the data.

Furthermore, we do not agree with example one. It seems to indicate that a purchasing branch which purchases the output of several affiliated manufacturing plants on behalf of the group would be entitled to retain the group’s entire volume discount for those purchases. Example one ignores the fact that the volume discounts achieved by a centralized purchasing function are typically shared among those members of the affiliated group that will acquire the goods in question.

All in all, a deletion of these activities from the PE exception would impact adversely on businesses trade and investment. The purchasing exception can also boost the local economy by attracting foreign buyers to make purchases from local sellers. In our opinion, neither of these activities is sufficient to constitute a PE and they do not by them themselves produce any profits. Considering the cost and administrative burden of running a PE, many companies are likely to shut down existing purchasing offices simply because the costs would outweigh any potential profit from these activities. From a broader perspective such a scenario would have a negative impact on cross border trade and investments.

As in the case of delivery, once again option E would be preferable compared to options G and H since then at least it would be possible to maintain a fixed place of business for purchasing goods or collecting information without triggering a PE. However, option E would open up for ambiguity and divergent interpretation, thus creating additional uncertainty regarding the existence of a PE.

C. Splitting-up of contracts

The Draft proposes two alternatives (options K and L) to deal with the splitting-up of contracts.

Since there is a 12 month time threshold to regulate when a building site or construction or installation project constitutes a PE we acknowledge the necessity to prevent abuse. However, it is reasonable to request rules that are clear and provide some certainty. Companies report having problems interpreting paragraphs 18 and 19 of the Commentary to Article 5 and would welcome additional guidance.

As a general comment concerning contracts, there are situations where the rationale behind regarding a construction site based on several contracts as a single unit can be questioned.
Assume that a company has finalized a construction project within an 11 month period. One year later the same company receives an additional order from the same customer at the same site. This project is finalized in 2 months. The two orders may be considered to be connected but the company had no knowledge of the additional order at the time of the conclusion of the first project. Could this even be considered as splitting-up a contract? Would this constitute a PE? If so, it would be very difficult retrospectively to deal with all the PE administration.

Returning to the two alternative proposals, a principal purpose test, as suggested in option K would presumably deal with the example above, giving the company a possibility to show that no abuse was intended. However, having a principal purpose test would undoubtedly open up for wide application by tax authorities and induce additional uncertainty into the PE test.

However, and as indicated in the Draft, the “automatic” approach in option K may be too wide since it applies indiscriminately and would also capture situations where there is no BEPS concern.

In order to narrow the scope of the automatic approach the Draft proposes a minimum presence of 30 days. BUSINESSEUROPE finds this period of time much too short. Many construction projects run for several years where a company may need to have specialists on the site a couple of days a month during the entire project. The result would be a PE on every major construction site. In addition, such a threshold would be very difficult to monitor, as all parts of an MNE may not be fully aware of all the activities of the group as a whole.

E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing

A major drawback with the Draft is the fact that it does not address the profit attribution implications of the potential PEs created under various options. To the contrary, the Draft seems to dismiss this issue as insignificant. BUSINESSEUROPE fully supports the comments made by BIAC on this issue and share the view that countries often are motivated to create PEs in order to attribute profits to those PEs.

If the proposals in the Draft are implemented, corresponding guidance under Article 7 would be necessary in order to avoid numerous cases of double taxation. Any profits to be attributed to a PE based on delivery, purchasing or data collection are likely to be insignificant, but that view may not necessarily be shared by tax authorities.

It is difficult to foresee the full consequences of the proposed amendments. However, we fear that they would lead to a dramatic increase in cases of double taxation and would hamper investment and trade.
BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on the treatment of PEs.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director
Economics Department
January 9, 2015

Marlies de Ruiter,
Head, Tax + Treaties,
Transfer Pricing and Financial Transactions Division,
OECD/CTPA

Dear Madam,

Re: OECD Base Erosion and Profit Shifting (“BEPS”) - Action Plan 7

The Canadian Life and Health Insurance Association (“CLHIA”) is pleased to provide comments on behalf of its member companies on the Discussion Draft released on October 31, 2014 by the OECD on BEPS Action Plan 7: Preventing the Artificial Avoidance of PE Status.

The CLHIA is the national trade association for life and health insurers in Canada. Our member companies account for 99 per cent of Canada’s life and health insurance business and provide a wide range of financial security products such as life insurance, annuities and supplementary health insurance to 28 million Canadians. Canadian life insurers operate in over 20 countries around the world and three of our members rank among the top 15 global life insurers by market capitalization. A quarter of the CLHIA’s members operate as subsidiaries or branches of foreign insurers or reinsurers from the United States and Europe. The CLHIA is also a member of the Global Federation of Insurance Associations (GFIA) based in Brussels.

The CLHIA supports the G20 and the OECD’s initiative to combat aggressive tax planning, including the artificial avoidance of permanent establishment status. However, we urge that the final measures taken by the OECD be proportionate and balanced, taking into account the unique commercial realities of the global insurance business model and try to avoid giving rise to any unintended consequences which would impede the efficient functioning of primary insurance and reinsurance markets. The CLHIA is concerned that the proposals, as currently drafted, may seriously hinder operations of insurers to the point where there is a reduction in the types and amount of life and health insurance products offered resulting in increased costs to and reduced choices for consumers.

The Discussion Draft notes that “in many cases Commissionaire structures and similar arrangements were put in place in order to erode the taxable base of the State where sales took place” and offers a number of options (Options A to D) to address those concerns. Specific to the insurance industry, the Discussion Draft explores deemed PE treatment for dependent agents who...
do not formally conclude insurance contracts to address cases where a large network of exclusive
agents sell insurance for a foreign insurer.

Key Message and Response to the Proposed Options

The OECD’s objections to Commissionaire arrangements do not apply to the insurance or
reinsurance distribution models used by foreign insurers or reinsurers to assume risks in a host
country. The nature of the contractual relationships and the risks and rewards transferred between
the parties in an insurance context do not result in unwarranted avoidance of PE status. However,
we are concerned each of the options A – D may pose a risk to insurance and reinsurance
business of creating unwarranted PEs.

The distinctions between Commissionaire arrangements and the distribution models of insurers as
articulated below demonstrate why insurance businesses should not be targeted by the OECD’s
efforts to counter Commissionaire arrangements. We highlight below the important role
reinsurance and management or service companies play in the insurance industry.

We understand the need for an appropriately targeted action to counter Commissionaire
arrangements. However, options A – D are quite wide in scope. In an effort to prevent perceived
harm from avoiding a PE status, the above options use excessively vague language which is likely
to result in unintended consequences which are inconsistent with the OECD’s goal of creating an
international tax regime which fosters certainty and clarity. The wide scope of these proposals is
such that they would be difficult to apply in practice and would almost certainly give rise to
different interpretations by different revenue authorities, thereby giving rise to unnecessary
disputes (including, where there is little or no material tax at stake) and increase the potential for
double taxation.

For example, much greater clarity and certainty by way of clear guidance is required with respect
to the meaning of certain terms and phrases (for example, the phrases “habitually engages with
specific persons in a way that”, “negotiating the material elements of contract”, “by virtue of the
legal relationship”) in an insurance context to ensure there is no unintended creation of multiple
PEs with little or no additional tax revenues to the host state. These expressions, and in particular
the first one, do not have the benefit of a long – or indeed any – usage with well-understood
meanings in legislative contexts. They lend themselves to interpretations that can vary with the
eye of each particular beholder. They are virtually certain to exacerbate the problems targeted by
BEPS Action 14 and the absence of a consensus by OECD Members for the use of binding
arbitration does not bode well for the predicted outcome of their adoption as currently worded.
We suggest that the OECD consider refining these expressions to make it much clearer what
behaviour is intended to be encompassed. Further, an explicit carve-out for insurance and
reinsurance activities (at least by way of guidance), without which these provisions have the
potential to do great damage to the industry and affect the efficient functioning of insurance and reinsurance markets, should at a minimum be provided.

Further, we believe that it is highly inappropriate to have a specific provision that applies to insurance activities and to the collection of premiums by an agent as outlined in Option M. To deem a PE to exist based simply on the collection of premiums is likely to produce a disproportionately large and inappropriate burden on insurers, particularly for those that write global risks. It would likely result in a multitude of tax PEs in jurisdictions where no underwriting, investment management, risk management or prudential regulations take place. It is akin to deeming a PE to arise in every jurisdiction where a manufacturer’s goods are sold, regardless of the existence of any material nexus with that jurisdiction. The fact that the insurer may have a clerk or other representative in the jurisdiction to facilitate premium remittances or other administrative functions seems quite far from the minimum threshold required in other contexts – in particular, the threshold required for a tangible goods vendor to be considered as having a PE in a jurisdiction. For example, if an insured person moves from country A to country B and the insurer facilitates premium remittances for that individual by accepting payment at a facility maintained in country B by the insurer’s affiliate that carries on a non-insurance related activity, a PE would result even if that individual were the only person insured by that insurer in that country. This proposal further exacerbates the potentially negative effects posed by the vague language of Options A to D as articulated above. In particular, it is likely to encourage insurers to terminate policies when people move to other jurisdictions. In an increasing mobile world this will cause hardship and difficulties to many. Therefore, we strongly recommend that the OECD not proceed with option M.

Key Considerations for the Insurance Industry

1. Distribution Model

Unlike a Commissionaire, an insurance or reinsurance intermediary has no contractual relationship with the local customer. The sale of insurance products through commissioned agents and brokers is not a new or recent phenomenon in the insurance industry, and it is not designed to achieve base erosion or other tax avoidance. It is the traditional distribution model followed by insurers around the world since inception and is common to both insurers’ domestic and foreign sales of insurance policies. This distribution model is a function of commercial considerations and regulatory requirements. As such, a BEPS concern with respect to insurance undertakings is questionable.

Insurance agents and brokers cannot conclude contracts on behalf of an insurer. They have no capital at risk nor do they bear any risk of loss under the insurance contracts. Their activity and value creation is limited to introducing and connecting customers to insurers’ products and services, for which they receive an arm’s length fee or commission. The fee or commission that is paid is demonstrably an arm’s length amount.
The insured or customer generally has no recourse to the agent/broker in the event of a dispute over the insurance contract. The risks and rewards of the insurance contract rest with the insurer and the insured.

The OECD’s 2010 Report on Attribution of Profits to PEs, specifically Part IV (Insurance), identifies the key functions that give rise to the attribution of profits to a PE in an insurance context. Part IV recognizes that the collection of premiums alone by agents does not necessarily create value for the insurer and does not amount to underwriting and assuming/accepting risks associated with insurance policies (the latter being the KERT functions). The value creation and the bulk of the insurer’s profit (or loss as the case may be) are attributable to its decision to assume a particular risk. As such, the mere collection of premiums (i.e., by an agent), in and of itself, does not create significant value for the insurer. This is recognized in Part IV, for example in paragraphs 93-98. Para 93 of Part IV states in unequivocal terms:

All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.

It would therefore be quite inconsistent for the BEPS project to ascribe a PE in the jurisdiction where premiums originate where that is the only activity that takes place in that jurisdiction. The claim to PE status in the jurisdiction[s] where business is regulated makes sense irrespective of the absence of KERTs in that jurisdiction. However, ascribing a PE in a jurisdiction solely on the basis of premium origination regardless of the significance of any other activity in that jurisdiction significantly undermines the purposes served by the PE concept and is clearly inconsistent with the regime that governs the international trade in tangible goods. It looks like a mere revenue raising measure rather than a response to a real base erosion or tax avoidance concern.

The distribution and management of insurance is highly regulated. Insurers are subject to two forms of regulations:

(1) prudential regulations with regards to various risks assumed (underwriting/insurance, investment, operational etc.) and solvency of the insurance business carried on in a jurisdiction; and

(2) market conduct regulations on being licensed to sell insurance policies in a jurisdiction.
We believe the PE for corporate income tax purposes should appropriately align with where the particular business is prudentially regulated where this follows the KERT functions (underwriting/insurance, investment, operational etc.).

In any event, insurers (including non-resident insurers) are also subject to tax on premiums originating in most jurisdictions. In addition, an agent (as intermediary) who is neither accepting nor managing risks, receives a commission or fee which is commensurate with the value of the services rendered. This compensation is also subject to income tax in the territory in which the agent operates.

An insurer that is not subject to prudential regulation in one state may receive premiums and pay commissions in that state that are subject to premium and other taxes in that state. Such an insurer may be prudentially regulated and subject to corporate income taxes in another state. In such a situation, many of the options described in the Discussion Draft would give rise to a potential inadvertent PE for corporate income tax purposes in the first state (where the only activity of the insurer is the collection of premiums and payment of commissions without any KERT functions). This is inappropriate and would give rise to unintended negative consequences that are the antithesis of the BEPS project.

We believe it is important to maintain consistency between PE status for corporate income tax and nexus for prudential regulation. To do otherwise (that is, to deem PE status in a state merely because of the collection of premiums and payment of commissions without any KERT functions in that state), as proposed in this Discussion Draft, in particular Option M, would amount to a disproportionate and inappropriate response by the OECD to the BEPS concern, if any, posed by the insurance industry.

In addition, we are of the view that the aggregate of premium taxes and taxes paid by agents on the commissions in the source state is a reasonable and appropriate tax base for activities conducted in that state if there are no KERT functions in that state. This tax base is material and it is commensurate with the value creation in the source state. Further, it also has a degree of certainty that is not always present with corporate income taxes. Corporate income tax revenues, which depend on profitability, can be delayed, are volatile and prone to uncertainty given the long-term nature of the life insurance business. As such, we submit that the “risks and rewards” associated with the various functions are aligned appropriately with the current nexus for prudential regulatory and taxation (income, excise and premium) purposes.

2. Reinsurance Business

It is common for local insurers to seek reinsurance coverage (both from related and unrelated parties) as part of their entity and group level risk management. The main objective of reinsurance is risk diversification and capital efficiency. Global reinsurance is essential to allow insurers to increase their capacity to write additional business (risk) in local markets. Without
global reinsurance, local markets would see a substantial drop in their capacity to assume risks
and a material increase in the cost of capital, resulting in rising insurance premiums and or lack of
coverage for the local consumer. Hence, jurisdictions (like Canada) acknowledge the need for
global reinsurance and the thinness of the local reinsurance market and take steps to encourage
foreign reinsurers to participate in the local market, for example, by exempting reinsurance
 premiums from the imposition of premium and certain excise taxes. These are conscious
decisions made by knowledgeable insurance regulators (and tax authorities) as to the benefits
afforded to consumers by the active participation of foreign reinsurers in the local market.

Application of the proposed Options A-D (but particularly C and D) in the Discussion Draft could
well mean that any insurance contract entered into by a Canadian insurer who has entered into a
quota share reinsurance treaty with a foreign reinsurer would result in a Canadian PE for the
foreign reinsurer solely because the foreign reinsurer has assumed a quota share of the insured
risks “by virtue of the legal relationship” created by the reinsurance treaty.

For example, if a large reinsurer provides reinsurance, through quota share, stop-loss or other
forms of non-proportional reinsurance, for the entire global book of business of an insurance
group, that global reinsurer could then have a PE in every jurisdiction where the insurance group
writes business. The retrocession of such risks among reinsurers could seemingly also trigger the
creation of multiple PEs under Options A-D (but particularly Options C and D). These
agreements, once in place, function automatically. They are widely used and serve a valid
business purpose in the efficient functioning of the insurance and reinsurance markets.

These rules could be particularly destructive to insurance and reinsurance markets (unintended
though it may be). The very act of achieving geographic diversification (which is highly desirable
from a risk management perspective) of the various risks borne by an insurer or reinsurer will
have the potential to create multiple PEs for multiple parties and cause unwarranted
administrative, compliance and tax burdens. Impeding geographic diversification will increase
the risk of default by insurers and reinsurers with consequential damage to the real economy.

3. Service Arrangements

A PE could also be triggered by Proposals A-D in instances where certain functions, such as
investment management or claims processing, etc. are provided by an affiliate to a related insurer
under an inter-company service agreement. Currently such activities would not create a PE as
long as the services are provided under policies and procedures set out by the insurer. We believe
a PE should not be triggered simply because an overseas management or service company is
used, provided the ultimate decision-making authority is retained by the insurer. These are
common business models in the industry, partly driven by its regulatory framework.
Conclusion

Given the highly regulated nature of the insurance industry, we are of the view, as articulated in detail above, that none of the options included in this PE Discussion Draft are appropriate for the determination of PE status for insurers and reinsurers. We recommend that the OECD provide an explicit carve-out for insurance and reinsurance activities (at least by way of guidance) to ensure the efficient functioning of insurance and reinsurance markets. Any BEPS concerns with regards to the insurance and reinsurance industry could be addressed through Action 9.

We trust the OECD will provide the industry with the opportunity to review final amendments and guidance to ensure that any potential for unintended PEs are eliminated or greatly reduced.

Sincerely,

[Signature]

Noeline Simon
Vice President, Taxation and Industry Analytics
I submit brief comments to a few aspects of the Public Discussion Draft of “BEPS Action 7: Preventing the Artificial Avoidance of PE Status” (herein the Discussion Draft), specifically, to the following points of the same:

- Point B.1., the exceptions are not restricted to preparatory or auxiliary activities.
- Point B.3, the exception for purchasing offices.

I make these comments on a personal and individual basis, wherefore they do not represent the views of any other person or organization.

**Point B.1., the exceptions are not restricted to preparatory or auxiliary activities.**

The changes to Option E are much more substantive than the Discussion Draft concedes. It essentially disavows that the activities enlisted in Art. 5(4) are all, *per se*, of an auxiliary or preparatory nature for tax convention application purposes; in doing so, the change would call in an additional layer of analysis, currently not required, to determine whether isolated storage, display, delivery, purchasing, etc., activities are auxiliary or preparatory in nature, or not.

In this context, I believe the following comments are pertinent:

1. The 2011 and 2012 discussion drafts on the clarification of the PE definition cited in the Discussion Draft sought to address the question of “whether the activities that are mentioned in subparagraphs a) to d) of paragraph 4 are automatic exceptions or whether these exceptions are conditional on the activities being of a preparatory auxiliary nature”.¹

The 2011 and 2012 discussion draft further pointed out the following:

The Working Party agreed that the wording of subparagraphs a) to d) [of Art. 5(4) of the Model Tax Convention] did not support the view that the application of these subparagraphs was subject to the additional condition that the relevant

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¹ Paragraph 71 of the 2011 draft; paragraph 70 of the 2012 draft.
activity be of a preparatory or auxiliary character, ... It was therefore agreed that the Commentary should be amended to clarify that subparagraphs a) to d) were not subject to the extra condition that the activities referred to therein be of a preparatory or auxiliary nature ... \(^2\)

The proposed changes of the Working Group paragraph 21 of the Commentary on Art. 5(4) also seem to confirm the view that these activities, when the sole activity of the place of business, are of a preparatory or auxiliary nature:

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. *Where the only activities carried on at the fixed place of business are activities to which one of the subparagraphs a) to d) apply, the place of business is deemed not to constitute a permanent establishment.* The common feature of these activities is that they are, in general, preparatory or auxiliary activities. *Since subparagraph e) deals with other unspecified activities, however, the requirement that the activity must have a preparatory or auxiliary character has been* This is laid down explicitly in the case of the exception mentioned in subparagraph e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.\(^3\)

Furthermore, those two 2011 and 2012 discussion drafts give clear reference that “to make all exceptions subject to the ‘preparatory or auxiliary’ condition would reduce certainty by subjecting the existing exceptions that currently apply automatically and therefore provide a bright line test to a condition that is inherently more subjective”.\(^4\)

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\(^2\) Paragraph 75 of the 2011 draft; paragraph 76 of the 2012 draft.

\(^3\) Page 25 of the 2012 draft.

\(^4\) Page 27 of the 2011 draft; page 24 of the 2012 draft.
3. Even as it stands, paragraph 21 of the Commentary to Art. 5(4) to the 2014 OECD Model Tax Convention and, in my mind, the text itself of Art. 5(4), have seemed to consistently and clearly indicate that its scope is referred to a purely preparatory or auxiliary character, and that the activities in question, when the sole activity of the place of business, is therefore per se of such character:

Paragraph 4

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in subparagraph e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

The additional paragraphs of the Commentary to Art. 5(4) to the 2014 OECD Model Tax Convention are also consistent in indicating that all activities referred to by Art. 5(4) are of such an auxiliary or preparatory nature for tax convention purposes.

3. Therefore, in my opinion, making this a standard test for all cases seems far removed from the scope of the OECD’s BEPS effort. It actually represents a policy decision on whether to tax or not these activities, when they are the sole activity of a place of business, as opposed to their current status as automatic exceptions to activities that constitute a PE.

Thus, the proposal seems to be a substantive change, and not a modification to set a boundary in a clearer way: the activities enlisted in Art. 5(4), being deemed to have been auxiliary or preparatory to date, would be subject to an analysis of whether they are auxiliary or preparatory on a case by case basis.
This approach is also inconsistent with the premise that “[i]t is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not”. Any such substantive change would therefore necessarily require a strong justification and the Commentary on Art. 5 (4) of the Model Tax Convention would have to be enriched with significant parameters for taxpayers and tax authorities alike to reliably be able to distinguish preparatory or auxiliary activities from activities that no longer qualify as such.

It is also inconsistent with a purpose of certainty, insofar as “[t]he change would therefore increase the potential for disputes between taxpayers and tax authorities.”

A clear demarcation line —“the bright line test” referred above— would be lost regarding the permanent establishment concept, which already has many factual grey areas, and when, from an entrepreneurial point of view, stable legal certainty is a prized intangible.

4. If a clarification of Art. 5(4) is being sought, it seems much simpler to opt for the following text:

   Notwithstanding the preceding provisions of this Article, the term "permanent establishment” shall be deemed not to include **the following auxiliary or preparatory activities**:

   a) ...

The automatic exemptions would still apply, with the attaching certainty for taxpayers and tax authorities.

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**Point B.3, the exception for purchasing offices.**

As the current 2014 text of the Model OECD Double Taxation Convention stands, paragraph 4 of Art. 5 indicates:

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

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5 Paragraph 24 to the Commentary on Art. 5(4) of the 2014 OECD Model Tax Convention.
6 Page 27 of the 2011 draft; page 24 of the 2012 draft.
In addition to what has been expressed above, paragraph 43 of the Commentary on Art. 7 seems to corroborate that an activity of mere purchasing (i.e., procurement) is, in itself, an auxiliary or preparatory activity, insofar as it indicates that “subparagraph 4 d) of Article 5 recognises that where an enterprise of a Contracting State maintains in the other State a fixed place of business exclusively for the purpose of purchasing goods for itself, its activity at that location should not be considered to have reached a level that justifies taxation in that other State”.

Therefore, I do not agree with paragraph 22 and 23 of the Draft Report, which indicate:

22. The above exception for purchasing activities seems to have been originally justified by the view that no profits could or should be attributed to such activities.

23. That view was expressly rejected in the course of the development of the Authorised OECD Approach (AOA) which, in 2010, resulted in the elimination of Art. 7(5) of the OECD Model Tax Convention, which provided that:

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

Actually, the exception was not rejected; it referred only to the case where a PE already exists for reasons other than mere purchasing and also carries on purchasing. Thus, the premise is that, once a permanent establishment exists, then the non-attribution rule previously established in Art. 7(5) of the July 2010 OECD Model Tax Convention should not apply. It follows that, even under the approach of the 2014 Model Tax Convention, if the only activity is purchasing, no PE should be deemed to arise. In this respect, paragraph 43 to the Commentary on Art. 7 of the 2014 OECD Model Tax Convention, already cited above, further indicates: “Where, however, subparagraph 4 d) is not applicable because other activities are carried on by the enterprise through that place of business, which therefore constitutes a permanent establishment, it is appropriate to attribute profits to all the functions performed at that location”.

It therefore seems that the premise being explored by the Draft Report is that there could be purchasing activities that are actually quite different from the one described by current paragraph 5(4)d) of the Model Convention and paragraph 43 of the Commentary to Art. 7, which would go beyond being of an “auxiliary or preparatory” nature.

In this context, I submit the following comments:
1. As a corollary to my comments made above to Option E, such Option E, by itself, may not be resolve the issue of whether mere purchasing is an auxiliary or preparatory activity, or of when given its volume, state of the purchased goods or significance to the overall enterprise it stops being so. Further substantial parameters —ideally normative, and not only through Commentary made to the article— would be required to grant international trade certainty in such situations.

2. As a second comment, in my mind, it seems that generating a permanent establishment situation for purchasing offices may be an unnecessary complication to international trade, since, from an economic point of view, export is one of the key components that drives GDP growth and purchasing for exports represents income for the source country, where the suppliers providing the purchased goods should be taxed on their income for such sales.

Furthermore, a more intense local procurement activity may be an accident of a given trade, and absent in others, and a differentiated treatment may not be warranted.

In such a context, alacrity to tax purchasing activity, when a stand-alone activity, could be seen as tantamount to having a country’s government charge a commission from businesses for buying from that country.

3. Lastly, as a third comment, the two scenarios for which BEPS concern is shown in Examples 1 and 2 of paragraph 26 of the Draft Document could be resolved through anti-BEPS tailored rules, such as the following:

   Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise from unrelated third parties or of collecting information, for the enterprise, and provided that, in the case of purchasing of goods or merchandise, the income derived from their sale or from the sale of other goods into which they are incorporated is not subject to a low-tax jurisdiction;

The reference “from unrelated parties” effectively combats Example 1; the second addition would effectively combat the situation described in Example 2.

END.
CBI RESPONSE TO OECD PUBLIC DISCUSSION DRAFT ON ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on Action 7: Preventing the Artificial Avoidance of PE Status, published on 31 October 2014.

2. As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

3. We have reviewed the response prepared by BIAC in respect of this paper and agree with the key points and conclusions submitted in that response. Our paper below highlights the keys areas of concern for British business, and where possible, we have provided real commercial examples to highlight the actual commercial impact of the proposals.

4. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that if complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

Overview

5. The preamble notes that the Action Plan intends to update the treaty definition of permanent establishment (“PE”), in order to prevent abuses of that threshold. This seems appropriate, but, to the extent that any update results in wider reconsideration of the allocation of taxing rights between source and residence states, there will be an increased risk of double taxation in non-abusive circumstances unless there is a very clear consensus as to the precise detail of the new approach.

6. The Action Plan has stipulated that it is not intended that there should be a wider discussion regarding the allocation of taxing rights. However, many options outlined could lead to a plethora of PEs which the discussion draft implies will result in an expected increase in the apportionment of profits to PEs over and above the profits currently being apportioned to local affiliates under existing transfer pricing principles.

7. We think there is a material risk that tax authorities will inevitably seek to extract a greater attribution of profits once a PE is created which will lead to increased disputes and uncertainty for business and
resource implications for tax authorities. For example, where there is no change in the functions, assets and risks currently being managed from the territory of a new PEs - if there is to be an increase in profits allocated to that PE – it must imply (otherwise double taxation would be created) that the counterparty country should accept a lower level of profit.

8. We welcome the acknowledgement by the OECD that other parts of the BEPS action plan, should amend some of the existing rules and guidance on profit attribution to PEs (in particular Action 9). We hope that this will give some much needed clarity to what is currently a subjective and contentious area. However, we request that the OECD carefully considers the balance between the attribution of what, in many cases, would be an immaterial amount of further taxation (if any) to the source country, and the uncertainty, additional compliance burden, and disputes that tax authorities and MNEs alike will have to deal with as a result of the Action 7 amendments currently being proposed. MNEs with PEs may be small companies expanding for first time into new jurisdictions, and for them, the compliance burden will likely be disproportionate.

9. We believe that any tax benefit from implementing a commissionaire structure generally arises due to the transfer of intangibles assets and risks from local companies to a central sales entity, and not as a result of there being no PE. The local sales entity should be compensated for the functions and assets of a sales entity. Creating a new PE where there is no change in the functional, risk or asset profile will mean companies are required to submit two separate tax returns and carry out a complex calculation of the allocation of profit between the PE and the local company – a significant burden for what should be no significant difference in total tax paid in that country. The options outlined to address this perceived issue could result in a significant increase in the number of PEs, not least from circumstances which are not commissionaire arrangements.

10. In relation to commissionaires, we recommend that none of the options outlined in A to D are implemented. Actions 8 and 9 are intended to address the transfer of intangibles and risk, and we would expect the proposals issued on the 19th December 2014 in respect of these actions to address any concerns about commissionaire structures. If this is not the case, a much more specific, targeted, rule applying to just commissionaires should be considered.

11. The specific entity exemptions provide business with a great deal of certainty through being objective and simple. The proposed changes would either bring about genuine uncertainty going forward in relation to all of these exemptions (by applying preparatory and auxiliary to each of them), or would create more PEs for sectors other than the digital sector, at which these changes seem to be targeted. On the other hand, attempting to target the digital sector would potentially create a two tier system, which was specifically cautioned against through the work under Action1.

12. Where there has been artificial fragmentation of activities in order to bring an enterprise within the preparatory or auxiliary exclusion, there may be a case for looking at new proposals. However, in cases where the fragmentation reflects a genuine commercial arrangement, it would not be appropriate to act in a way, which, essentially, pierces the corporate veil. The new proposed rule is widely drawn and attacks the established principle of no force of attraction. The options outlined in I and J are an extension to the OECD Commentary on Article 5 which already addresses fragmentation of a single enterprise’s activities in deciding whether a PE exists. We consider that the principle purpose test proposed under Action 6 could be applied to the fragmentation of activities, such that only tax motivated structures would then be affected.

13. As outlined in the paper, if the anti-abuse rule proposed in Action 6 is capable of dealing with the perceive abuse of the splitting of contracts in relation to building sites and installation projects, then we see no reason for any additional measures to be included. The anti-abuse rules should be capable of
targeting just the abusive structures, whilst normal commercial arrangements that are not tax motivated would not be subject to additional compliance burdens. Specific examples in the guidance notes will be required.

14. The specific proposal (option M) outlined in respect of insurance companies would generally result in the same issues as outlined for commissionaires. There would be a significant increase in tax PEs created with no additional tax being allocated to the country. The current definition of PE for tax purposes is generally quite similar to the definition of PE for regulatory purposes. This ensures that tax and regulatory reporting requirements can be aligned. We believe that it is important to retain this alignment. To do otherwise, which would be the outcome of Option M, would put a disproportionate compliance burden on insurers without much, if any, expected additional tax.

15. The creation of new PEs does not only have an impact on corporate taxes and could, for example, also be relevant for indirect taxes, levies and withholding taxes etc. In some countries, a PE could trigger withholding tax obligations if corporate tax liabilities are attributed to it (e.g. branch profits tax in the US). Access to treaty relief could also be affected if payments subject to withholding tax are attributed to the new PE (especially if the triangulation provisions outlined in Action 6 are enacted). It will also be necessary to consider the indirect tax consequences of global supply chains given VAT registrations can often follow the corporate tax requirements. Before any changes to the definition of a PE are proposed, we encourage the OECD to consider each of these other factors.

Artificial avoidance of PE status through commissionaire arrangements and similar strategies

16. We believe that Option B would impact commercial business models the least and would create less uncertainty than the other proposals. The OECD Commentary to Article 5 explains in paragraph 33 that, if someone effectively negotiates all the elements and details of a contract, a PE will be created. This is notwithstanding the contract actually being signed elsewhere. Option B aligns with paragraph 33 but extends Article 5 so that it applies where a person “negotiates the material elements of contracts.” This should address the perceived issue for those territories where there is currently no legally binding contract. However, it does introduce many issues, for example, being able to establish international agreement on what are the “material elements” of a contract are.

17. In each of the options A to D, the proposal is that an independent agent cannot act exclusively (or almost exclusively) on behalf of associated enterprises. There will be many commercial and other non-tax reasons why different entities within different countries carry out various parts of the group’s activities, and do so in an independent capacity. We don’t believe that it is desirable or necessary to create a PE in all such circumstances. A group company should be able to act as an independent agent of another group company where that is in the ordinary course of its business, both companies have substance to their operations, and the independent agent is being appropriately rewarded for transfer pricing purposes.

18. We do not believe that any of options A to D will result in a significant change in the profits allocated between countries (provided all countries properly analyse the activities in accordance with OECD guidelines – which is burdensome in itself). However, each proposal will create a significant number of additional PEs which will create significant compliance burdens in relation to both filings and profit calculations.

19. Using the example outlined in paragraph 7 of the discussion draft, if XCO is to have a PE in State Y, then the activities which would be attributed to it under an Article 7 profit attribution should be the same sales functions and assets currently carried out by YCO. Whilst the sales income may be allocated to the new PE, the new PE will have to transfer price all that income away to YCO for the sales activities. It
will also have a deemed recharge back to the head office for the intangibles and risks which are managed from the head office company. Therefore there should be no (or nominal) profit left in the new PE of XCO.

20. The main reason for the reduction in profits in the example in paragraph 7 was likely to be the elimination of risk and movement of intangibles from State Y. If any of the proposals outlined in options A to D were enacted, provided the risk and intangibles remain managed by people in State X then it should be right that State X retains the taxing rights. The transfer of risk and intangibles is potentially the cause for concern for commissioner structures, but these issues are being separately reviewed under Actions 8 and 9 of the BEPS programme. Unless there is a change in the allocation of taxing rights, of the calculation of profits attributable to the new PE (both of which are stated not to be the case in this paper), there should be no reason to change the definition of PE, but instead, address the concerns through Actions 8 and 9.

21. Some employees of multi-national enterprises will typically engage in international business travel, and may interact with customers of the multi-national enterprise whilst travelling. Those interactions may include discussions of services that the multi-national enterprise can provide, and will often be of a preparatory, introductory or marketing nature. We believe that the OECD’s current work on PE should make it clear that such activity does not constitute a PE. However, options A to D cast some doubt over this position, to varying degrees.

22. We have outlined below a number of commercial situations which we consider would be impacted by the proposals in options A-D which we do not consider to be BEPS behaviour.

23. **Example 1 – Umbrella Contracts**

   A number of our members have confirmed that one of their key ways of doing business with other multi-national groups is for the parent company of each group to enter into a contract with the parent company of another group for the supply of goods. However, this contract will also cover the activities of each subsidiary in local territories when supplying the local subsidiaries of the other group.

   Examples include an oil and gas group whose parent company enters into agreements with an airline to provide fuel for aircraft wherever a plane is located. The local subsidiaries will then supply the fuel under the contract. Under the proposals outlined in the discussion draft, each local fuel supplier would have a PE in the parent country, and would have to file a tax return even though the parent company already receives an arm’s length return for its work in concluding the contract at group level.

   Another of our members in a different industry would estimate that due to similar group level arrangements, around 100 new UK PEs would be created.

   It is our view that entering into umbrella contracts like this should not constitute BEPS behaviour as the arm’s length income is appropriately received and taxed in the parent country. However, the proposals outlined in Options A to D will create numerous PEs in the home jurisdiction and therefore significantly increase compliance for no change in the allocation of taxable income.

24. **Example 2 – local sales support for group sales functions**

   A sales support office based in the source country acts exclusively on behalf of foreign affiliates and provides local expertise in relation to the foreign affiliates’ regional market and customer base (linguistic support, market intelligence, competitor analysis etc.). Employees of the sales support office attend customer meetings alongside employees of foreign affiliates and routinely pass information (including quotations and orders) between regional customers and foreign affiliates. Despite the local sales support
office having no direct involvement in the conclusion/negotiation of contractual terms between foreign affiliates and customers, the subjectivity of Options A to D could result in the creation of a PE through even the vaguest of connections between the local office and the negotiation/conclusion of contracts by one or several foreign affiliates. Again, this seems likely to significantly increase compliance for no change in the allocation of taxable income.

25. **Example 3 – Buy-sell and other back to back arrangements**

A local affiliate of a foreign manufacturer provides repair services (including the provision of replacement parts) to regional customers. The foreign manufacturer holds parts in a local third-party warehouse to minimise lead time. The local affiliate procures parts from the foreign manufacturer’s stock in the local warehouse that it uses in its repairs. The local affiliate engineers carry out the repair and take all risk on the labour element of the contract. However, the local affiliate acts as a limited risk distributor in relation to the parts holding no obsolescence, warranty or inventory holding risk and receiving only a small margin on all the parts it sells. Whereas currently the local affiliate would not be considered a dependant agent of the foreign manufacturer as it did not conclude contracts in the name of the foreign principle, under all options, it might now be considered a dependant agent PE of the foreign manufacturer owing to the flow-through contractual arrangements for the parts (being on the account and risk of the foreign manufacturer) and the fact that it is acting exclusively on behalf of the foreign manufacturer in relation to parts supplied.

Back to back arrangements are common in commodity trading markets and these could also be affected under the same analysis.

26. **Example 4 – Financial services regulatory requirements**

Within regulated financial services, such as banking, typically only certain entities are regulated to carry on specific activity e.g. the provision of bank accounts, or the issue of investment products. Also, a wide range of regulated financial services require the provider to hold an appropriate amount and quality of regulatory capital. An associated entity should not be prevented from being independent simply because it introduces business for execution by a suitable regulated entity or entities within the same group, especially when it is not regulated, or does not have the regulatory capital to undertake the business. It is expected that the local associated entity would be rewarded appropriately for transfer pricing purposes in respect of any functions it carries out in introducing business for execution by another group company. Again, options A to D will potentially increase compliance costs for no change in the allocation of taxable income.

27. **Example 5 – Local customer contact**

We expect that additional commentary on Action 7 will follow any alternations to the definition of a PE. We believe that such commentary should provide detailed definitions and clear guidance as to what is meant by the terms “habitually engages with specific persons in a way that results in the conclusion of contracts” and “negotiates the material elements of contracts”. Unless there is a specific reference to the actual contact negotiation process, we are concerned that any ongoing regular contact with clients could be construed as an activity resulting in the conclusion of a subsequent contract (e.g. would it be said that the good customer service provided on the first contract was a key factor in a second contract being awarded even though the customer services function is already being properly remunerated on an arm’s length basis?).

28. **Example 6 – International business travel**
An employee of a multi-national company travels to Country X for a short visit, which includes meeting various potential customers. Customer X (resident in Country X) subsequently enters into a contract for a service provided to customer X by a member of the MNE resident in Country Y. That service was originally discussed when the travelling employee met the customer whilst visiting Country X. Taking option A, will it be said that the employee’s engagement with the customer when visiting Country X has ultimately resulted in the conclusion of a contract? We don’t believe this should be the case because of the nature of the interaction that took place in Country X, i.e. that interaction should not be regarded as engaging in a way that resulted in the conclusion of a contract because it was not directly connected to the contract. Also, if employees of the MNE group company resident in Country Y undertake relatively few visits to Country X, that should not be regarded as habitual engagement. If an approach along the lines of options A to D is adopted, we believe that the final report on Action 7, and the commentary on Article 5, will need to make clear that customer interactions of the type described in this paragraph do not constitute a PE.

29. Example 7 – Invoicing Agent

A large MNE operating across the globe has determined that there are operational and commercial benefits from the use of a single invoicing agent throughout the supply chain. This simplifies the external face to its 3rd Party customers but also brings operational simplicity. The entity providing the invoicing activity is remunerated for its activities, but in this case, does not have the same purpose as a traditional commissionaire arrangement. Any definition of commissionaire would need to be clear that it would exclude such invoicing agents where the appropriate functional, risk and asset tests would align with their remuneration as these arrangements do not constitute BEPS behaviours.

30. In each of the examples above, the local entity is already receiving an arm’s length return for the functions, assets and risks which it is performing, assuming and managing. It is therefore difficult to see where BEPS concerns would arise, but each would potentially be caught by one or more of the options outlined in the paper.

31. In addition to the examples outlined above, there is another important issue for growing small and medium sized businesses which are looking to grow and use the existing definitions as a ‘safe harbour’ to prevent a disproportionate compliance burden.

32. Example 8 – Growing business foreign sales operations

A growing medium sized company has one sales person responsible for a number of countries (say a UK headquartered group employs a salesman in Germany who is responsible for sales across all of mainland Europe). The sales person sources customers and takes the sales relationship so far before handing over to the UK parent to conclude the contract. Under existing rules, there is no need for tax filings in each individual country (e.g. 20 different countries) where total sales in each one would not be profitable enough to cover the tax compliance cost in each jurisdiction.

Considering the OECD’s proposals, there is activity in each jurisdiction leading to a that could potentially caught by each option. The existing test is an important de-minimus to allow the business to operate in different territories for a few days profitably. If such proposals are implemented, greater emphasis will be placed on the word “habitual” by both tax administrations and by companies, particularly medium sized businesses which may wish to manage their compliance burden through maintaining a de-minimus level of activity. Although this wording is in the current OECD discussion draft, it is not well tested due to the objective test of actually concluding contracts. We would request that specific examples are given showing what is meant by this term especially regarding short term sales visits and calls made to customers whilst travelling in another country.
Recommendation

33. We recommend that the work on BEPS Actions 8 and 9 should be concluded and the impact understood before any change to the definition of a PE is finalised to deal with commissionaires. Actions 8 and 9 should be effective in dealing with the specific tax issues outlined in the discussion draft in respect of commissionaire structures.

34. If Actions 8 and 9 are not successful in dealing with the perceived risk presented by commissionaire structures, and it is deemed necessary to make changes to Article 5 of the model treaty, we would recommend that instead of implementing any of Options A to D, a targeted rule dealing with just commissionaires is implemented. This could be achieved by seeking to define arrangements involving undisclosed agency (whereby a principal in another country provides goods or services to a party that has transacted with the undisclosed agent) and specifying that such arrangements are a dependant agent PE.

35. If the final proposal has to be one of A to D, then B would be preferable. However, much greater clarity would be required as to what is meant by “habitually”. It should also be explicitly noted that a group company can be an independent agent, at the very least if both parties have substance to their operations, act in the ordinary course of business, and the independent agent is appropriately rewarded for TP purposes.

Artificial Avoidance of PE status through the specific entity exemptions

Preparatory and Auxiliary

36. Option E makes each of the specific entity exemptions subject to a preparatory and auxiliary test. This brings subjectivity to each of the tests, which are currently relatively simple and objective in nature. This will no doubt lead to disagreements between States as to what are preparatory and auxiliary activities and a potential risk of double taxation. If this option is applied, significant amounts of detailed clear guidance would be required and would need to be agreed by all countries.

37. One key issue to address is whether the preparatory or auxiliary test should be applied by reference to the company involved or group as a whole.

38. Example 9 - Company v group activities

In a multi-national group, different functions are carried out in different entities for management and operational reasons. Take an example where a multinational company has set up a distribution company and has established warehouses in a number of jurisdictions. It is part of a large manufacturing group which develops, manufactures, markets and distributes all of its own products. In the context of the group, an individual warehouse for final delivery of goods to the customer would be a preparatory or auxiliary function with little or no value provided. However, in the context of the company, that warehouse is the business of the company and therefore could not be preparatory or auxiliary in nature.

We request that the OECD specifically and clearly addresses this situation in guidance and suggest that consistency with the developments on anti-fragmentation should be achieved.

Delivery

39. Option F considers the possibility of removing the word delivery from the specific exemptions. Whilst the removal of “delivery” from clause 5(4) does not predicate a PE of a foreign enterprise that maintains a stock of goods for delivery in the source country (a fixed place of business under paragraph 1 would first need to be fulfilled), any such revision of subparagraphs (a) and (b) of the OECD Model Tax Convention
would change a clearly defined exemption into a subjective test. We therefore do not support the removal of the word “delivery”.

40. As outlined in paragraph 18 of the discussion draft, the purpose of this proposal seems to be specifically aimed at digital companies that maintain a stock of goods in each country to enable quick delivery as a unique selling point (and therefore, delivery would arguably not be preparatory or auxiliary in nature). However, we are concerned at a number of other commercial situations where groups are required to hold a stock for delivery that would be impacted by the proposals in Option F. We have provided examples of these below and request that if Option F is pursued, the OECD provide guidance on the position of each example below and the reasons for the answers given. We also request that clear examples are provided of the situations of when “storage” and “display” end, and “delivery” begins.

41. Example 10 - Oil and Commodities

Oil companies and commodities dealers (which require physical delivery) will normally be dependent on goods being delivered in large quantities, usually by ship, at relatively infrequent intervals, and stored in country for delivery to customers. Such a process cannot be managed as simply as the movement of smaller goods by a digital seller.

The rental payment in relation to the storage paid to the local owners should already be subject to tax in that jurisdiction. The consequence of the removal of the word delivery, resulting in the creation of the PE from holding oil or gas in a storage tank would require additional direct tax registrations with knock on effects for indirect taxes. The resulting compliance burden would add to costs of such transactions that could make them uneconomic if compliance costs outweighed contractual benefit.

The sales of oil and gas into developing countries provides the energy sources for these countries to develop their local economies. We do not believe this type of activity (which in the context of the group, is preparatory or auxiliary) should fall within the scope of BEPS.

42. Example 11 – Retailers

The premise set out in the UN commentary is that “a stock of goods for prompt delivery facilitates sales of the product and thereby earning of profit in the host country”. However, the major factors that actually influence the siting of a warehouse are generally access to the infrastructure and supply chain that enable a smooth and efficient delivery process, not necessarily targeted at the host country. For instance, Rotterdam is often viewed as a prime location for warehousing due to its port and it proximity to a major international airport (Schiphol in Amsterdam), rather than due to the need to deliver quickly to Dutch customers. Similarly, warehouses serving the Eastern European market could be sited in Germany.

It should also be noted that the location in the same jurisdiction will not always facilitate the fastest movement of goods to market. For example, a warehouse in Brussels (Belgium) would be far more effective in serving customers in Lille (France) than a warehouse in Marseille (also in France). Yet under the UN guidelines, issues arise in relation to the warehouse in Marseille whilst the warehouse in Brussels is considered to be OK.

Secondly, the concern in the discussion draft about delivery stems from concerns around online sales. The suggestion is that a warehouse storing goods belonging to an online business would create a PE, whereas the supplies to a traditional physical shop would not. This would seem to create the two tier tax system the digital economy paper is at pains to avoid. For example, a multi-channel retailer could face the possibility of part of the warehouse representing a PE and part not, assuming that the stock can be separated between the online and physical business.
Purchasing Goods

Article 5(5), and options A to D of the discussion draft do not distinguish between local involvement in selling and purchasing contracts. Therefore, if the purchasing exemption in Article 5(4) is removed, groups with centralised/or regional purchasing hubs, where local personnel are involved in contract negotiations with regional suppliers on behalf of multiple group entities, may create a local PE for every group entity that contracts with the supplier.

Collection of Information

43. Option H contemplates the removal of the exemption for the collection of information. A distinction needs to be made between cases where the collection of information is a core function of the enterprise, when it may be appropriate to regard the activity as more than preparatory or auxiliary, and, on the other hand, cases where the collection of information really is of a preparatory or auxiliary nature. A functional analysis may be required, but the exception should not be wholly removed as this would greatly increase the risk of disputes and double taxation. In some cases, information may be provided gratuitously to an enterprise. It is not practical to seek to attribute profit to a PE represented by third parties who are providing information to an enterprise for free.

44. Example 12 – Provision of free information

An enterprise contracts and sells to customers only in the resident country. It collects information from businesses throughout the world through local representatives to provide databases to companies in that particular business sector. Companies provide their information free of charge. It is not possible to specifically value particular data. Companies volunteer their information so the enterprise cannot control how much information is provided or from where. It carries out quality control and other functions only in the residence country. There is no practical way of attributing value to the provision of particular information from the various “source” countries. For this reason, the exception for the provision of information should not be altogether excluded.

45. Example 13 – Insurance companies

We believe that the collection of data by insurers with a view to understanding the market would be preparatory and auxiliary. If this is not the case, the removal of the collection of data from a specific exemption could potentially distort the insurance market. It may stop insurance groups from collecting information to enable them to understand the market well enough, and therefore be prepared to write risks in a territory.

46. Example 14 – Local marketing companies

Many enterprises retain local ‘marketing’ entities which are intended to provide relevant information on the local market which are generally simple, limited risk entities providing the type of ‘low value added’ service addressed by Action 10. There is not usually any tax avoidance motive for the existence of these entities and the removal of this exception would seem to give rise to an opportunity for double taxation where none currently exists.

Recommendation

47. We believe that data collecting undertaken by enterprises, other than media or other businesses whose primary activity is collecting information, should always be regarded as preparatory or auxiliary.

Fragmentation of activities between related parties
48. Where there has been artificial fragmentation of activities in order to bring an enterprise within the preparatory or auxiliary exclusion, there may be a case for looking at new proposals. However, in cases where the fragmentation reflects a genuine commercial arrangement, it would not be appropriate to act in a way which, essentially, pierces the corporate veil and seeks to re-characterise those activities. Examples of legitimate commercial arrangements include; where there has been an acquisition, where activities have been divided between legal entities in order to focus the business, to manage risk from a commercial perspective, or, in decentralised/divisionalised business models, where highly skilled specialists are employed by different entities. The new rule appears widely drawn and appears to attack the established principle of no force of attraction. The options outlined in I and J are an extension to the OECD Commentary on Article 5 which already addresses fragmentation of a single enterprise's activities in deciding whether a PE exists.

49. Both options I and J only provide protection where the different activities of an MNE do not form complementary functions that are part of a cohesive business operation in the relevant jurisdiction. Accordingly, we think the approach needs to be more targeted to the abuse it seeks to address than the current options outlined in options I and J. Whilst a clearer rule would be preferable, at a minimum, the commentary should make clear that the many standard cases involving genuine commercial separation of activities within a territory will not be regarded to be complementary functions that a part of a cohesive operation.

50. **Example 15 - Centralised Supply Chain**

In an increasingly globalised world, it often makes commercial sense to centralise as much of the supply chain as possible in one location. This is particularly relevant in trade blocs and where there are products that are globally or regionally similar.

In a highly centralised supply chain, the only activity which generally must remain local is the conversion of raw materials to finished product even this being limited to narrow production slots. Toll manufacturing, in which the raw materials and subsequent finished goods are owned by the foreign enterprise and conversion is undertaken by the local company is a common business model.

Ordinarily, the exemption at subparagraph (c) of paragraph 4 would apply, i.e. the maintenance of a stock of goods...solely for the purpose of processing by another enterprise. Clarification is required as to what constitutes a 'business activity' under proposal I and J. If there is no clear guidance, then MNEs face uncertainty and potentially erroneous enquiries where stock holding for processing, previously an acceptable practice, is considered a 'business activity' and hence a PE is created for the foreign enterprise.

51. **Example 16 -- short business trips**

Clarification is needed where an employee of a group company in country X visits a group company in State Y for a short business trip e.g. an engineer performing services for a few days – would this automatically create a PE for the company in country Y by the fact that the activities in the Company in country Y are significant? It is unclear from the discussion draft as to whether the fact that the Company in country X has no fixed place of business still means that there would be no PE, or the fact that another company in the group in country Y would have to also be considered as a complementary function for a PE to exist? This is common practice, but the compliance costs and burden would be significant compared to the tax at stake for a few days' work. This should not be considered BEPS behaviour.

**Recommendation**
52. We propose that the same general principle purpose test being proposed under Action 6 – Treaty Abuse could be applied to the fragmentation of activities (with detailed guidance on the application) such that only tax motivated structures would then be affected.

Splitting-up of contracts

53. Options K and L are presented to address the artificial splitting of contracts and we would support change where this specifically targets just the abusive structures. The principal purpose test has the advantage of ensuring that in cases where contracts are separate for wholly commercial purposes the enterprise is not inappropriately deprived of the benefit of the “preparatory or auxiliary” test. The treaty should allow for cases where there are genuinely separate contracts either for particular commercial reasons or as a result of the history of the business.

Insurance

54. We have seen the comments submitted by the Association of British Insurers which deal with the insurance industry issue in more detail. We endorse the key points and conclusions made in that paper.

Profit Attribution to PEs and Interaction with Action Points on Transfer Pricing

55. We note the comments made in paragraph 45 of the discussion draft, and would generally agree with the conclusions contained within. However, as noted above, there is an implication throughout this paper that the options outlined above will see a significant amount of profit allocated to the State where the new PEs arise. We have outlined in this paper a number of commercial examples of where new PEs will be created, which, based on existing profit attribution rules, would create little or no extra profit in the new PE.

56. If the allocation of profit is based on the location of key entrepreneurial risk takers and special people functions in relation to assets, functions and risks, then as outlined, even where there is a perceived abuse, there could be little change in the allocation of taxing rights. For example, commissionaire structures where the management of the risk and intangibles remains within the centralised sales centre. It is highly likely that the proposals under Actions 8 and 9 could deal with the perceived abuse associated with commissionaires much more effectively than changing the definition of PE which could create multiple PEs (even in cases that are not commissionaire arrangements), no change in profit allocation, but a significant burden on business to comply.

57. Whilst we agree with the conclusion that no significant change is required to the attribution rules (though accept that they may change to address specific issues under Action 9), we are concerned that as a result of the implications outlined in this paper, tax authorities may seek to take a greater share of profits based on local sales rather than understanding the full value chain and allocating profits to where value is created and managed. Without clear clarification of issues and examples as to how profits should be attributed to the new PEs created in this paper, we see potential for significant disputes and double taxation arising.

58. Given the interaction of the different elements of the BEPS work, we believe that business should have the opportunity to provide further comment on any proposals to alter the definition of a permanent establishment in the light of developments on the other Actions.

IMPACT ON INDIRECT TAXES

59. We believe it is also necessary for the OECD to consider the indirect tax consequences and impacts of any changes to the definition of PE. There is a lack of clarity between the definition of PE for corporate
tax purposes and that of fixed establishment for indirect tax. Creation of new PEs will add significant cost, complexity, compliance administration, and confusion around supply chains for indirect tax purposes, both for businesses and tax authorities. In many countries, a PE for corporate tax triggers indirect tax registrations, automatically increasing administrative compliance burdens and costs. The indirect tax presence of an additional entity in a country will create confusion around the supply chain, creating operational complexity as well as increased risk of disputes. Where a UK trading company has an indirect tax registration in an overseas country, a new PE may impact its existing local indirect tax status e.g. *becoming resident from non-resident*, impacting taxability of transactions and its working capital on top of the additional compliance burdens.

We trust that you will find the above comments helpful in understanding the potential impact of the proposals outlined in the discussion draft. We remain committed to ensuring that each BEPS Action achieves its stated goals whilst at the same time mitigating the negative impacts for genuine business arrangements. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
Dear Ms de Ruiter

BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT ("PE") STATUS - COMMENTS ON PUBLIC DISCUSSION DRAFT

INTRODUCTION

1 Thank you for the opportunity to comment on the discussion draft. We set out below our comments on the proposed options for amending Article 5 of the OECD Model Convention, followed by the principles in support of our comments. We are a law firm based in New Zealand and make this submission in our own right and not specifically on behalf of clients.

COMMENTS ON PROPOSED OPTIONS

Submission 1: Our preferred language for addressing the artificial avoidance of PE status through commissionaire arrangements and similar strategies

2 We suggest that paragraph 5 of Article 5 be amended in accordance with a variation of Option B, to read as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts that are:
   a) in the name of the enterprise, or
   b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
   c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

3 We accept the desire to move away from the present rule’s focus on contracting in the enterprise’s own name as necessary to address commissionaire arrangements. We consider the above to be the most appropriate response to the perceived issues
around commissionnaire and similar arrangements. This approach is specifically targeted at the perceived concern and leaves intact the primary “concludes contracts” test which is well understood and can be applied with certainty.

**Submission 2: If Submission 1 is not accepted, we support Option B**

If our suggested language for paragraph 5 of Article 5 in Submission 1 is not accepted, we support Option B.

We note that the reason we promote the variation to Option B in Submission 1 is that in our view the additional test of “negotiates the material elements of contracts” is unlikely to produce better outcomes for source jurisdictions. The “negotiates material elements” test incentivises enterprises to confine their source jurisdiction activities to building relationships, entertaining potential customers and other background support functions and to effect the negotiation/ conclusion of contracts from their residence countries (for example by teleconference). If against our first preference Option B is adopted, we predict that the result will be: to reduce negotiation activities and employment in the source countries; and to create more compliance costs for enterprises without increasing the source countries’ tax take. It is for that reason that we support the proposal in Submission 1. Option B may have some cosmetic benefit in creating the appearance of a more hard line approach.

**Submission 3: We suggest Option A be rejected because “engages with specific persons in a way that results in the conclusion of contracts” is not an appropriate test**

First, the additional “engages with specific persons in a way that results in the conclusion of contracts” test in Option A is on its face inadequate. The Explanation adds the context that the interactions of the intermediary must “directly result in” or have a “direct causal connection to” the conclusion of the contract but that concept is not reflected in the language. If this approach was to be adopted, at the very least “directly” should be added to the express text of the rule, and an explanation such as that in paragraphs 1 and 2 together with examples would be required.

More importantly though, we are concerned that direct causal connection to the conclusion of contracts is a flawed test and should be rejected for that reason. There are no doubt a variety of legal standards to establish a causal link (for example the legal test for liability in the context of damage caused by negligent action). It is not entirely clear to us what is meant by “directly results in” or “direct causal connection to” in this context. For example, is it a “but for” test? If an enterprise has a relationship person located in the source jurisdiction, the enterprise would not have a relationship with the client and the contract would not be signed “but for” the relationship person’s activities in the source country, even if all elements of the contract are negotiated and concluded outside the source jurisdiction. Can it be said then that the “results in contracts” test in Option A is met because “but for” the relationship person’s activities the contracts would not come about? In that situation there is arguably a direct causal connection between the relationship person’s interactions with the customer and the conclusion of the contract. But our impression, from the explanation given for Option A and our understanding that Option A is intended to be narrower than Option B, is that the intended answer is that mere relationship building and business development activities are not intended to create a PE in the source country.
But we are concerned that the test in Option A, if adopted, would lead to considerable uncertainty of outcome and diverse practice and outcomes across the broad array of member countries.

If the language is intended to bring about the application of a “but for” test, the change is going far beyond the stated purpose of addressing situations of artificial avoidance of PE status.

**Submission 4:** We suggest Option C be rejected for the same reasons as Option A and also because "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise” is not an appropriate test.

We suggest Option C is rejected for the same reasons as Option A set out in Submission 3 above as regards the “results in contracts” language.

In addition, we believe Option C should be rejected because its reference to "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise” lacks certainty and would as with Option A lead to diverse practice and outcomes across the broad array of member countries.

For example, take the situation where a parent company resident in one country sells goods to its source country subsidiary which on-sells to customers in the source country. Assume also that there is a contract or understanding that any time the source country subsidiary effects a sale to the source country customers, the parent company will supply the goods to the source company subsidiary at a price that leaves the subsidiary with an appropriate margin. Our question under the “on the account and risk” test is whether all countries would be clear that in this on-sale situation the sales by the source country subsidiary cannot be regarded as “on the account and risk” of the parent? I.e there appears to be an argument that the sales by the source country subsidiary might be said to be economically on the account and risk of the parent: the parent earns profit from its sale to the subsidiary triggered by the sale to the subsidiary’s customer and the parent is at risk to the subsidiary if it cannot deliver to allow the end customers orders to be fulfilled. Even this simple example, leaves us with the view that the broader economic “on account and risk” test is not appropriate (perhaps the answer in the example is that the subsidiary personnel in the example would not be acting on behalf of the parent enterprise).

**Submission 5:** We prefer where possible targeted solutions along the lines of Options F, G and H, rather than an overall “preparatory or auxiliary” condition in Option E; but we have real doubt about removing the delivery and collecting information exemptions.

We do not support subjecting all the subparagraphs in Paragraph 4 to an overall “preparatory or auxiliary” condition. The OECD commentary on Article 5 of the Model Convention itself observes (at paragraph 24) that it is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. If there are clear answers to the delivery, purchasing goods or collecting information issues then the rules should provide these answers, rather than have the issue be obscured in the preparatory or auxiliary test.
We are concerned with the concept of removing “delivery” of goods from the exemption. For many exporters it is inevitable that they will need directly or through agents to have premises in the source country for storage and delivery of goods. We believe that there is continuing wisdom in the idea that that process alone should not transform an exporter into an organisation considered to be “trading in” rather than “trading with” the source country—whatever the tax that might be collected on the storage and delivery activity, it does not justify bringing many exporters into the source country tax nets who have not previously been subject to source country tax. This type of change is also not within artificial avoidance label for BEPS Action 7. We have some sympathy for the idea that very large warehouses in source countries to effect distribution of products sold online where goods originate from multiple producers may warrant a particular measure.

We also believe that the rationale for removing “collecting information” is not valid—if activities are disguised for what they are not, the tax authorities should address that on audit. (We do not address the purchasing goods point as, given the history for the elimination of Article 7(5) from the OECD Model, there will be others better placed to comment).

Submission 6: We prefer Option J over Option I for addressing the fragmentation of activities between related parties

We support the proposal to address the fragmentation of activities between related parties. Option J seems more appropriate to us than Option I because we do not see a policy reason for limiting the scope of the anti-fragmentation rule to circumstances where the related party has a permanent establishment in the source jurisdiction.

Submission 7: Effect of unilateral member country solutions such as the UK’s "Diverted Profits tax"

We believe some thought should be given to what significance there is, if any, for these PE treaty amendments where countries adopt unilateral solutions such as the UK diverted profits tax. Others will be better placed to comment on that issue. We do note though that our understanding is that that 25% tax is to be imposed without legislative treaty override and on the basis that the diverted profits tax is not an income tax. If that is correct, this type of development seems to us to be most unfortunate. In particular, if the tax is not an income tax, then residence country companies will not have treaty assurance that they should have the benefit of a tax credit in their residence country for any diverted profits tax paid and may not be eligible for the benefit of a credit under their domestic law. This creates the real possibility of double taxation on international trade.

Submission 8: Mutual agreement procedures and arbitration

If contrary to our submissions, rules are to be adopted that are uncertain in effect and/or create the risk of double taxation of companies engaged in international trade, in our view it is particularly important that the discussion extends to the need for timely and effective (including cost effective) mutual agreement procedures and arbitration provisions so that companies engaged in international trade can take some comfort from the likelihood that, whatever the rules mean, they will not have to pay tax twice.
PRINCIPLES IN SUPPORT OF OUR COMMENTS

Amendments should be targeted at/and clearly tailored to the specific concerns that have been identified

19 The purpose of the proposed amendments, as enunciated by the title and headings of the discussion draft, is to prevent the artificial avoidance of PE status through (among other things) commissionnaire and similar arrangements and the specific activity exemptions. The proposed amendments should be tailored to respond to the specific issues that have been identified and should not effect broader changes beyond those that are strictly necessary to address the perceived concerns. In addition, the changes made should be reasonably clear and not uncertain.

20 For example, accepting that commissionnaire arrangements should give rise to a permanent establishment, our suggestion is that greater clarity and tailoring is achieved by the language proposed in our Submission 1, without the extensions and uncertainties in proposed Options A to D.

The express artificial avoidance scope of BEPS Action 7 should not be implemented by language that risks imposing significant costs on international trade that have not been clearly signalled or creates risk of double taxation

21 Although elementary, it is worth starting with the observation that tax treaties limit source country taxation of business profits to situations in which a resident country enterprise carries on business through a PE and then profits may only be taxed to the extent attributable to the PE. If there is no PE in the source country, business profits of the resident country enterprise cannot be taxed. This PE definition is therefore the key mechanism for allocating taxing rights as regards business profits between source countries and countries in which enterprises are resident. In a sense the division is between "trading in" a country (profits from which can be taxed by the source country jurisdiction where the PE test is met) and "trading with" a country (profits from which cannot be taxed by the source country where there is no PE).

22 Many jurisdictions’ domestic source rules are expansive in scope, with the consequence that the treaty limitations in relation to PEs and business profits have a real impact in constraining source jurisdiction taxation. Accordingly, the PE discussion is not a merely academic exercise concerning definitional minutiae. Rather it goes to the fundamental taxation of all world trade. In addition, in many cases for exporters the PE line is their threshold for whether they become income tax payers at all in the source country market. This all reinforces the need for the changes to be tailored to the issues identified and clear in scope.

23 The current internationally agreed standard for the PE/"trading in"/ "trading with" divide under the treaties for dependent agents/employees operating in a source country is whether the dependent agent has and exercises power to conclude contracts for or , under paragraph 32.1 of the Commentary on Article 5, receives orders which are routinely approved by the resident country enterprise (and see more generally paragraph 32 of the Commentary on Article 5 which makes clear that the absence of such authority means there is no PE).

24 We accept the need for a tailored solution to the commissionaire arrangements (see our Submission 1). But we do not support Options A, C and D because uncertainty in the tests leads to potential movement in the PE line and potential new tax on international trade beyond what is signalled/intended. This uncertainty also creates
real risk of diverse interpretations across member countries and the risk of unacceptable double taxation and places increased pressure on treaty dispute resolution procedures.

25 We observe that there may be a questioning by countries with major populations and markets as to whether they wish to move away from a framework where profits from international trade to a large degree are taxed in the countries in which exporters are resident (by virtue of the contracting test in current Article 5(5)) towards a framework that allows source countries a greater ability to extract more income tax on those profits as in a sense a toll for access to their source country markets. But that argument needs to be played out, if it needs to be, in a different forum. That argument is not in our view one of any relevance in the context of a revision of PE rules focused on artificial avoidance of PE status.

26 We acknowledge that the issue is not always one of tax allocation between two high tax countries (for example, in cases where products emanate from a high tax jurisdiction, but are sold to a low tax jurisdiction with treaty protection, before being sold into a high tax source country) and that may colour member countries’ views on this issue. But in our view, that issue should be addressed in the context of the CFC rules of the residence jurisdiction or, alternatively, in the context of the preparedness of the source jurisdiction to negotiate double tax agreements with low tax jurisdictions or to extend benefits to intermediate companies in those jurisdictions (eg limitation of benefits and treaty shopping issues).

Reasons for rejecting the Proposed “Negotiates Material Elements of Contracts” test (Options B and D)

27 Our reasons for suggesting that this approach be rejected are set out at paragraph 5 above. We acknowledge that a shift to this standard has superficial appeal and that those contracts whose significant terms are negotiated in the source country may seem easy prey for an extended PE definition. But as set out in more detail at paragraph 5 we predict that if this rule was adopted it would not prove beneficial to source countries and would just add compliance costs for multinational companies.

Concluding remarks

28 Thank you for considering our comments. We do not wish to speak in support of our comments at the public consultation meeting on 21 January 2015, but we would be happy to answer any questions that you have. Please do not hesitate to contact us.

Yours faithfully

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23 December 2014

Marlies de Ruiter
Head
Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

Dear Madam

BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Thank you for the opportunity to comment on this public discussion draft.

Our organisation

Chartered Accountants Australia and New Zealand is a professional association with over 100,000 members. We engage in advocacy and thought leadership in areas that affect the domestic and international economies. We actively work to advocate for sound public policy in the financial, regulatory and taxation areas.

In formulating our submissions, we take a best practice, public policy perspective. We recognise Governments’ and other international bodies’ legitimate right to set tax policy direction. Our public policy perspective means we endeavour to provide comment free from self-interest or sectoral bias.

Our submission

Our key concern about the discussion draft is that it does not define the mischief(s) accurately and that therefore there is a real risk of ‘overreach’ with some of the proposals.

The purpose of the proposals in the discussion draft is to update the treaty definition of permanent establishment (PE) to prevent abuses of the PE concept.

We accept that the current definition means a taxable presence can be avoided in some circumstances and that this is a cause for concern. We support the need to prevent abuses of the definition; however, we caution against making changes to the definition that are too broad in scope and may have a detrimental effect on the global economy or unfairly disadvantage smaller or emerging economies.

We suggest that the mischief or mischiefs need to be defined more narrowly so that more focused solutions can be developed. In the absence of narrower definitions of the mischief(s) the risk of the proposals ‘over reaching’ is high.
Commissionnaire arrangements

The rationale for the proposed reform of the rules relating to commissionnaire arrangements should be reconsidered. The focus should be on the misuse or potential misuse of these arrangements and not the arrangements themselves.

We note with concern the following statements in the discussion draft:

“It is clear that in many cases commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place.” (p6, and p11, paragraph 10).

“The Action Plan indicates that whilst actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, …” (p 10, paragraph 3).

In our view these statements suggest the analysis is starting from the wrong place, namely from assumptions that tax is the primary driver for the choice of business structures in overseas jurisdictions and that the ‘contra’ position is always non-taxation or taxation at ‘very low rates’.

In our view, these broad assumptions ignore the fact that many commissionnaire and similar arrangements are set up primarily for genuine commercial reasons. In our experience, many businesses use such structures to ensure that the tax payable in a jurisdiction is commensurate with the risks and rewards that relate to that jurisdiction. Their motivation is not to avoid tax.

The proposals in respect of commissionnaire arrangements are likely to be detrimental to businesses in smaller and emerging countries, as it will increase their costs of doing business, and should be reconsidered. If a commissionnaire arrangement is used for commercial reasons and allows an entity to establish and build its business in a cost-effective manner, there is no obvious mischief. There is a risk that the proposed reforms will remove the opportunity for businesses in smaller and emerging countries to expand overseas.

A fairer outcome would be achieved by applying a risk/reward analysis. The amount of income to be returned in the foreign jurisdiction should be commensurate with the risk and reward borne by the operation there. The proposals in the discussion draft do not refer to commercial risk and reward. In our view these are key considerations.

In this regard the draft appears to lack any consideration of the context of the PE rules.
We note that the PE article will retain the independent agent rule. If there is an independent agent, the “host” country accepts that its right to tax is limited to the margin that the independent agent makes from the sales commission activity. It does not seek to (and never has sought to) tax the profit that the “home” enterprise makes from the sale of the goods or services.

A commissionaire structure achieves the same tax result for an enterprise without the involvement of third parties. It does not in our view make economic sense to have a different result for effectively the same functions. The effect of the proposal would be to advantage independent agent structures, which will create additional business costs.

The Discussion Draft does not address this inefficiency. We assume this may be addressed in the Action 11 Economic Analysis Discussion Draft due late January 2015.

The proposal in option A (to replace the words “conclude contracts” with “engages with specific persons in a way that results in the conclusion of contracts”) will significantly extend the concept of a dependent agent and, in our view, risks significant overreach with potential application to marketing and promotional activity, which falls well short of what should be considered a dependent agent PE.

Absent the fragmentation of activities such that the existence of a PE is artificially avoided (which can be dealt with separately), in our view the more appropriate focus would be on ensuring the activities in a country are remunerated on an appropriate basis regardless of the structure or arrangements that are in place.

Other strategies

Our view of the other strategies canvassed in the discussion draft is as follows:

- **Artificial avoidance of PE status through the specific activity exemptions**

  We note with concern the reference to the “artificial avoidance of PE status”. In public statements the OECD has consistently stated that it is for Governments to change rules which do not have the desired effect. In our view, the proposed changes to the PE rules seem to be in that category, as they clarify and amend the PE rules, rather than being focused on BEPS. The use of “avoidance” in the discussion draft does not properly describe the effect of what is being proposed.

  The proposals will affect more than the potential BEPS examples quoted at, for example, paragraph 26. They will also change the taxing rights between high tax jurisdictions. The language used masks this result. This should not be of concern if the proposals are principled so that they result in a PE when a PE arises. However, the effect of the proposals lacks transparency.
If the proposed amendments are aimed only at BEPS concerns (i.e. at low or no taxation), the proposals do not achieve that objective.

Should the changes proposed in relation to the specific activity exemptions proceed, Option E (to subject all paragraphs to a “preparatory and auxiliary” condition) would seem the most appropriate.

- **Splitting up of contracts**

  We agree that there is a potential risk that these types of arrangements will be used to circumvent the PE rules. However, an automatic rule will mean that commercially driven contract splits (as in the commentary to option K, or if different subsidiaries contract because they employ the persons with the required expertise to deliver the project) are also proscribed.

  Our preferred approach is option L (general anti-abuse rule) as it is more targeted than the other options.

- **Insurance**

  In our view including insurance agency arrangements in a document labelled *Preventing the Artificial Avoidance of PE Status* is misleading and lacking in transparency. The proposals change the rules so that a PE arises when it does not currently without the need for artificiality or pretence.

  We note that New Zealand’s treaties generally exclude insurance from the business profits article so that domestic rules apply to tax such business sourced in New Zealand. It seems to us that this is a better route to taxing insurance for countries that wish to be able to do so in the absence of a PE under current PE rules.

- **Profit attribution and interaction with Action Points on Transfer Pricing**

  We note the concerns outlined at paragraph 43 and that the proposed changes would not be limited to low or no tax scenarios. They will also affect high tax “home” and “host” jurisdictions. It remains important that the expanded definition of a PE is adequately and properly dealt with in the OECD’s transfer pricing guidance so that the opportunity for disputes and double taxation is minimised.
We do not wish to speak in support of our comments at the public consultation meeting in Paris on 21 January 2015.

Yours sincerely

Peter Vial
Tax New Zealand Leader
Introduction

The Chartered Institute of Taxation (CIOT) is pleased to submit this response to the public discussion draft issued on 31 October 2014 by the OECD which looks at BEPS Action 7: preventing the artificial avoidance of PE status.

The CIOT supports the aims of the OECD to tackle artificial avoidance of PE status, but we are not convinced that changing the definition of what constitutes a PE in some of the ways suggested is the best approach.

Executive summary

Our principle concern with the proposals is that the downsides – being greatly increased administration costs for tax authorities, compliance costs for taxpayers and an increased number of disputes - may outweigh any benefits from the re-allocation of tax base to the State where the activities giving rise to ‘new’ PEs take place.

Inevitably there will be many more PEs, due to the proposed widening of the definition, and affected taxpayers will have to consider profit allocation and resulting reporting requirements. We envisage that in the majority of circumstances, the resulting PEs would either not be allocated a profit, or any allocation would be trivial. We think that additional guidance on profit attribution will be needed, as the existing guidance is focussed on financial services.

In relation to changes in the definition of dependent agent, which are aimed to tackle ‘abusive’ commissionaire structures, we would urge the Focus Group to consider including a monetary threshold for sales, below which a PE will not arise. We would support such a threshold and would suggest this be set at $1m. This is
discussed further in paragraph 4.6 below.

2.4 We hope that Governments will provide sufficient resource to ensure effective and efficient resolution of the greater number of disputes which will arise. We suggest that tax authorities consider providing rulings as to whether or not a PE will result prior to establishment of a business in their territory. We would welcome the offering by tax authorities of prior rulings, and suggest that such rulings would reduce the administrative burden for tax authorities in the long run.

2.5 We would like to suggest that the Focus Group gives further consideration to other aspects of the BEPS project before finally deciding on what recommendations to make in relation to Action 7. Action 6 aims at preventing treaty abuse. We suggest that the results of this Action, together with transfer pricing measures may be sufficient to address artificial avoidance of PE status.

2.6 Of the options suggested to tackle commissionaire arrangements, we regard Options B and D as likely to lead to the least ‘collateral damage’, particularly if a monetary threshold is incorporated into the test.

2.7 Option E, introducing a general requirement for activities to be of a preparatory and auxiliary nature would cause problems due to increased complexity and uncertainty. We suggest that the concerns might be better addressed by including a substantial human resources test to all activities.

2.8 We suggest that the issue addressed by Option F would be better tackled by creating a separate exclusion for the use of facilities solely for the purpose of delivery, or the maintenance of a stock of goods or merchandise belonging to the enterprise, subject to a proviso that the exclusion does not apply where the majority of the human or technical resources devoted by the enterprise to transactions involving the goods or merchandise are located in the relevant jurisdiction.

2.9 We are strongly opposed to Option H, which is that the exception for the maintenance of a fixed place of business for the purpose of collecting information be removed.

2.10 It is not clear to us why insurance activity has been singled out, and doing so appears to go beyond the scope of what was due to be considered under this BEPS action.

3 Scope of Action 7 and changes to PE definition

3.1 The CIOT supports the aims of the OECD to tackle artificial avoidance of PE status, but we are not convinced that changing the definition of what constitutes a PE in some of the ways suggested is the best approach to tackle the strategies resulting in the artificial avoidance of PE status that have been identified. This is because, although the changes, which widen the definition of a PE, may bring the targeted arrangements into charge, they will also, inevitably, bring in very large numbers of non-abusive situations. The proposals do not limit the changes to circumstances of artificial avoidance of PE status (excepting Option L in relation to splitting-up of contacts). Instead the proposals amend the meaning of PE generally, without distinguishing between cases that are artificial avoidance and those that are not.

3.2 The changes will greatly increase the compliance burden for a large number of taxpayers (including many which are not, in fact, being targeted by these
proposals). In the first instance the uncertainty generated by the proposed new rules would mean that it would be very hard for taxpayers to determine whether or not they have a PE. However, inevitably there will be many more PEs, due to the widening of the definition, and taxpayers will have to consider profit allocation and resulting reporting requirements. It is valid to question the extent of practical implications (in terms of tax allocation) as a result of the proposed changes. Is there a significant profit margin in most of the arrangements which will become PEs? We envisage that in the majority of circumstances, arrangements which would be treated as a PE under the amended rules as proposed would, using arm's length principles to calculate profit, either not be allocated a profit (indeed they could be loss making), or any allocation would be trivial. Thus there may be limited practical benefits as a result of amending the rules in the manner proposed in terms of allocation of profits to the ‘new’ PEs.

3.3 Our concerns with the proposals are compounded by the fact that the increased uncertainty regarding the application of the rules would result in more disputes between taxpayers and tax authorities. Although BEPS has its own Action to look at dispute resolution and to improve this, we do not think it is realistic to expect all tax authorities to have the ability and/or the resources to assess and understand each individual business well enough to be able to operate the proposed new rules correctly. An overarching consideration of the BEPS project (for the benefit of tax authorities and taxpayers) should be to minimise the likelihood of disputes involving competing tax rights of different jurisdictions due to the lack of quick and cost-effective dispute resolution procedures.

3.4 It is also essential to ensure that international trade is not inhibited by difficulties in applying tax treaties. The benefits arising from tax treaties in facilitating international trade and investment should not be forgotten; and facilitating international trade and investment should continue to be a fundamental aim of the work in this area. Nor should the fact that most taxpayers who claim benefits under treaties are not attempting to abuse the terms of those treaties be forgotten. We have significant concerns that the current proposals go wider than is necessary to counter the perceived artificial avoidance of PE status; whilst they may reduce avoidance they will, in practice, also severely impact on taxpayers carrying out their businesses in a non-abusive way. In particular, concerns of double taxation and excessive administration may deter companies from establishing small, exploratory presences in territories, especially if such territories are considered marginal. It is possible some countries may lose valuable inward investment if they implement these measures.

3.5 Thus our principle concern with the proposals is that the downsides – being greatly increased compliance costs for taxpayers, administration costs for tax authorities and increased disputes - will outweigh any benefits – being a re-allocation of tax base to the State where the sales and/or activities took place.

3.6 The role that tax authorities are able and prepared to play in addressing these concerns will be key to ensuring that any changes to the definition of PE are successfully implemented. It will be necessary for Governments to provide sufficient resource to ensure effective and efficient resolution of the disputes which will arise as a result of making the definition of what constitutes a PE wider and less clear. It may be preferable for tax authorities to consider providing rulings prior to establishment of a business in their territory. We would welcome the offering of such rulings and suggest that prior rulings would reduce the administrative burden for tax authorities in the long run.

3.7 The final section of the discussion draft discusses the BEPS work in relation to Action 4 (Limit base erosion via interest deductions and other financial payments),
8 (Intangibles) and Action 9 (Risks and capital) and recognises the importance of considering profit attribution. We agree with this approach and suggest that the Focus Group should go further in considering other aspects of the BEPS project before deciding on what recommendations to make in relation to Action 7. Action 6 aims at preventing treaty abuse. It is questionable whether any measures beyond those being considered as part of Action 6 are needed in addressing artificial avoidance of PE status.

3.8 The interaction with domestic law is also important. Some countries have a wide definition of PE and a treaty is helpful in identifying arrangements that are PEs under domestic law but can be excluded under the treaty. For example, although they used to be much wider, the UK now has treaty-like provisions in relation to PEs in its domestic code, so the treaty threshold is of less importance. Consideration should be given to the implications if the treaty wording changes; will countries change their domestic provisions? We suggest that the somewhat broad wording in treaties tends to be incorporated as more black and white wording in domestic law - which might become a significant issue moving forward.

3.9 We suggest that the proposals in the discussion draft would result in a shift of the tax base from residence to source countries. It has been stated that this is not an objective of the BEPS project but this would be an inevitable result of applying the proposed new rules whether or not there is actually BEPS.

3.10 For these reasons we would urge caution before proceeding with the proposed widening of the definition of what constitutes a PE.

**A Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies**

4 **Tackling commissionaire arrangements - general**

4.1 We suggest in this paragraph some other options to be considered that, in our view, would mitigate the concerns we have identified, whilst still dealing with the arrangements identified in the discussion draft. For the reasons set out in paragraph 3 above we are cautious about the proposed changes set out in Options A-D, which, we suggest, may cause more problems than they solve, however, the options are discussed in paragraph 5 below.

4.2 As a general point, each of the proposals significantly widens the definition of a PE and is inherently uncertain. This gives rise to two concerns which are interlinked and which exacerbate each other:

4.2.1 The widening of the definition of PE would mean there would be many more PEs; the uncertainty of the rules would mean it would be hard to determine whether or not they apply; the changes would impose a significant additional burden of proof on taxpayers which would be difficult to satisfy;

4.2.2 The uncertainty of the rules would lead to more disputes with tax authorities; this would place increased administration burdens on tax authorities and will test the capacity of tax authorities to deal with disputes; will tax authorities have the ability to understand businesses to a sufficient degree to apply the new rules correctly?

4.3 The current test in paragraph 5 of Article 5 of the OECD Model Tax Convention, which refers to ‘concluding contracts’ is clear and unambiguous. We appreciate that
such a ‘bright line’ test can lend itself to artificiality, because it is possible to have arrangements which get very close to, but do not quite meet the test. However, once there is a move away from a clear and unambiguous ‘bright line’ in the process of procuring, negotiating, concluding, conducting business, the test necessarily becomes less clear because it is seeking to determine ‘a point along a line’. Other than the conclusion of contracts, there is no logical or determinative place where that point should be. Thus the test becomes unclear and subjective as to where the point should be and, therefore, whether there is a PE.

4.4 The new tests would cause the strategies identified as being ones which are artificially avoiding PE status to have a PE. However, the new tests would also mean that many non-abusive arrangements and activities may give rise to a PE and tax authorities and taxpayers would have to grapple with the new rules. The result would be many more PEs, but PEs to which (probably) there is little or no profit attribution. We are not convinced that the perceived benefits of having a wider, less clear test to catch the artificial arrangements outweigh the downsides of the problems that the operation of such a new rule would cause in practice for many taxpayers at whom the rules are not targeted. The language of the proposed new tests is very uncertain and wide in its scope. It is bound to have unintended consequences.

4.5 In the event that changes are made to Article 5 which widen the definition of a ‘dependent agent’ PE, consideration should be given to possible amendments to Article 7 (Business profits) to ensure that a long tail of commercial/business profits potentially brought in as a result of there being a PE are, in fact, excluded; the aim would be to exclude innocent/non-abusive cases from the changes. To achieve any benefit in this regard it would be necessary to ensure that the changes to the two Articles worked together such that there is no requirement to file for a new PE if any profits are excluded, to minimise the compliance burden for taxpayers and the additional administration for tax authorities.

4.6 A possible approach to ensure that many small/trivial PEs are not created by these changes would be to introduce a monetary threshold for sales, below which a company having no physical presence in a territory would not create a PE. We would support such a threshold and would suggest a figure of $1m to cover sales from a company and any associated entities from outside the territory in which the PE might arise (territory A). Sales arising from PEs and associated entities within territory A would not count towards the threshold. This would allow for a situation in which a large group has a presence in a territory related to one business, but wished to set up in that country independently from another part of the business, but also ensures a group could not avoid creating a PE by supplying from multiple entities outside territory A, each entity falling just below the threshold.

4.7 The discussion draft highlights commissionaire arrangements as being a strategy for artificial avoidance of PE status. While no doubt there may be instances where this can be the case, we do not agree with the premise that commissionaires are, per se, avoidance. This question has been thoroughly examined by the highest courts of a number of European countries whose legal systems contain the commissionaire concept (French Conseil d'Etat (Supreme Administrative Court) in Société Zimmer Ltd v Ministre de l'Économie, des Finances et de l'Industrie; Norwegian Supreme Administrative Court in Dell Products(Europe) BV v Skatt Øst). The courts have systematically rejected the argument that such arrangements are necessarily an abuse. Similarly, in cases where abuse has not been argued, supreme courts have concluded that a commissionaire arrangement itself does not give rise to a permanent establishment (Italian Supreme Court in Boston Scientific v Italian Revenue Agency). The example given at paragraph 7 of
the discussion draft, is the Zimmer case.

4.8 We suggest that an alternative approach would be to deal specifically with those commissionaire arrangements that are diversionary in nature.

4.9 If the policy is that commissionaires ought to be treated in the same way as conventional agents, even though, as a matter of legal analysis they are not, then, a simple solution would be for States concluding treaties where the commissionaire is recognised in law, to include a provision that deems the commissionaire under the relevant law to be a person with authority to conclude contracts and within Article 5(5). That would meet the stated policy objective.

4.10 Before any such change is made, a careful comparative analysis of both agency and commissionaires should be undertaken to test whether the proposition that commissionaire ought to be treated in the same way as conventional agents is indeed sound as a matter of principle.

4.11 In this regard the discussion draft does not address the root cause of the issue that has arisen surrounding commissionaires. A company resident in a civil law country operating in another civil law country, both of which recognise a commissionaire, can do so without giving rise to a PE under domestic law of that second country; whereas the same arrangement of operating in a common law country (or a civil law country with a variant commercial law) will give rise to a PE. In the late 1980’s and early 1990’s it became apparent that this favoured groups operating from particular jurisdictions (for example, Switzerland and Netherlands). Some groups (for example, US parented multinationals operating in Europe) sought to gain the same treatment by changing the terms of business to mimic the commissionaire arrangement. Unless countries which have a commissionaire concept under their domestic law change that, the proposals will result in an international tax system where these countries have a competitive advantage again.

4.12 Another alternative would be to qualify Article 7 with a purpose/abuse test along the lines of ‘there will be a PE if taxpayer has sought to use the rule artificially to avoid having a PE’, to the extent that work of Action 6 (Preventing Treaty Abuse) would not result in this being the case.

4.13 A further point in relation to the widening of the definition of a PE is that tax authorities will have more information as to how businesses are structured and operate as a result ofCbC reporting. It is important to have clarity as to how the different BEPS actions will overlap. As a practical matter it is necessary to address what form PE information would take. Would a taxpayer have to submit a self-assessment of its PEs each year/regularly, with some specific supporting documentation, or would the tax authority be expected to conclude where PEs should be based on documentation submitted under Action 13? Without a practical methodology as to what is expected, taxpayers will find it very difficult to comply with the new rules and tax authorities will find the increased information being submitted to them very difficult to audit.

4.14 Consideration should also be given to the penalty implications for incorrect self-assessment regarding new rules. There should not be compliance penalties if, in fact, no tax is due even if it is determined there is a PE. Penalties should also reflect situations of best endeavour with an error, and errors as a result of deliberate abuse.

5 Tackling Commissionaire arrangements – Options A-D
5.1 As discussed above, we have concerns with all of the Options A-D because all introduce uncertainty and will be difficult to administer in practice. It is difficult to envisage that the benefits will outweigh the downsides. We would prefer an alternative approach as set out above or a monetary threshold for sales, below which a PE will not arise.

*Options B and D*

5.2 Of the options suggested, we regard Options B and D as likely to lead to the least ‘collateral damage’ in terms of bringing non-abusive situations into scope. In Option B the additional test of ‘concludes contracts or negotiates the material elements of contracts’ is the most objective test of those proposed, due to the reference to ‘material elements’. This Option is thus the ‘least worst’.

5.3 In regard to Option D we recognise that the ‘on the account ….. of’ formulation may be necessary to ensure that all commissionaire structures are included. If the ‘in the name of’ formulation is used (as in options A and B) the Civil Law commissionaire structure could be argued not to be caught as that structure traditionally involved a sale on a principal to principal basis by the original owner to an intermediary (the ‘commissionaire’) who also on-sold as principal to a purchaser. Accordingly, if it is necessary that all commissionaires must be covered, we would see that Option D would have to be used rather than Option B, even though it would create more uncertainty in non-abusive situations.

5.4 We suggest that it would be preferable, though, to use the expression ‘for the account of’, rather than ‘on the account of’. Whilst both expressions are possible, the former is probably less likely to lead to questions as to whether the transaction has to be recognised in commercial accounts and if so on what basis.

5.5 The test in Options B and D does, however, effectively eliminate the requirement that, in the case of negotiations, they should be binding on the enterprise. We suggest that this is not a very satisfactory place to draw the line between taxing business profits or not.

5.6 The ‘concludes’ element in Options B and D gives more certainty than the ‘results in conclusion’ formula in Options A and C as it is usually clear who concludes the contract. This avoids the uncertainty which would arise in determining causation created by ‘results in the conclusion of contracts’. However, the proposed test would make it difficult to grant a power of attorney to a local subsidiary purely for the execution of documents.

5.7 One of our objections to Options B and D is the concept of ‘material elements’. We suggest that there would have to be guidance in the Commentary around what ‘material elements’ means. For example, does it mean:

- all of the material aspects (so that it may be relatively simple to avoid a PE by arranging for one aspect to be negotiated outside the PE jurisdiction); or
- the majority of the material aspects (assuming that those aspects can in practice be separated out and counted); or
- the most material aspects (assuming these can be clearly identified and appropriately measured); or
- merely some of the material aspects?
These questions demonstrate what an inherently difficult concept ‘material elements’ is. It is a subjective concept that will be different for each business and, indeed, for each contract within that business. For larger contracts, negotiations often take place in more than one jurisdiction. For example, price may be negotiated from the US but the condition of the goods is inspected and relevant warranties are negotiated in the UK.

5.8 Thus these proposals will inevitably lead to increased uncertainty for tax administrations and taxpayers.

5.9 There will also need to be an explanation of what is meant by ‘negotiates’. Presumably the choice of word is intended to be wider than ‘agrees’ material terms of the relevant contract and would apply to the common situation where negotiation is carried on by the agent under a delegated authority to get to a position which is then recommended to the actual decision maker. For example, if the decision maker does not accept the recommendation and insists on a significant change in the deal, has the agent negotiated or failed to negotiate the material elements?

5.10 What would be the position of a person who makes introductions under Options B and D? *Prima facie* the actions of an introducer do not produce (or conclude) contracts, and if the contracts are to be made on standard terms of one of the parties or on the published terms of a trade body without substantial negotiation, would there be no PE?

5.11 For example, what is the position where a company has a subsidiary in the UK where the staff are engaged to explain its standard contractual terms and conditions and to discuss pricing only by reference to fixed rate sheets (ie they can only describe/explain, they cannot change or negotiate anything). The staff then refer (or introduce) the would-be customer to a non-UK affiliate which carries out its own procedures for forming the contract?

5.12 Is ‘habitually’ intended to refer to both limbs of Options B and D, so that the test is: ‘habitually concludes contracts or [habitually] negotiates the material elements etc’? Or is the test intended to be ‘habitually concludes contracts or negotiates [ , whether habitually or otherwise,] the material elements…’? The printed text suggests that the latter is intended although there is no obvious reason why this should be the case. We suggest that it should be made clear that ‘habitually’ applies to both limbs.

5.13 Whether Option B or D is chosen, such a change will increase the administration burden for tax authorities and the compliance burden for a large number of taxpayers who are not involved in *commissionaire* structures. Uncertainty generated by either test would mean that it would be very hard for taxpayers to determine whether or not they have a PE. Inevitably there will be many more PEs, due to the widening of the definition, and affected taxpayers will have to consider profit allocation and resulting reporting requirements. We envisage that in the majority of circumstances, arrangements which would be treated as a PE under the amended rules as proposed would either not be allocated a profit, or any allocation would be trivial. This is why, as suggested above, we suggest that if either Option B or Option D is adopted, there is a monetary threshold for sales, below which a PE will not arise and arrangements are put in place to ensure that a long tail of commercial/business profits potentially brought in as a result of there being a PE are, in fact, excluded.

Options A and C

5.14 We have strong reservations about the tests in Options A and C. The expression ‘*specific persons*’ is too vague to have any real meaning. Article 5(5) has always dealt with, and should continue to deal with, PE’s that arise by reason of contractual
relationships. This makes the parties identifiable.

5.15 Similarly, ‘habitually engages… in a way that results in the conclusion of contracts’ is too vague and would give rise to considerable uncertainty. For example, does it capture the situation where the agent is responsible for lots of contracts but rarely or never with the same persons or a situation where the agent is indifferent as to whether it contracts with the same person more than once? The test raises the possibility of engagement in relation to a contract with several persons in different countries; could this give rise to multiple PEs in relation to global contracts? (If there are multiple PEs in relation to the same contracts, there is no current tiebreaker provision).

5.16 The expression ‘results in the conclusion of contracts’ in Options A and C would also lead to disputes. Does it mean ‘is a necessary element in getting to contract’ (but for causation) or ‘is the immediate cause of the contract’? If the former is the case, then what is the position if the actions of the entity in the possible PE jurisdiction are necessary but not sufficient to produce a contract? What is the position if the activities are helpful but not strictly necessary as, for example, where a would-be customer talks to a sales desk and obtains information which is also available on a web-site? Again, this is a concept that would be very difficult to apply in practice. It would appear to mean that a taxpayer would be required to analyse each and every transaction/contract within its business. In theory a single transaction, representing 0.000001% of a group’s turnover, could create a PE. We suggest that this would be unworkable in practice and is not required to address the concerns raised.

5.17 In this regard, the language of the proposed Article 5(5) is wider than which appears to be intended from the explanation. Specifically, the explanation of Option A refers to interactions which ‘directly results in the in the conclusion of contracts.’

Article 5(6)

5.18 We suggest that the automatic exclusion of associated enterprises from Article 5(6) as independent agents would result in a proliferation of permanent establishments that runs contrary to the practical allocation of taxing jurisdiction. This concern would be more appropriately addressed under transfer pricing principles. Article 9 ought to address issues of associated enterprises. Proper application of the arm’s-length principle will therefore mean that there will be little profit, if any, for such PEs once the local agent has been properly remunerated, but such a change would result in considerable administrative cost.

5.19 Similarly, automatic exclusion from Article 5(6) as independent agents of persons who act exclusively or almost exclusively for one person will have an adverse impact, particularly on start-up agents. Any person setting up an agency will inevitably be a PE under the proposed language until they have sufficient work for other principals. This is likely to inhibit such activity, favouring established agents over start-ups and creating a significant barrier to entry.

5.20 We would like to request that the Focus Group looks again at these aspects of the proposed changes to Article 5(6).

5.21 That said, each Option offers a redrafted Article 5(6) which no longer contains a reference to a ‘general commission agent’. As it is often unclear what this term means in practice, this is a useful modernisation of the language. The reference to ‘brokers’ has also been removed. Again this is useful as the term often has different meanings in different contexts.
B Artificial avoidance of PE status through the specific activity exemptions

6 Option E – preparatory or auxiliary activities

6.1 In our view Option E would cause problems due to increased complexity and uncertainty.

6.2 The current structure and language of Article 5(4) suggests that the items in subparagraphs a) to d) are specific examples of matters which are assumed always to be preparatory or auxiliary even though they are not specifically stated as such.

6.3 However, Option E does not simply make the existing position explicit. Instead, it eliminates that certainty, by requiring all activities to be judged by reference to a general test as to whether the activity is 'preparatory or auxiliary'. Accordingly, any activity in each of the areas is to be judged by reference to the general test. Option E introduces the possibility for each category that the actions described will in some cases be preparatory or auxiliary but in other cases will not be. Clearly this would mean a considerable increase in uncertainty for those seeking to rely on the rules as the test would no longer be straightforward and would require a detailed investigation into the facts.

6.4 There is also no clearly articulated theory of what is meant by preparatory or auxiliary. In practice, it is generally possible to recognise when an activity is preparatory to an economic activity but deciding what is auxiliary can be very difficult. The fact that the items in subparagraphs a) to d) cannot be regarded as 'per se' preparatory or auxiliary removes the current benchmarks for comparing other activities falling within subparagraph e) or f).

6.5 Thus Option E would create boundary problems which will give rise to disputes with and between tax authorities. Disputes can be costly and time-consuming to resolve. This risks unfairness to smaller business (as compared to large multinationals) who may not be able to afford dispute resolution.

6.6 Since the activities in subparagraphs a) to d) are restricted to 'goods or merchandise', the language is somewhat outdated by changes in the nature of international trade. One way to re-draft Article 5(4) would be to retain the general principle only. However, we suggest a better approach would be to expand the category of specific activities that are thought to be preparatory or auxiliary to cover, for example, services, so as to give rise to a higher degree of certainty for the modern economy, rather than less certainty.

6.7 The discussion at paragraph 18 indicates that the proposal is being driven by specific very large multinational companies that have attracted publicity, rather than a comprehensive analysis of how the changes might impact on the full range of businesses undertaking activity cross-border. This concern could be addressed by including a substantial human resources test to all activities; ie if the activities require substantial human resources, they can be presumed to create a PE.

6.8 A key issue is determining what is 'auxiliary'. We suggest that the 'core of the business concept' could be used by considering where the majority of human resource is located, in order to achieve the sale of the goods. The language in VAT cases which considers this is helpful – if what a business has is mostly delivery people, because ordering is on the internet and being able to deliver is a key unique selling point, then the delivery aspect is at the core of the business.
6.9 It would be helpful to have an alignment, so far as possible, between a PE for direct tax purposes and a PE for indirect tax purposes. Disparity between the various tax rules can only lead to additional complexity and unintended consequences.

7 Option F – ‘delivery’

7.1 Option F proposes the deletion of delivery from subparagraphs a) and b). It is not clear whether the intended effect of this would be that delivery would in future never come within the specific activity exemption or whether it is envisaged that it might still come within subparagraph e), if it could be shown to be preparatory or auxiliary.

7.2 The difficulty with relying on the subparagraph e) exclusion in relation to delivery for a seller of goods is that in a sale of goods, delivery is normally a core activity and it is difficult to characterise it as ‘auxiliary’ to the sale (and even harder to say that it is ‘preparatory’). This means that the Option F approach is likely to harm businesses which had not been abusing the rules by causing them to have small scale PEs in jurisdictions where they hold stock and having the compliance burdens that accompany PE calculations.

7.3 It would be better to tackle abuse of the ‘delivery’ exclusion by creating a separate exclusion for the use of facilities solely for the purpose of delivery, or the maintenance of a stock of goods or merchandise belonging to the enterprise subject to a proviso that the exclusion does not apply where the majority of the human or technical resources devoted by the enterprise to transactions involving the goods or merchandise are located in the relevant jurisdiction. This should be reasonably targeted on the abusive behaviours which have been the subject of press comment. For EU jurisdictions, this would also have the benefit of aligning more closely the direct tax test for permanent establishments with the VAT test for fixed establishments.

7.4 The discussion at paragraph 19 of the discussion draft reveals that the exclusion of the delivery is likely to give rise to increased compliance and administrative cost without revenue yield. That suggests that the current PE threshold in this regard is set at the correct level.

8 Options G and H – purchasing goods or merchandise or collecting information

8.1 As with Option F, there is a real possibility that Options G and H would adversely affect businesses which have not been abusing the rules. Assuming that Option E is not adopted (and as argued above, it would be better if it were not), a human resources proviso similar to that suggested for delivery above could be used.

8.2 The examples at paragraph 26 are unpersuasive: Example 1: From the perspective of state S, the purchasing could easily be undertaken outside of state S. The impact on tax paid in state S would be identical. From an economic point of view, such activity could migrate elsewhere, simply resulting in closure of the purchasing office. This does not seem to be a desirable outcome.

Example 2: this is entirely dependent on the particular case where Sco is resident in a low tax jurisdiction. It is inapt to design a rule for trade generally on that basis. The example at paragraph 28 on collection of information is unpersuasive. Disguised
activity is typically addressed in tax systems, such as the UK, by general legal principles such as sham or viewing transactions realistically. There is no need to change the rule for such behaviour.

8.3 We are strongly opposed to Option H, which is that the exception for the maintenance of a fixed place of business for the purpose of collecting information be removed.

8.4 Data collection itself, however massive, is generally useless. Data itself has no intrinsic value. Value is created by properly analysing data, and knowing what data to throw away. This analysis will be done by people or, possibly, in part by people and in part by algorithms designed by people. The crucial question is thus where the significant people functions’ analysing the data or creating the analysis tools exist.

8.5 There may be cases where the collection of information is a core function of the enterprise, when it may be appropriate to regard the activity as more than preparatory or auxiliary. However, the more common case will be that the collection of information really is of a preparatory or auxiliary nature.

8.6 An example of an information value change would be an enterprise contracting and selling to customers only from its country of residence. It collects information from businesses throughout the world through local representatives to provide databases to companies in that particular business sector. Companies provide their information free of charge. It is not possible to specifically value particular data. Companies volunteer their information so the enterprise cannot control how much information is provided or from where. It carries out quality control and other functions only in the residence country. There is no practical way of attributing value to the provision of particular information from the various ‘source’ countries.

8.7 We therefore conclude that, the exception for the provision of information should not be deleted.

9 Options I and J – fragmentation of activities between related parties

9.1 The discussion draft sets out two proposals, both of which take into account the activities of associated enterprises at the same place (or different places). Where there has been artificial fragmentation of activities in order to bring an enterprise within the preparatory or auxiliary exclusion there may be a case for doing so. However, in cases where the fragmentation reflects a genuine commercial arrangement, where, for example, activities have been divided between legal entities in order to focus the business or to manage risk from a commercial perspective, it would not be appropriate to act in a way which, essentially, pierces the corporate veil.

9.2 In order to ensure the rule is genuinely aimed at anti-fragmentation, it should require both that the fixed places of business and associated enterprises (a) act together and (b) do so such that their combined activities are not preparatory or auxiliary. We suggest that the concept of ‘cohesive business operation’ is too vague and general; the concept is likely to give rise to disputes. Similarly, ‘complementary functions’ is insufficiently precise to achieve the intended purpose without unintended consequences: that is a proliferation of small PEs which give rise to a substantial compliance burden for taxpayers and an administrative burden for tax authorities.

9.3 We do not have any strong views as to which is the least bad option.
10  **Artificial avoidance of PE status through the specific activity exemptions**

10.1 Again, any widening of the definition of the PE should be coupled with considering the business profits Article to see if innocent profits can be carved back out to avoid explosion of additional PEs which have to file, but with no tax impact. This could also be supported by a monetary threshold for sales, below which no PE would arise.

11  **Splitting up of contracts – Options K and L**

11.1 We do not have any strong views as to which is the least bad option.

11.2 The principal purpose test in Option L has the advantage of ensuring that in cases where contracts are separate for wholly commercial purposes the enterprise is not inappropriately deprived of the benefit of the ‘preparatory or auxiliary’ test. The treaty should allow for cases where there are genuinely separate contracts either for particular commercial reasons or as a result of the history of the business.

11.3 However, in other aspects Option K is preferable as Option L involves ‘having regard to all relevant facts and circumstances’. In the example consideration must be given to the reasonable conclusion ‘in the absence of other facts and circumstances’. It is inconceivable that other facts and circumstances will not be present in a contract of any significant size and so Option L is likely to result in more disputes between taxpayers and tax authorities. As commented previously, in any situation involving competing tax rights of different jurisdictions, the lack of quick and cost-effective dispute resolution procedures makes it important to minimise the likelihood of disputes.

12  **Insurance**

12.1 The discussion draft includes an insurance specific proposal that there should be a PE where premiums are collected by a dependent agent. In this context it is understood that a dependent agent will be a third party agent who acts exclusively (or almost exclusively) for an insurer. In a similar way, and in addition to the non-insurance specific proposals in (A-D), this amendment would cause a disproportionate compliance burden to be placed on insurers as, we understand, potentially hundreds of tax PEs would be created with no or minimal profit being attributed to them and where there would be no regulatory PE.

12.2 Furthermore, since the income of the insurer is already subject to tax in its home country any attempt to attribute profit to a local PE, in addition to the arm’s length fee paid to the third party agent, would result in double taxation unless the home state was prepared to offer relief.

12.3 It is not at all clear to us why insurance activity has been singled out, and doing so appears to go beyond the scope of what was due to be considered under this Action. The discussion draft does not contain any explanation as to the perceived mischief arising in relation to PEs within insurance groups; as a result it is difficult to respond with clarity as to how any such mischief may best be addressed. As the issues to be addressed in Action 9 (Risks and Capital) are targeted at insurance groups and other
financial services groups in particular, we suggest that any perceived mischief be clarified and addressed under Action 9 rather than having an additional set of rules applying to insurance groups under Action 7.

13 Profit attribution to PEs and interaction with Action Points on Transfer Pricing

13.1 As mentioned above, we think there are other relevant BEPS actions; in particular treaty abuse which will also assist in this area. We agree that the attribution of profits should be a key consideration in determining which changes should be made to the definition of PE.

In our view, additions are needed to the existing guidance on profit attribution, since virtually all the guidance is focussed on financial services. The changes proposed to the PE rules are mainly directed at other types of business activity. An inevitable need from reducing the threshold for recognising a PE is that there will need to be guidance on how to attribute profit – especially in more borderline scenarios.

13.2 As noted above, we would urge caution before making changes to the PE definition which would bring into scope many PE’s which would have a modest profit attribution. The principles of profit attribution should thus be kept in mind when considering any changes to the PE definitions.

14 The Chartered Institute of Taxation

14.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

The Chartered Institute of Taxation
9 January 2015
Dear Ms. De Ruiter,

As invited please find below my comments on the discussion draft on Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Action Plan.

If you have any questions, I would be please to respond.

Kind regards,

Claudine R. Kraus
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1. Article 5 is generally well designed. There are some wording adjustments to make but overall the principles set by Article 5 are clear and smart. To clarify Article 5, the following three blocks of possible changes may be explored:

   1.1. Business Restructurings. Many readers focus on the wording of article 5 sometimes overlooking the underlying principles.

   1.2. Technology and business changes. Some business changes -occurred over the last couple of decades- are difficult to fit in Article 5.

   1.3. Methodology to test and document the PE analysis. The Commentary should provide practical insights on how to perform a PE study, in terms of working steps and documentation of process and results.

These proposed changes are explained below.
2. **Business restructuring & principal structures.** Rather than “commissionaire\(^1\) or similar structures” Action 7 should more properly focus on principal structures and business restructurings\(^2\). Principal structures reflect the trend of MNCs to centralize the control of the value chain in one or few hubs (i.e., principal or principals, which may be –for instance– organized by region or division). This trend is generally not a tax driven episode, but often a change to survive in business. Where a MNC implements a principal structure for tax reason, yes, it cannot be tolerated. But this formalistic approach to structuring is something of the past (at least in the developed countries). Already when the OECD issued the report on business restructurings, many of these conversions were truly business driven. Today, particularly after the 2008 economic crisis, this change is practically a surviving necessity.\(^3\)

Action 7 should therefore focus on tax driven business restructuring, completing the work started with Article 9 on business restructuring. Principals with no substance or conversions with no economic change should be targeted by both Article 9 and Article 5 of the treaty, depending on the type of problem. If a principal has no substance because its activities are actually performed in the source country, a PE problem is likely to exist. Similarly, a change in the legal structure of the group (e.g., split of a single fully-fledge entity into a contract manufactures and a commissioner) with no actual change in the company’s way of doing business should also be targeted under Article 5 (e.g., not acceptable a conversion where all reporting and decisions are still localized (post-conversion), and the principal has no real role in decisions related to core processes driving the value chain).

But let’s focus on three core problems of principal structures and business restructurings, as it relates to Article 5:

2.1. Post-restructuring, the foreign principal may still carry on its business in the source country directly. This may happen through the use of its own employees or, most likely, employees of the local entity.

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\(^1\) These types of structures were initially used mostly for US tax planning purposes. Under US Subpart F rules, sales from a Swiss principal were not subject to Subpart F pick up because they were legally made directly to third parties (the sale to the local commissioner was not relevant for US tax purposes). After the check-the-box rules were implemented in late 90’s this difference became irrelevant, with other forms of agreements becoming common, e.g. limited risk distributors or alike. To this extent, all the discussion of common or civil law commissioner is a false problem.

\(^2\) Reference to commissioner structures is misleading, inappropriate and limitative. This will cause a massive and unjustified round of tax audits on a number of MNCs operating with similar structures. If the conversion is real, the functional profile of the entities is reduced and the profitability must be reduced accordingly. If this is not accepted by the OECD, article 9 – rather than article 5 – should be changed. If the conversion is not real, Article 5 should be used to challenge the transaction, together with article 9 for specific TP matters. This should clarified in Action 7.

acting like dependent agents\textsuperscript{4} of the principal. In this case, the restructuring failed in re-designing the operational/HR structure of the local entities vis-à-vis the principal. These situations may possibly result in a physical PE; however, most of the times, this PE is unlikely to be highly profitable (unlikely to be a high value added service).

2.2. \textbf{The critical decisions for the overall business remain in the source country} (i.e., no real change in the decisional processes and hierarchal/reporting lines). A simple example (but not too far from many real cases, particularly in the mid-90’s conversions): a company is acquired and split into three separate entities, each performing one function for the new Swiss principal (Manufacturing, Distribution and contract R&D). To be respected also for Article 5, these functions would not only need to be formally split (separate contracts and separate entities) but they would also need to work in an operationally-separate fashion, from a reporting and decisional process perspective. If not, the principal would likely have a PE in Italy\textsuperscript{5}. Critical decisions related to the business of the three separate entities (and contracts) should actually be made in Switzerland. This segregation should not be recognized in case (i) The critical business decisions (assigned by contract generally to the principal) are still actually taken by managers resident in the source country (like pre-conversion) or (ii) There is –in facts– a local person (e.g., the former local group CEO or its team) coordinating the entire local business regardless its intended separate legal and contractual structure. In these cases, a PE is likely to result based on one of the following arguments: (i) the aggregation of activities is unlikely to pass the preparatory and auxiliary test, (ii) the principal would be carry on its business through the local managers (actually exercising powers which are naturally of the principal) or (iii) there is an agency PE caused by these individuals deciding on behalf of the foreign entity.

\textsuperscript{4}In this context, “dependent agent” is to be interpreted broadly (not the same concept as paragraph 5/6 of Article 5. It is the concept of para. 10 of the Commentary on article 5: “This personnel includes employees and other persons receiving instructions from the enterprises”. For instance, individuals working as private consultants are likely to be treated like employees, unless acting genuinely as independent contractors (independence also in terms of how-to-instructions, working time and reporting). Similarly, employees of the local distributor, agent or commissionaire may be treated as dependent agents for this test if they act as if they had a direct employer-employee relationship with directly with the principals (e.g., compensation decided by the principal is a strong indicator of a problem for article 5).

\textsuperscript{5}Note that in most non-FS cases, article 5/7 and article 9 are likely to provide very similar results in terms of taxable return in the local jurisdiction, as long as the three functions are tested for TP purposes as three separate transactions with the entity in the local jurisdiction as the tested party in the transaction. In this case both article 7 and 9 would leave the residual profit to the principal. Article 5/7 would have its greatest effect in cases of contentions of agency PEs. Personal PEs are linked to the decisions of individuals. Similarly, article 7 allocates most of the income to locations where the decisions are taken (SPF test). In case of an agency PE, a large tax adjustment is likely to happen.
2.3. **Someone (still) negotiates on behalf of the principal in the local country.** Most commonly a principal selling through disclosed agents is likely to have a PE in the source country. A disclosed agent should not result in a PE only to the extent that it carries on only limited and initial negotiations, which is actually difficult in practice to apply or monitor. When sales are substantially concluded in the source country, the principal acting through a disclosed agent would very likely have a PE.

On the principal with commissionaire, consideration should be given to clarify, once for all, the “authority to conclude” discussion re: common law vs civil law reading of commissionaire and para. 32.1 of the Commentary. The discussion is confusing to most and, from a practical perspective, it is unlikely to have a material impact on BEPS behaviors. This technical discussion does not play any appreciable role in structuring a principal structure, although it may certainly be used as a defense strategy in case of problems. Very similar tax results can be achieved through commissionaire, limited risk distributor, instant buy-sell or more generally any undisclosed agency relationship with a limited risk profile. For that matters, a principal with a branch performing limited distribution functions is likely to require a profit allocation close to the one of a principal with commissionaire or limited-risk distributor, so again all this discussion is likely to consume energies rather than solving BEPS problems.

But what is the solution to this problem? not sure, but one option could be to simplify and clarify the agency PE rules, possibly by inserting a treaty definition of “disclosed agent” or “undisclosed agent”.

Disclosed agent may cause the foreign principal to have a PE in the source country. Undisclosed agents would instead be subject to Article 9 adjustments in cases of model inconsistencies (which may also be using a negotiation authority going beyond the purported limited role). Article 5 makes a lot of sense when applied to a disclosed agency arrangement. In this case, the foreign principal generally takes the view that most of the distribution income should be allocated to

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6 Action 7 proposes a more stringent independency requirement. This change is clearly unfair to groups as it tends to put on a different level companies with exactly the same functional profile or activities. Again, this will cause a peak in tax audits with the attempt to claim more profits also for companies/agents which are clearly acting independently from their parent. The real impact (article 9 vs article 7) would also be limited.

7 The recent article from John F. Avery Jones and Jürgen Lüdicke on “The Origins of Article 5(5) and 5(6) of the OECD Model” (World Tax Journal, October 2014) is a great example of how ridiculous this problem has been over the last decades. In structuring their operations, MNCs give no real weight to this point, leaving much of this discussion to the academic world and hoping to have an additional formalistic defense argument in case of dispute.

8 This solution follows the idea that there is little additional income to be allocated to a PE in case the agent is well remunerated. This is certainly a questionable theoretical questions, extensively discussed by the OECD in various occasions. However, in a non-audit context, the profitability of a light-distribution-branch and a limited risk distributor/commissionaire are going to be very similar, if not identical in most cases. In an audit-context, experience indicates that in the vast majority of the cases, a settlement is reached through the adjustment in the profitability of the commissioner/distributor rather than the recognition of a PE.
the principal location. However, where a PE is created, the application of Article 5/7 would cause the foreign entity to significantly increase its taxable share of income in the source country (significant people functions likely to be in the source country – contra the starting assumption that the principal owns the client and the sale).

According to these considerations, the debate would be minimal where a PE were to exist in the following two cases:

(i) A source-country-resident disclosed-agent negotiates the main terms locally (signing irrelevant).
(ii) A non-source-country-resident undisclosed agent negotiates the main terms locally (signing irrelevant).

For a source-country-resident undisclosed agent, article 9 should apply exclusively. If it exercises any activity (i.e., authority) in excess of its declared functional profile, this extra-amount should be collected through a TP adjustment on its profitability (more complex functional profile) rather than a PE challenge. A different interpretation would likely result in an unjustified differentiation between a commissaire or a limited-risk-distributor. In a TP world, this difference is somewhat limited. In an article 7 environment, this different is also very limited, if any (mostly looking at where the distribution function is performed and, to some extent, who is managing the inventory risk).

3. **Technology and business changes.** In many cases, article 5 is read thinking to the past. Two simple examples to fix:

3.1. **Procurement structures.** Procurement activities in most large groups have taken a key role in the value chain. The exception under para. 4 of Article 4 fixed place solely for the purpose of purchasing goods or merchandise leads many to conclude that a procurement office is not problematic under Article 5. This is far from be true, particularly when the procurement office is a modern high-value adding function, managing billion of spending for multiple group entities.

3.2. **High-Frequency-Trading.** A place where a server is located may result in a PE under certain circumstances. In HFT, the geographical location of the server is a key component in the trading strategy, as the “physical” distance from the exchange may save microseconds in the trade, which in turn may be necessary to be faster than competitors and be profitable. In modern times, Article 5 should be read as to include “distance” of a location in the auxiliary/ancillary test when this factor makes the place unique. This is simply an example to say that Article 5 needs to be read flexibly, taking into account changes in technology and businesses. To this extent, para. 4 of Article 5 may be a limitation to be possibly removed.

4. **Methodology & documentation.** Article 5 is somewhat mathematical and a lot of subjectivity can be taken out from the equation with the right analysis. For Article 9, and to some extent for Article 7, there is an
entire set of guidelines to illustrate how to apply and document the analysis (TP or branch allocation). Article 5 has no such benefit. The OECD should start contemplating the idea of putting together a set of guidelines to help MNCs to properly perform the tests of Article 5 and document its outcome. In addition to TP-type content, the analysis should include:

4.1. The analysis of the value chain of the foreign person.

4.2. The list of the core processes associated to the activities of the foreign person.

4.3. The core processes should be mapped (i.e., documented). Mapping of business processes is a very common activity for MNCs. However, for purposes of Article 5, the map should indicate (for each core process), who takes the decisions in the organization and where this person is (or should be) sitting. As a matter of fact, a physical PE test requires a clear understanding of what activities have to be performed (by the Principal and the local companies) and where they are performed. The agency PE test requires a clear understanding of who decides, what and where. Decisional process mapping will greatly help MNCs and tax administrations to find a common understanding of the tax.
Preventing the Artificial Avoidance of PE status – Concerns and Recommendations

A REPRESENTATION
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BEPS: Action 7 – Preventing the Artificial Avoidance of PE status – Concerns and Recommendations

Background

On 31 October 2014 the Organization for Economic Co-operation and Development (‘OECD’), as part of its work on the Action Plan to address Base Erosion and Profit Shifting (‘BEPS’), released a Discussion Draft (Action Item 7) in relation to preventing artificial avoidance of permanent establishment status. This Action is focused on the need to amend/update the OECD tax treaty definition of permanent establishment (‘PE’) (Article 5 in the OECD model treaty) in order to prevent the artificial avoidance of PE status in any jurisdiction.

The amendments proposed include change in the current rules governing dependent agent, specifically with respect to the current treatment of commissionaire and similar arrangements. It is also proposed in the Discussion Draft to amend the list of exceptions for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, and purchasing) under which a fixed place of business is treated as not creating a PE. The OECD is also considering proposals to deal with the splitting up of contracts between related parties in relation to the time period for creating installation/construction PE and insurance business being carried out in various countries.

We recognize the efforts of OECD towards changing the definition of taxable presence / PE to address the tax leakages. However, in view of the existing Indian tax system and the legal and economic environment in India, we foresee certain practical challenges with regard to the cross border transactions and implementation. Accordingly, we wish to bring to notice the concerns and recommendations for your kind consideration.

Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The major concern on this ground is that foreign enterprises make sales in various geographies without creating a PE in any of these jurisdictions. The Discussion Draft proposes to watertight the definition of dependent agent PE by putting forth four alternatives which are provided below:

A. Adding a reference to contracts for the provision of property or services by the foreign entity where the intermediary ‘engages with specific persons in a way that results in the conclusions of contracts’.

B. Adding a reference to contracts for the provision of property or services by the foreign entity where the intermediary ‘concludes contracts, or negotiates the material elements of contracts’.
C. Replacing the phrase ‘contracts in the name of the enterprise’ by ‘contracts which, by virtue of legal relationship between the person and the enterprise, are on the account and risk of the enterprise’ where the intermediary ‘engages with specific persons in a way that results in the conclusions of contracts’.

D. Proposals to focus on contracts which, by virtue of the legal relationship between the person and the foreign enterprise, ‘are on the account and risk of the enterprise’ where the intermediary ‘concludes contracts, or negotiates the material elements of contracts’.

In addition, the OECD proposes to strengthen the requirements for an agent to be considered ‘independent’ so as not to create a PE of a foreign entity. The exemption would only apply where the agent is acting on behalf of ‘various persons’ and not acting ‘exclusively or almost exclusively on behalf of one enterprise or associated enterprises’ to be considered an independent agent.

Concerns

(a) The Discussion Draft provides that negotiation of material elements of contract would create a PE. This seems to open the doors for subjective interpretation since interpreting as to what material elements of a contract are different from industry to industry. The controversy regarding what constitutes material elements that remains at present would continue to exist.

(b) Further, it is not clear, if a person who merely attends/participates in a negotiation meeting would lead to creation of a PE? The OECD commentary on Article 5 provides clarification on this aspect (para 33). As per the OECD commentary:

“the mere fact, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.”

However, India reserves its right and is of the view that under certain circumstances, a person attending/participating in negotiations could lead to conclusion of the contract in the name of the foreign entity. Therefore, clarity on this aspect would be required to remove any ambiguity.

(c) The Discussion Draft proposes that a person would be considered as an independent agent provided such agent should not be acting exclusively or almost exclusively on behalf of one enterprise or associated enterprises. The term “almost exclusively” seems to be vague and open for varied interpretation.
Recommendations

(a) The Group may consider providing guidelines/parameters as to what constitute material elements of the contract. It may consider providing a list of monetary (like contract value) or non-monetary (like duration of the contract) parameters that are vital for negotiation of a contract. Such parameters should however vary from industry to industry.

(b) Clarity should be given in the guidelines whether mere attending/participating in a negotiation meeting leads to conclusion of contract.

(c) It is suggested to provide a broad threshold that could be relevant to determine the meaning of “almost exclusively”. For instance -either a percentage of the total revenue (like 90%) earned by the agent or the percentage of his total time spent (like 90%) for the foreign entity could be relevant to determine the meaning of almost exclusively.

Artificial avoidance of PE status through specific activity exemptions

The Discussion Draft proposes changes in the list of exceptions in case of fixed place of business (paragraph 4 of Article 5 of the model treaty). This is a proposal to counter artificial structuring of activities so to fall within the ‘preparatory or auxiliary’ exemption. It suggests following alternatives:

E. Amend Article 5(4) so that not only clause (e) but also all other clauses should become subject to the condition of ‘preparatory or auxiliary character’.

F. An alternative proposal if E is not adopted would be to remove ‘delivery’ from the specific activity exemptions.

G. A further proposal if E is not adopted would be to remove ‘purchasing goods or merchandising’ from being a specific activity for exemption.

H. An alternative to proposal G if proposal E is not adopted would be to remove ‘purchasing goods or merchandising’ and ‘collecting information’ from being specific activities for exemption.

Further, the Discussion Draft counters situations where activities are ‘fragmented’ between related parties to fulfill the requirements for activities to be preparatory or auxiliary. The alternative proposals suggested are:

I. Under this proposal, the specific activity exemption would not apply where ‘the same enterprise or an associated enterprise’ carries on business activities (at the same place or at different place in same jurisdiction) and one of the enterprises has a PE and the business activities constitute complementary functions that are part of a cohesive business operation.
J. Under this proposal, the specific activity exemptions would not apply where the ‘overall activity resulting from combination of the activities is not of a preparatory or auxiliary character’, where the activities constitute ‘complementary functions that are part of a cohesive business operation’. Under this option, there is no need for one or other enterprise to have a PE.

**Concerns**

(a) Option E of the Discussion Draft subjects all the exceptions in paragraph 4 of Article 5 to the preparatory or auxiliary qualification. It means that all the specified activities from clause (a) to (e) should be ‘preparatory or auxiliary’ in nature to qualify for exemption from the definition of a PE. This would unsettle the settled position so far in relation to exemption availed earlier. Following concerns also arise in this regard –

- Whether occasional purchase or delivery would qualify as preparatory or auxiliary.
- What should be the frequency of such specified activities i.e. twice in a quarter or a year, or 6 months in a year to be considered as preparatory or auxiliary?
- What would be the fate of liaison offices which are primarily formed for the purpose of collecting information? Would the activities carried out by a liaison office continue to remain as preparatory or auxiliary in nature?
- What nature of information collection would be considered as preparatory or auxiliary etc.?

(b) Further, Discussion Draft suggests that in the event option E is not adopted then ‘collecting information’ should be removed from specific exemption. Deleting ‘collecting information’ would lead to creation of PE, even when minimal activities leading to business are undertaken in the source country ignoring other key factors viz. ability of making decisions, core functions of the business etc. which may reside outside the source country.

**Recommendations**

(a) Principles/ guidelines should be provided to explain/describe as to when the specified activities would not be considered as preparatory and auxiliary. The Group may consider incorporating a threshold limit after which the specified activities would fall outside the ambit of preparatory or auxiliary

(b) Removing ‘collecting information’ from the list of specified exemption may not be a worthwhile option rather guidelines should be provided to determine as to when ‘collecting information’ and what ‘nature of information’ may be considered as creating a PE exposure.
Splitting-up of construction contracts

The OECD is considering proposals to deal with the splitting up of contracts between related parties in relation to the specific 12-month time period for creating permanent establishments for building sites, construction or installation projects (paragraph 3 of Article 5 of the model treaty) (and also non-OECD model services PE articles for countries that have adopted them). The proposals put forward are as follows:

K. For the purposes of determining the 12-month period, activities carried on by associated enterprises will be added to the period of time of an enterprise’s activities on site.

L. As an alternative to the specific rule proposed in K, the principal purpose test proposed in relation to preventing treaty abuse under Action 6 of the BEPS Action Plan could be used to address splitting up of contracts. An example would be added to the Commentary on Article 5 of the model treaty to illustrate this.

Concerns

The proposals for countering fragmentation/splitting-up are likely to disregard the idea/concept of setting up a local subsidiary in the source country. In other words, the concept of separate legal entity seems to be undermined by bringing the aggregation principle. The entity in source country would pay taxes on the income earned. Aggregation of the time may lead to double taxation of profit unless the attributions rules are tightened to counter this situation.

Recommendations

(a) The Group may consider adding a minimum threshold before such aggregation could be applied.

(b) Considering the ramifications of option K, option L seems to be a better option. The Group should consider option L so as to protect genuine cases wherein the splitting-up would have been imperative/call of the business requirement.

General Comments

(a) All business have gone digital in some way or the other. Even the brick and mortar businesses are digital. The traditional businesses also have significant IPRs structured in low/no tax jurisdictions. Since Discussion Draft provides guidelines on the change in the definition of PE status, the alignment of Action 1 on digital economy should be done with Action 7.
(b) The Discussion Draft comments that the preliminary work by the OECD to date has not identified substantial changes that would need to be made in relation to the attribution of profits to a PE (although some additions and/or clarifications would be useful). The attribution of profits is complex and a major area of concern to taxpayers. These principles should be updated and made robust, if the revised PE concepts have to made effective.

It is proposed that watertight mechanism of attribution of profits in all the above scenarios should be brought in place because it is ultimately the principles/guidelines of attribution on the basis of activities undertaken and risks subsumed that would determine the tax leakage or otherwise from a source country.
The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme of 'Accelerating Growth, Creating Employment' for 2014-15 aims to strengthen a growth process that meets the aspirations of today's India. During the year, CII will specially focus on economic growth, education, skill development, manufacturing, investments, ease of doing business, export competitiveness, legal and regulatory architecture, labour law reforms and entrepreneurship as growth enablers.

With 64 offices, including 9 Centres of Excellence, in India, and 7 overseas offices in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

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Dear Marlies,

The Confederation of Swedish Enterprise is Sweden’s largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft regarding the prevention of artificial avoidance of PE status (hereinafter referred to as the Draft).

The Confederation of Swedish Enterprise acknowledges the fact that this area constitutes a challenge from a BEPS perspective. However, in our view, the current draft does not sufficiently distinguish between BEPS and the allocation of taxing rights between the source state and the residence state. Under the mandate of the BEPS-project, any new standards should in our view be limited to addressing only the former topic. Where a taxpayer is appropriately taxed in the state of residence, it is typically not a matter of BEPS but one of “splitting the cake”. Even though there is a strive within the project to better align taxation to value creation, this should in our view only be done within the framework of BEPS. This needs to be better reflected in the document and in the proposed actions.

We are concerned that the proposals in the Draft will result in a lowering of the PE threshold that goes far beyond the specific problems related to BEPS in general and the digital economy in particular. PE issues often result in double taxation and all efforts to provide additional clarity to the OECD Model Tax Convention are naturally
of interest to business. Unfortunately, we believe that the proposals are likely to induce additional ambiguity into an already complex area resulting in a dramatic increase in PEs with allocation disputes and double taxation as the end result.

Although companies face many challenges in relation to PE issues, the list in Article 5.4 still mitigates administrative costs and facilitates the determination of when a PE is at hand. Compliance costs in relation to a PEs are significant and increased uncertainty in this area is likely to have a negative impact on cross border trade and investment.

In addition, and as acknowledged in the UN Model, some of the activities may generate little income and due to divergent treaty application, lead to prolonged litigation regarding how much income should be attributed to the PE.

A. Artificial avoidance of PE status through commissioneer arrangements and similar strategies

The Draft proposes the following four alternatives to address abuse in relation to commissioneer structures and similar arrangements:

A. (Para 5.5): Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”;

(Para 5.6): strengthen the requirement of “independence”

B. (Para 5.5): Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”;

(Para 5.6): strengthen the requirement of “independence”

C. (Para 5.5): Replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”;

(Para 5.6): strengthen the requirement of “independence”

D. (Para 5.5): Replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”;

(Para 5.6): strengthen the requirement of “independence”

As a starting point it is essential that any initiative to counter abusive cases is targeted and provides clear guidance so as to avoid application also in relation to non-abusive cases or cases involving allocation of taxing rights rather than BEPS. In general, tests based on objectivity provide far more certainty and predictability than
those based on subjectivity. Regrettably, a common feature of all four proposals seems to be that they all add additional subjectivity into the PE test.

All four proposals entail a more restrictive interpretation of the independent agent concept by basically disqualifying the use of associated enterprises in commissionaire arrangements and also by removing the possibility to be an independent agent if acting exclusively or almost exclusively on behalf of an enterprise. In relation to the proposed changes in the dependent agent test we are concerned that the proposals may affect not only commissionaire arrangements but also other principal sales structures.

According to our understanding all of the above examples are based on the presumption that a restructuring of a sales company to a commissionaire structure will substantially reduce the taxable profits in the country of the commissionaire. Although this clearly constitutes a concern, we think it should rather be addressed as a transfer pricing issue than a PE issue. If a proper functional analysis is made which establishes that the subsidiary is essentially performing the same functions before and after the restructuring, tax authorities should have a good argument not to allow a drop in profits without having to reclassify the subsidiary as a PE. Indeed, in a direct sales situation following a restructuring to a commissionaire, the turnover may be reduced which depending on method used (notably Return on Sales) will reduce the profit level and the taxable income. However, this should in our view rather translate into a discussion about appropriate remuneration method and Profit Level Indicators than that of the existence of a PE. The fact that this is sought to be resolved by extending the PE-concept will most likely give rise to a significant increase in disputes and administrative problems. Therefore, in order to avoid undue administrational consequences and risk of disputes, the notion of a subsidiary as a taxable person should be upheld to the largest extent possible.

Additional clarity on the wording “engages with specific persons in a way that results in the conclusion of contracts”, “material elements of contracts” as well as examples on what is to be considered as “similar arrangements” is necessary. As previously indicated we find the proposed options too far-reaching since they go beyond the commissionaire structures and can involve buy-sell distributors and/or even pure marketing activities.

B. Artificial avoidance of PE status through the specific activity exemptions

We acknowledge the fact that it is possible to be heavily involved in the economic life of another country by doing business via the internet and that this may open up for abusive cases. However, in trying to find ways to tackle this, it is of utmost importance not to amend the PE threshold to the detriment of traditional business engaged in non-abusive situations.

Although it might be desirable to address situations of artificial avoidance of PE status it needs to be acknowledged that there are still valid and perfectly legitimate reasons for the exceptions that are currently found in Article 5.4 of the Model Tax Convention.

For a great number of MNEs the exceptions in Article 5.4 facilitate less administration and cost by enabling a relatively simple and consistent approach to the determination of whether or not a PE exists. Companies report that whenever they are considered to have a PE, there is the inevitable dispute on how much
income should be attributed to that PE. On many occasions this results in long litigations and large costs.

Since the kinds of activities mentioned under 5.4 traditionally have been recognized as not generating any material income, it will be quite difficult to allocate income to such a PE. Hence, with the proposed amendments, disputes in this area are likely to increase significantly.

**The exceptions are not restricted to preparatory or auxiliary activities**

In option E in the Draft it is suggested to make all of the activities in para 5.4 subject to a preparatory or auxiliary condition.

Although the activities listed in 5.4 in many cases are of a preparatory or auxiliary character, it is acknowledged in para 21 in the Commentary to Article 5 that this is not always the case. To introduce an explicit reference to “preparatory or auxiliary activity” will affect traditional businesses and the number of PEs would no doubt increase dramatically.

In addition, the concept of “preparatory or auxiliary activity” is vague and opens up for ambiguity and divergent interpretation. Para 24 in the Commentary to Article 5 also states that “it is often difficult to distinguish between activities which have a preparatory or auxiliary activity and those which have not”.

If all activities are subject to the condition that they have to be preparatory or auxiliary, why do we need such a list at all? Another way to deal with this issue would be to leave para 5.4 as it is and provide for a PE exception unless the tax authority can show that the activity is not of a preparatory or auxiliary nature.

The Draft indicates that the target is internet companies with large warehouses in which a significant number of employees work. Our concern, however, is that also industrial companies with warehouses will be challenged by tax authorities.

Consequently, if option E is adopted, the new commentaries should clarify/give examples of situations in which the activities would qualify as “of preparatory or auxiliary nature”. A situation in which a company in state A sells products in state B solely on the Internet and with no presence in state B, other than a warehouse, is different from a situation in which a company in state A uses a warehouse in state B, used for delivery of products sold by an affiliate in state B (or sold by other affiliates in third states, e.g. central warehouse situations).

Although the intention may be to target the first case, tax authorities could argue that the company in state A would have a PE in state B in both described situations. In the latter case, a local sales profit resulting from sales activities will be duly taxed in state B and a PE for company A would only add administrative burden and risk of additional disputes for allocation of PE profits (if any). As noted above, for the purpose of amending the current guidelines, it is important to distinguish between situations which create BEPS and those that merely refer to the allocation of taxing rights between the source and the residence state.
The word "delivery" in subparagraphs a) and b) of paragraph 4

In option F the Draft proposes deleting the word "delivery" from subparagraphs a) and b) of paragraph 5.4

We strongly object to the deletion of "delivery". Many companies report an increasing trend and need of having warehouses closer to their customers. It is difficult to understand the purpose of having the exception for storage when deleting the exception for delivery. Having a warehouse for storage without the possibility of delivery makes little sense and would have significant consequences for their business operations. Excluding delivery from the PE exception would also have a much wider impact than on cases where there is a BEPS related concern.

The deletion of delivery would to our understanding effectively put an end to long established and well accepted principal TP-structures maintaining central warehouses in geographically strategic locations for the delivery of goods using local low risk distributors for their sales operation. It would also affect companies maintaining a warehouse for the delivery of spare parts to customers for machinery supplied to those customers even where it does not maintain or repair such machinery (see para 25 of the Commentary to Article 5). To avoid the risk of double taxation and disputes, it is likely that such a principle would lead to costly reorganizations and sub optimizations in cases which are fully business driven. Such a change would thus go far beyond the objective of preventing BEPS. The effect on businesses and trade/investments decisions is unacceptable.

Additionally, if adopted, the altered definition risk to create confusion and/or additional risk for disputes since the wording will continue to include "storage". If warehouses are allowed for storage purposes but not for delivery, when and under what circumstances does storage purpose change into delivery purpose? Obviously, in many situations storage will ultimately lead to delivery. In practice, also sole/primary storage activities which at one point may end up in delivery will constitute a PE. Additional uncertainty and obvious risk for disputes is created if this last delivery activity retroactively re-classifies storage activities.

The Draft also explains that the omission of the word “delivery” is a departure from the OECD Model Convention, reflecting the view that a stock of goods for prompt delivery facilitates sales of product and thereby the earning of income in the host country. We acknowledge the fact that there could be a BEPS concern if the goods or the merchandise are delivered to customers in the same country where the goods or merchandise are stored. If, however, the delivery is made in a cross-border circumstance, it is difficult to understand such concern. There may e.g. be situations in which a company has a central warehouse from which no deliveries are made to the host country but only to third countries. It needs to be clarified that such a situation should not constitute a PE.

If deliveries are made to the host country as well as to third countries the company would have a PE in the host country. However, it needs to be clarified that only profits from sales to the host country could be attributed to the PE.

We fully agree with the word of caution in the UN Model that “…even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into attributing too much income to this activity if they do not give the issue close
consideration, which would lead to prolonged litigation and inconsistent application of tax treaties”.

From this perspective option E would, as indicated earlier, be preferable.

The exception for purchasing goods or merchandise or collecting information

Option G proposes the deletion of “purchasing goods” from subparagraph d) and option H proposes to delete the entire subparagraph, thus both the exception for purchasing goods and collection of information.

We do not support either of these two options. These exceptions are very important for companies and the deletion of these activities would no doubt increase the number of PEs dramatically. Before deciding whether to invest in a new market companies need to be able to examine and “scan” the market. In this respect purchasing and data collection is necessary. In addition, raw data by itself has limited value. Value is created only by the process and interpretation of the data.

Furthermore, we do not agree with example one. It seems to indicate that a purchasing branch which purchases the output of several affiliated manufacturing plants on behalf of the group would be entitled to retain the group’s entire volume discount for those purchases. Example one ignores the fact that the volume discounts achieved by a centralized purchasing function are typically shared among those members of the affiliated group that will acquire the goods in question.

All in all, a deletion of these activities from the PE exception would impact adversely on businesses. In our opinion, neither of these activities is sufficient to constitute a PE and they do not by them themselves produce any profits. Considering the cost and administrative burden of running a PE, many companies are likely to shut down existing purchasing offices simply because the costs would outweigh any potential profit from these activities. From a broader perspective such a scenario would have a negative impact on cross border trade and investments.

As in the case of delivery, option E would be preferable compared to options G and H since then at least it would be possible to maintain a fixed place of business for purchasing goods or collecting information without triggering a PE. However, option E would in our view open up for great uncertainty and arbitrariness with respect to the existence of a PE. This would no doubt significantly drive tax disputes and double taxation. Considering that the proposed amendments would arbitrarily hit both BEPS situation and perfectly sound business structures, we strongly advise not to change the current principles in this respect.

C. Splitting-up of contracts

The Draft proposes two alternatives (options K and L) to deal with the splitting-up of contracts.

Since there is a 12 month time threshold to regulate when a building site or construction or installation project constitutes a PE we acknowledge the necessity to
prevent abuse. However, it is reasonable to request rules that are clear and provide some certainty. Companies report having problems interpreting paragraphs 18 and 19 of the Commentary to Article 5 and would welcome additional guidance.

As a general comment concerning contracts, there are situations where the rationale behind regarding a construction site based on several contracts as a single unit can be questioned.

Assume that a company has finalized a construction project within an 11 month period. One year later the same company receives an additional order from the same customer at the same site. This project is finalized in 2 months. The two orders may be considered to be connected but the company had no knowledge of the additional order at the time of the conclusion of the first project. Could this even be considered as splitting-up a contract? Would this constitute a PE? If so, it would be very difficult retrospectively to deal with all the PE administration.

Returning to the two alternative proposals, a principal purpose test, as suggested in option K would presumably deal with the example above, giving the company a possibility to show that no abuse was intended. However, having a principal purpose test would undoubtedly open up for wide application by tax authorities and induce additional uncertainty into the PE test.

However, and as indicated in the Draft, the “automatic” approach in option K has its flaws due to the fact that it applies indiscriminately and would also capture situations where there is no BEPS concern.

In order to narrow the scope of the automatic approach the Draft proposes a minimum presence of 30 days. This period of time is too short. Many construction projects run for several years where a company may need to have specialists on the site a couple of days a month during the entire project. The result would be a PE on every major construction site. In addition, such a threshold could be difficult to monitor, as all parts of an MNE may not be fully aware of all the activities of the group as a whole.

E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing

A major drawback with the Draft is the fact that it does not address the profit attribution implications of the potential PEs created under various options. To the contrary, the Draft seems to dismiss this issue as insignificant. BUSINESSEUROPE fully support the comments made by BIAC on this issue and share the view that countries often are motivated to create PEs in order to attribute profits to those PEs.

If the proposals in the Draft are implemented, corresponding guidance under Article 7 would be necessary in order to avoid numerous cases of double taxation. Any profits to be attributed to a PE based on delivery, purchasing or data collection are likely to be insignificant, but that view may not necessarily be shared by tax authorities.

It is difficult to foresee the full consequences of the proposed amendments. However, it is not difficult to foresee that the impact these changes would have on business would not be positive. Should these proposal be incorporated into the
Commentaries we fear that there will be a dramatic increase in cases of double taxation.

On behalf of the Confederation of Swedish Enterprise

January 9, 2015

Krister Andersson
Head of the Tax Policy Department
Dear Ms de Ruiter,

Re: PUBLIC DISCUSSION DRAFT: BEPS ACTION 7: Preventing the Artificial Avoidance of PE Status

We welcome the opportunity to comment on the above document issued on 31 October 2014. We wish to make two general observations on the work in the discussion draft.

Role and function of the PE concept

The PE concept has given governments over the years a legal basis for charging taxes on the activities of foreign enterprises, particularly in situations where no legal entity (such as an incorporated subsidiary) is present in the destination country. Changing the definitions of a PE will not necessarily raise additional tax overall, but it will relocate where those taxes are to be levied. Our concern is that this relocation will tend to be towards countries with larger...
domestic markets. Therefore any redefinition of PE is a challenge to the taxing rights of smaller nations.

Proposed revisions to the concept of commissionaire arrangements may be contrary to the freedom to provide services principles of the EU treaties. In common with the LOB proposals under Action 6, it may be necessary to make special provision for EU Member States.

We have concerns that the proposed revisions to the concept of commissionaire arrangements may overextend the scope of the PE provisions and not tax commissionaire arrangements in like manner to other agency type arrangements which have equivalent functions. We suggest that it is reasonable to tax in like manner agency arrangements (whether disclosed or undisclosed) where there are equivalent functions performed in the source State but that the proposals to address concerns on the abuse of commissionaire structures should not extend beyond this.

**PE definitions**

One of the strengths of the existing PE article in the model Tax Convention is its reliance on clear definitions. This has reduced the incidence of cross-border disputes by reference to what constitutes a PE or otherwise. If it is ultimately deemed necessary to revise the current PE definitions along the lines proposed in the discussion draft, we strongly urge that the clarity of the definitions be retained as far as possible. Other proposals within the BEPS mechanisms will, in our view and as we have outlined in separate correspondence, open opportunities for dispute with perhaps protracted resolution mechanisms. This would be counter-productive and should be avoided. A resultant proliferation of cross border treaty disputes and PE’s (especially administrative PE’s to which no profit might be actually attributable) would be without benefit to either national Exchequers or to business.

For example, the language of Option B (in relation to the artificial avoidance of PE status) may well address concerns with the current language insofar as it would capture scenarios where a person negotiates the material terms of a contract in a State which is then "rubber stamped" and approved by the enterprise in another State. However, further clarity would be welcome on the meaning of the words "concludes contracts or negotiates the material elements of a contract".

We would be concerned that the suggested language could be read to imply that any negotiation of the material terms of a contract in a State could give rise to a PE, even if the material terms are not concluded through these negotiations. Guidance would be welcome to confirm that this phrase is only intended to cover the negotiation of the final material terms of a contract in a State and not situations which can commonly occur in business where preliminary or interim
discussions of terms of a contract occur in a State which do not reflect the final agreement of terms.

Other examples arise in the proposals related to specific activity exemptions. We have concerns that these proposals for smaller countries on the periphery of large markets could result in the creation of multiple PEs for enterprises with low value activities and increase the compliance costs as well as the uncertainty for business in smaller economies in carrying out these activities in the course of provision of goods and services to customers in large markets.

We suggest that the concerns surrounding the availability of a general exemption from PE status for the activities listed at subparagraphs (a) to (d) of Article 5(4) might be addressed by adopting a variation to General Option E. This variation might work by including a presumption in the lead in statement in paragraph 4 of Article 5 that the specific activities in subparagraphs (a) to (d) in article 5(4) could continue to be eligible for exemption unless those activities are core to the business activities of the enterprise - perhaps using wording such as “form a significant and essential part of the enterprise as a whole”. This approach might achieve a balance between preserving certainty and clarity for the majority of potentially affected business with low value in country activities which are not core to the business model of the enterprise and changing the PE status for enterprises where these activities are core to their business model.

You may wish to note that this response is from a representative body. The Consultative Committee of Accountancy Bodies – Ireland is the representative committee for the main accountancy bodies in Ireland. It comprises Chartered Accountants Ireland, the Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, and the Chartered Institute of Management Accountants, which represent a combined membership of some 40,000 accountants. Brian Keegan, Director of Taxation at Chartered Accountants Ireland (brian.keegan@charteredaccountants.ie, +353 1 6377 347) may be contacted if any further details in relation to this letter are required.

Yours sincerely

Paul Dillon, Chairman, CCAB-I Tax Committee
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Milano / Barcelona, January 9, 2015

Dear Mrs. De Ruiter,

Cuatrecasas, Gonçalves Pereira (Spain) and Chiomenti Studio Legale (Italy) appreciate the opportunity to provide comments on the OECD Discussion Draft on Action 7 – Prevent the Artificial Avoidance of Permanent Establishment (PE) Status published on 31 October 2014 (‘the Draft’).

Cuatrecasas, Gonçalves Pereira is a leading law firm in Spain and Portugal. It represents most of the largest listed Spanish and Portuguese companies, and advises on strategic transactions and foreign investments in the Iberian market. The firm has 241 partners and 715 associates recruited from the best talent, all with the same focus: the client. With 25 offices worldwide, the firm’s headquarters are located in Barcelona, Madrid and Lisbon. Cuatrecasas, Gonçalves Pereira has international offices in the largest financial centers, Latin America, Asia and Africa. The firm has relationships and experience with the best law firms worldwide, so it can meet clients’ legal needs anywhere. The firm advises on all areas of business law, including 18 practice areas and 15 industry-specific knowledge groups.

Chiomenti Studio Legale has accompanied the growth of the major Italian businesses and the continuing increase in incoming and outgoing foreign investments from the post Second World War economic recovery to the recent market integration reforms. The firm’s success is based on the combination of
its international outlook, recognised quality and reputation of its professionals. The firm today has approximately 270 attorneys and tax advisers and has offices in Rome, Milan, London, Brussels, New York, Beijing, Shanghai and Hong Kong. Chiomenti Studio Legale is the exclusive member firm in Italy for Lex Mundi - the world’s leading network of independent law firms with in-depth experience in 100+ countries worldwide.

Due to time constraints we will provide only our preliminary non-exhaustive view as follows:

Our overall comment relates to the approach taken to address the artificial avoidance of PE status, as better explained by Paragraph 2 at page 9. The Draft suggests changing the OECD Model Convention (‘MC’) by amending the wording of the Article 5 at different stages. The Draft addresses changes in the MC to prevent the abuse of PE definition within commissionaire arrangements, specific activity exemptions, splitting up contracts and insurance activity. We wonder whether it is more feasible to attack abuses in the application of the PE definition through other means.

Thus our remark would suggest relying on the General Anti Abuse Rules (‘GAAR’) which are the tool designed to prevent abuses rather than introducing changes into the MC. Hence, we suggest limiting the MC amendment to include new paragraphs to the Commentaries on the Article 5 in order to enhance the effectiveness of the GAAR. These new paragraphs should clearly identify the type of situation that OECD Member States agree to be abusive. That approach would help everyone to understand that a GAAR would apply under cases similar to the ones described as abusive on the Commentaries to Article 5.

Changing the wording of the Model Convention will take years to produce some concrete effects in practice, as these would require treaties drafted along the lines of the revised MC texts to enter into force, whereas a change into the Commentaries would have immediate application as from its publication and would avoid coexistence of different PE concepts in different treaties applicable in the same jurisdiction, which would encourage treaty shopping. Of course a Multilateral Treaty according to Action 15 would avoid this concern.

More in detail, please find some thoughts related to the different alternatives put forward by the Draft:
1. As a general remark to ‘A. Artificial avoidance of PE Status through Commissionaire arrangements and similar strategies’ is that lowering the dependent agent threshold might generate new controversies based on the increased subjectivity. Eliminating that independent agents might act exclusively for a company if appropriated requisites are met seem to us a too far reaching approach.

   a. Option A, end of page 12: the Draft reads “Unlike the wording of Art. 9(1), however, that definition would apply to enterprises of the same State or of third States.” In our opinion, a different interpretation of the same phrase in the context of two different MC provisions should be avoided. Perhaps, it could be considered to phrase differently the definition.

   b. Option B; it seems better framed than option 1 as there is no cause-effect relationship (as the wording states: “in a way that results”) but rather a more substantial approach based on the negotiation of certain specific clauses and elements only.

   c. Option C; it would seem that a “transfer pricing” approach (i.e., an approach based on risks and functions) is adopted. This alternative seems more easily manageable than option A. One of the main problems, though, could reside in the meaning of “account and risk” as these two notions seem cumulative. It would then be concluded that a formal (account) and substantive (risk) approach needs to be taken?

2. The remarks with regards the ‘B. Artificial avoidance of the PE Status through the specific activity exemptions’ are:

   a. Option E is to be welcome as it is coherent with the rationale of article 5(4).

   b. Option F, removing reference to delivery should be followed by a better definition of the concepts of storage and display, to avoid subparagraphs a) and b) being left without content.

   c. Option G and H should be disregarded as far as we support Option E.
d. For Option I to apply, a group of associated enterprises must have at least one fixed place of business that satisfies the PE threshold in a country. This approach seems to leave less room for disputes and litigation as to the existence of a “group PE”, as required by the alternative Option J, according to which a PE could arise even if none of the places of business in a country constitute a PE insofar as the combination of all the activities by the group (whether at the same place or at different places) is more than preparatory or auxiliary.

We hope you will take our comments into consideration in further developing this Action point. Of course, we are available to elaborate on these comments should this be helpful and we look forward to further discussion on this important issue.

Yours sincerely,

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Chiomenti Studio Legale

Joan Hortalà
Partner
Cuatrecasas, Gonçalves Pereira
Dear Marlies de Ruiter
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Centre for Tax Policy and Administration
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9 January 2015

Dear Marlies

**Discussion Draft on BEPS Action 7: Preventing the artificial avoidance of permanent establishment status**

We welcome the opportunity to provide comments on the Discussion Draft – ‘**BEPS Action 7: Preventing the artificial avoidance of permanent establishment status**’ released on 31 October 2014 (the ‘Discussion Draft’).

The purpose of the permanent establishment (PE) definition is to allocate taxing rights over business profits between two national governments. There is a great virtue to governments and to business in setting clear boundaries, so that governments can agree where profits should be taxed when negotiating double taxation treaties and when their tax authorities assess taxes on business. We acknowledge that governments wish to alter current PE thresholds to reflect modern business practices and the development of digital commerce. However, we urge the G20/OECD to seek as much clarity as possible in the revised definition. Inevitably any significant change through the BEPS project will lead to a certain amount of uncertainty but the prevention of disputes, double taxation and administrative burdens benefits governments and business alike.

In our view, some of the proposals in the Discussion Draft, particularly around agency permanent establishments, will create a high level of uncertainty out of proportion with the objectives of Action 7 in relation to the prevention of ‘artificial avoidance’. We anticipate that many more businesses will want to obtain Advance Pricing Agreements (APA) in relation both to the existence (or not) of a permanent establishment, and the amount of profit to be allocated to it. Currently an APA will often deal with the quantum of profits but not with the question of whether a PE exists, and not all countries have an APA programme. It will be important for tax authorities to address both questions within an APA programme and for them to have sufficient resources to meet the needs of business.

One of the objectives in setting the original PE definitions was to minimise administration and lowering the threshold is expected to create many more PEs than currently. We think it would be helpful to avoid
creating PEs where the amount of tax at stake is modest. We recommend that the OECD consider appropriate de minimis limits (whether by revenue, time or frequency). This is of particular importance to businesses considering expanding internationally for the first time.

The specific proposals for insurance are not related to ‘artificial avoidance’ and base erosion and profit shifting. We cannot see that there are good reasons for having a lower threshold for creation of a PE for insurance and consider that the general rules for agency PEs should be applied equally to insurance. If a lower threshold were established for insurance businesses, the amount of profit attributable to the PE is likely to be low or zero where the key entrepreneurial risk taking (KERT) functions are not located in the PE jurisdiction, and commensurate with the returns awarded to local sales or brokerage activities under current models.

We do not agree that there is currently adequate guidance on the attribution of profits to permanent establishments in sectors other than financial services. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments has detailed analysis and examples of its application to the financial services sector, but only the general principles in Part I (63 of the 241 pages) apply for other businesses. Even in Part I, many of the examples relate to financial services. In our view, additional guidance on assets, risks and internal dealings in relation to other trading activities will be needed to ensure that businesses and tax authorities take a consistent approach and in prevention of dispute.

Detailed comments on the Discussion Draft are set out in the appendix.

If you wish to discuss any of the points raised in this letter please do not hesitate to contact either me (bdodwell@deloitte.co.uk), Tim Tuerff (ttuerff@deloitte.com) or Alison Lobb (alobb@deloitte.co.uk). We would be happy to speak in support of our comments (although we think insurance would be better covered by representatives from the industry) at the public consultation meeting scheduled for 21 January 2015.

Yours sincerely

W J I Dodwell
Deloitte LLP

The following independent member firm of the Deloitte Touche Tohmatsu Limited network has contributed and concurs with this submission:

On behalf of Deloitte Tax LLP
United States
T. Timothy Tuerff
Appendix

General comments

Whether a company in one country has a PE in a second country is determined, first, by whether there is a fixed place of business in the second country through which the business is wholly or partly carried on. Options E-L in the Discussion Draft deal with proposals for amendments relating to fixed places of business within this broad definition. Where there is no actual fixed place of business in the second country, Article 5 deems one to exist where an agent acting on behalf of the company concludes contracts in the second country, unless the agent is independent. Options A-D consider potentially far-reaching amendments to the agency PE concept. As these changes affect trading arrangements, both within groups and with unrelated parties, the consequences of creating uncertainty are significant and may restrict businesses’ appetite for expansion into new markets. Certainty of treatment for businesses is one of the core objectives of double tax treaties, and we do not think that prevention of base erosion and profit shifting necessitates moving away from this principle.

The changes proposed by some options are potentially widely-drawn and appear to change the balance between source and residence taxation rather than target artificial avoidance. Businesses that thought themselves outside of the target of the BEPS project because they have not engaged in structures or planning for tax advantages are very concerned at the potential scope of the changes to the PE definition and implications for their trading activities and tax compliance.

There needs to be further thought given to situations where there should, reasonably, be ‘de minimis’ amounts or time thresholds before a PE is created. For example, there is no time period for the creation of a general fixed place of business or agency PE specified in the text of the Model Tax Convention. In addition, for agency activities related to sales there should be a de minimis turnover threshold before a PE is created. These are important safeguards to balance compliance burdens and enforcement costs with the tax at stake, and will particularly benefit smaller businesses and those expanding overseas for the first time.

A. Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

Options A, B, C and D

Action 7 calls for changes to the definition of PE, causing a commissionnaire (or other form of undisclosed agent) to be treated as a PE of the principal. Each of the four alternative options A, B, C and D, while addressing the concerns regarding commissionnaires, will have unintended collateral consequences. If a decision is made to change the PE definition, a more targeted approach is necessary, such as an amendment that specifically addresses commissionnaires (or other forms of undisclosed agent).

Each option in the Discussion Draft contains new concepts and terms which are not defined, and are vague and capable of being interpreted differently by different tax authorities (and businesses), causing uncertainty.

On balance, of the options presented, Option D appears to be the ‘least worst’ option because it has a higher degree of objectivity and contains terms that may, with further definition and clarification, be
capable of consistent interpretation. Such definitions will be key to interpretation of the treaties that adopt the changes, and should be included within Article 5 itself and not the Commentary.

Of particular concern is the wording of Options A and C, ‘Engages with specific persons in a way that results in the conclusions of contracts’, which challenges the very concept of definition. For this to be interpreted consistently there would need to be new and clear definitions for ‘engages with’, ‘specific persons’ and ‘in a way that results in’. It would appear difficult or impossible to provide objective definitions that could be applied consistently to all businesses in all situations.

Applying these widely-drawn concepts (particularly in relation to services via the ‘c’ test in option A) will also affect commercial situations that are not related to artificial avoidance, and which would have the effect of shifting the balance of taxation towards ‘source-based’ concepts (for example, for services in a manner similar to the service PE concept included in the UN model treaty). This appears to go beyond the remit of preventing artificial avoidance and the stated objectives of the BEPS project in the Action Plan.

The explanations in the Discussion Draft discuss the use of an ‘intermediary’ such as a commissionaire or other entity, but this concept is not mentioned in the proposed amendments to Article 5(5). Any changes to the concept of agency PE will need to take into account the complexities of modern business. For example, a business that is expanding into new markets may take steps over time working towards a position of full activity in country. This might (recognising that there are many options for expansion that a business could choose to take, depending on their facts and circumstances) look as follows:

1. Sales in a new country market are made from the home country (which has well-established business operations). Sales to the new country market may be infrequent/intermittent. Business travel may be required. There are no entities or employees based in the new country and no fixed place of business there.
2. A small local support team is set up in a new entity established in the country. Their role is to support and maintain contracts that have been entered into by the home country entity. They are not involved in negotiation of the contracts or sales, or identification of new sales opportunities.
3. Sales in the new country are successful, and the local support team is expanded. As well as identification of sales opportunities, local entity employees may be involved with meetings with potential new customers, to provide support to the home country entity in terms of local knowledge, and language skills, and to start to build relationships for maintenance and support of the customers after the contracts have been entered into. Local entity employees do not have the authority nor experience to conclude contractual terms or to make any material contribution to them.
4. Local entity employees begin to assist the home country entity in the negotiation of contracts. The home country entity has final authority on material items. The contracts are in the name of the home country entity and are entered into by them, as this is the entity that has the distribution rights for the product in the region.
5. Local entity employees have authority to negotiate and conclude contracts for the local entity, which has now been licenced rights to distribute products in the local jurisdiction. The home country entity provides support services during the negotiations, and may have oversight of the contracts as a result of the licencing arrangement.

This example evidences normal commercial trading arrangements, and is not motivated by tax avoidance. Usual business concerns will relate to size of the market opportunity, local costs relative to predicted sales, ease of exit if sales forecasts are not realised, management of business risks and control of product, recruitment and experience of local employees etc. It is clear that over time taxing rights over
the profits from sales to customers in the local country will move from the home country to the local country, but at what point in the process does that change occur? In the example, are there points at which the home country has a permanent establishment in the local country because of the ‘intermediary’ local entity’s activities? Is this also the case when the local entity has the sub-licenced distribution rights and is selling products locally? Detailed examples setting out the tax outcome would be helpful, including those where a small change of facts is sufficient to change the outcome such that the boundary can be clearly seen. (There are further questions around the attribution of profits to any such PEs too, see later).

Further clarity will be needed around a ‘person acting in a Contracting State’. The explanation in the Discussion Draft discusses the use of an ‘intermediary’ such as a commissionnaire or other entity, but this is not completely clear from the use of ‘person’. The existing Commentary to Article 5 of the Model Tax Treaty at Paragraph 32 says that an agent includes persons ‘whether or not employees of the enterprise’. This highlights the question of how the proposals, and particularly the wide drafting of Options A and C, would be interpreted in the context of business travel (where there may be no intermediary entity or local employees). For example, where business people (employees in the residence country of an entity) travel overseas to meet potential customers and discuss the possibility of making a sale (without creation of a fixed place of business PE) it is possible that they would be ‘engaging with specific persons’ and this may ‘result in conclusion of a contract’. If it is the intention of governments that all business travel that results in sales will create PEs then this is very far-reaching, has implications for compliance and resourcing as set out above, and seems to be a significant change from residence to source taxation. It also would be unlikely to be workable as a practical matter. (See also comments below about further guidance required on the amount of profit that should be attributed to a PE in such circumstances).

The term ‘negotiates material elements of contracts’ used in Options B and D also requires definition (which will be challenging in order to give the necessary objectivity and certainty). Other terms that require definition include ‘on the risk and for the account of’ (Options C and D) and ‘transfer of the ownership of… property owned by that enterprise…’ (Options A and B). It does not seem to be the intention that distributors acting on their own account should create a permanent establishment of other parties in the supply chain. Any changes to the boundary for PE that suggested this would be too widely drawn and could defeat the fundamental purpose of Articles 5 and 7 of the OECD model treaty in determining taxing rights and, potentially, so difficult to comply with as to be ineffective. For example, products may be sold from one company, say a manufacturer, to a distributor (which might be a third party) in another country on consignment or where title to the stock passes to the distributor on sale. These are commercial situations commonly found in the legal relationships between third parties, depending on factors such as market conditions, negotiating powers and other options available, business strategies etc. The primary route of creating a taxable presence, of having a fixed place of business, should be considered first, including in the context of holding stock in a local country (under Options E and F). As a result there should be no separate requirement to consider distributors as potential agency PEs.

Changes to ‘independent’ agent requirements (paragraph 6)

Each of Options A-D include proposals that prevent an entity acting exclusively for one group from being considered independent. This change goes further than is required to address ‘artificial avoidance’ of PE status through commissionnaire or similar arrangements.

Acting exclusively or almost exclusively for one group should be one indicator that an agent may be dependent, but this should be considered alongside other factors. Situations where third party agents operate only for one group can and do occur between independent businesses. For example, an
unrelated sales agent may be entitled to sell the products of various different suppliers, but for commercial reasons (e.g. success of one product in its market, problems with other product suppliers) it could in effect - at times or continuously - sell the products of only one supplier. As a matter of principle, independent choices by a third party broker or agent should not result in a taxable presence for a supplier. It would also be difficult for an unconnected supplier to obtain the information to assess its tax compliance position.

If the potential wide-reaching changes being considered, in particular in Options A and C, are adopted, consideration should be given to the difficult consequences for other commercial circumstances, such as franchising arrangements.

B. Artificial avoidance of permanent establishment status through the specific activity exemptions

Options E, F, G, H

Some of the concepts included in the ‘specific activity exemptions’ of the current Article 5 relate to drafting of the 1920s, and as such it is right to consider whether these remain appropriate in the context of modern businesses. However, the complexities of modern business mean that there will be significant consequences for many businesses and sectors, including significant compliance requirements for those that have not been undertaking ‘artificial avoidance’. The question for governments is whether the balance between some additional tax (and the question may be ‘how much’ after double tax relief is considered) outweighs these adverse consequences. To the extent that there are additional compliance requirements for businesses and auditing and collection costs for tax authorities then these will be minimised where clear guidance is available to minimise disputes. However it is changed, paragraph 4 must take into account the stock (inventory) management practices and procedures normally used by well-run businesses engaged in the cross-border manufacture and sale of products. For example, holding stock in a country without conducting business operations in that country should not constitute a PE. (This should also be made clear as a general matter about the way in which ‘a fixed place of business through which the business is wholly or partly carried on’ in paragraph 1 should be interpreted). However, by replacing the current objective test with a subjective test, it is possible that Option E will be interpreted to treat the holding of stock as more than a preparatory and auxiliary function, thereby leading to significant controversy and double taxation of income.

There are many commercial circumstances in which a stock of goods is held in a country by an overseas entity. Under Options E and F, it could be the case that stocks of goods create a permanent establishment where none would exist under the current rules, and no ‘artificial avoidance’ of a PE is involved. Some examples, which would be subject to preparatory or auxiliary considerations under Options E and F, include:

- Situations where a third party supplier in Country B holds stock at the manufacturing premises of a manufacturer in Country A to ensure continuity of supply. This might arise for example in the car industry, where car part suppliers will keep a stock of goods with the manufacturer. Title to the stock will pass to the manufacturer as the parts are required for manufacturing, usually when they are taken from an automated stock bin system owned and operated by the manufacturer. The supplier may have no people functions in Country A where it holds stock.
- In other industries, such as aircraft parts, suppliers may hold stock in locations for speedy maintenance and replacement.
• In relation to aviation and marine fuel, contracts may be agreed with, say, an airline in one country, and fuel owned by the contracting entity will be supplied locally as needed.
• Toll manufacturing arrangements (or other tolling arrangements sometimes encountered such as oil refining or smelting of iron ore or bauxite) where an overseas entity retains title to stocks of raw materials, goods in process and finished goods throughout the manufacturing process (which may be undertaken by third parties).
• Businesses in the oil and gas industries will often hold ‘strategic storage’ of crude oil – storage capacity to enable oil to be held in periods of low price with the expectation that, when prices rise, it will be removed from storage and sold. As oil is a relatively mobile and homogeneous commodity this tends to lead to cross border storage and import/re-export - it is rarely seen with gas or liquefied natural gas due to the higher cost of storing and transporting.
• It is common for extractive groups to hold stockpiles of product in China (often in the port) before sale to third parties.
• In the downstream oil sector, aviation fuel storage and marine fuel storage may be a key commercial driver and obtaining storage tanks in confined areas where space is at a premium (such as airports) is often difficult.
• Some commodity exchanges (such as the London Metal Exchange ‘LME’, for example) will operate a network of storage facilities in which the physical products traded on the exchange are stored. A purchaser may therefore upon purchase own stock in a jurisdiction where the LME warehouse is located. Purchasers may hold the stock and then sell it on without doing anything to it.

If Option E is adopted, the pressure to determine what is, and is not, ‘preparatory and auxiliary’ will increase. Further detailed guidance including examples drawn from different industries will be needed in order to aid interpretation and minimise the potential for dispute. The guidance should include discussion of when the location of the stock holding is a key commercial driver as well as the stock holding itself. For example, where stock must be held in country to satisfy customer demands, would the PE answer be different from situations where the stock could be held in a variety of suitable locations? These examples should illustrate the point that similar activities by different businesses may give rise to different answers, depending on the facts and circumstances.

Options F, G and H consider alternatives that remove specific activities from automatic exemption, with the effect that such activities will create PEs except where the activities are preparatory or auxiliary.

In addition, the absolute exemption for collection of information should be retained (given the very significant issues that would arise in relation to attribution of profits to this activity – see also later section on attribution of profits).

**Fragmentation of activities between related parties**

Options I and J consider situations where different group companies carry out activities in a country, where some of those activities may be considered preparatory or auxiliary. Further definition will be required of the key term ‘constitute complementary functions that are part of a cohesive business operation’ and in particular how this will apply to different commercial divisions (which may operate completely separately from one another and in relation to different products/services). Since activities that might be considered preparatory or auxiliary will usually be of low value, the additional tax anticipated should be balanced against increased compliance and enforcement costs.
C. Splitting-up of contracts

The Discussion Draft refers to the example in the Commentary involving offshore oil and gas projects on a continental shelf being deliberately split to avoid the 12 month rule. In our experience this is rare (at least in the UK North Sea). It is however common commercial practice for companies in the extractive industries to split construction contracts between the supply of goods and the supply of services. It is not inconceivable that there may be instances of this nature where a PE will be created under the proposals where no PE would be created under the current framework.

We agree that the difficulty with Option K is where an entity sends specialists for only a short period (a few days) but activities of a related party on site when added to this time may exceed 12 months. The amount of profits attributable to a PE in this scenario may be out of proportion to the compliance and administration costs. For this reason, application of the treaty abuse ‘principal purposes test’ under BEPS Action 6 (Option L) targeted at artificial avoidance would in general be preferable.

D. Insurance

We do not believe that the Discussion Draft provides sufficient rationale for treating insurance differently from other businesses. Of the two proposals in the Discussion Draft, we therefore prefer Option N over Option M, as it would place the insurance industry on the same footing as other sectors. (See also comments below re the attribution of profits to PEs arising under Option M).

E. Profit attribution to PEs and interaction with action points on transfer pricing

There is a need to consider further the consequences of creating additional PEs alongside the principles in the 2010 OECD Report on the Attribution of Profits to Permanent Establishments (the Authorised OECD Approach) particularly (but not exclusively) for sectors outside of financial services. One of the concerns of business over uncertainty in relation to PEs is the difficulty and lack of guidance in determining the levels of profit (or loss) in a PE and the likelihood of dispute and potential for double taxation that may result. Particular areas of concern that require further guidance include:

- Application of OECD principles where there is a stock of goods held outside of an entity’s home country but no ‘significant people functions’ in the country where the stock is located.
- Application of OECD principles in other situations where there are no ‘significant people functions’ in the country of the PE.
- Application of OECD principles where a sales agent outside of an entity’s home country is remunerated on an arm’s length basis for sales activity, and where there are no other ‘significant people functions’ in the country of the sales agent.
- Application of OECD principles to agency arrangements which do not involve contracts for sales.

Option M (which specifies that a deemed PE would be created if an insurance enterprise collects premiums in a territory or insures risks therein through a person other than an independent agent) would lead to some difficult issues on profit attribution. This is because the deemed PE would typically not undertake any insurance KERT (‘key entrepreneurial risk taking’) function, and so would be expected only to receive a routine return against which it would set the amounts payable to the dependent agent enterprise for carrying out those functions. Part IV of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments refers to the issue of attributing profit to such insurance PEs at paragraph 64, but concluded that the scope of that report was limited to PEs as defined in Article 5 of the OECD Model Tax Convention. If Option M were adopted it would be necessary to determine, under the Authorised OECD Approach, whether any net profit would in fact be attributable to such PEs after
deduction of the arm's length agency fee payable to the dependent agent enterprise (Part IV specifies that for insurance enterprises the KERT function that leads to the attribution of surplus and of the insurance profit or loss is that of underwriting and assuming insurance risk).
9 January 2015

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Comments on OECD Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. De Ruiter:

EY appreciates the opportunity to submit these comments to the OECD on the Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status dated 31 October 2014.

We are concerned that the options for changes to the permanent establishment (PE) standard that are included in the Discussion Draft are overly broad and overly vague. We believe that these changes if implemented would create both uncertainty and significant risk of double taxation for global businesses which would undermine one of the central objectives of treaties to facilitate cross-border trade and investment. The options have implications that extend well beyond the concerns about potential base erosion and profit shifting (BEPS) that are the focus of the OECD’s BEPS project.

We believe that the PE standard is an overly blunt instrument to use to address BEPS concerns about the potential for income to be artificially shifted to a low or no tax jurisdiction. Indeed, in many situations, the options proposed in the Discussion Draft would have the effect of creating a PE in a high-tax country for an entity that is resident in a comparably high-tax country.

We urge the OECD to work to develop narrower and more precise measures to target specific BEPS concerns without destabilizing a fundamental element of the international tax architecture like the PE standard. In considering the most appropriate measures, the OECD should not lose sight of the fact that corporate income
tax generally attaches to profits from labor and capital, while sales and the place of consumption are the focus of indirect taxes.

The Role and Importance of the PE Standard

As a starting point, it is important to ground any reconsideration of the PE standard in a recognition of the role it serves in tax treaties and the global international tax system. Permanent establishment is the core concept used to allocate taxing jurisdiction between the country of residence of an enterprise and another country where such enterprise conducts activity and derives business profits. The PE standard in treaties establishes the minimum level of activity that must be conducted within a country by a non-resident enterprise before the enterprise can be subjected to tax in that country on any resulting business profits. If an enterprise’s activities in the country do not rise to the level of a PE, the country waives its right to tax income derived from the enterprise’s activities within its borders. If the PE threshold is met, the non-resident enterprise is generally taxed as a resident on its income attributable to such PE. As a corollary, in order to avoid double taxation, if an enterprise’s activities rise to the level of a PE, the country of residence cedes the right to tax the income of its resident on the income attributable to the PE, whether by means of providing for a credit for taxes paid to the PE country or by exempting such income from residence-based taxation.

The consequences of finding that an otherwise non-resident enterprise has a PE in a country of course is relevant to the base question of whether an enterprise is liable to tax in such country. However, the designation also carries with it significant tax compliance responsibilities and tax administration obligations. Moreover, in many countries, a PE finding creates burdens outside of the income tax, including VAT and payroll tax consequences. Providing a threshold level of activity below which these compliance and administration burdens are not triggered allows an enterprise to make a decision about where to conduct a particular activity based on the economic and commercial considerations. Providing this threshold means that countries can allow new investors to get a foothold in the country before bringing them within the full reach of the tax system.

In order for the PE standard to serve its intended purpose, it must be clear and objective. How it applies in a particular case must be mutually understood by the taxpayer and the tax authorities of both countries involved. Doubt or disagreement regarding the application of the PE standard would represent a real barrier to cross-border trade and investment.

The options for modifying the PE standard set forth in the Discussion Draft are not consistent with a PE standard that is clear, objective, and mutually understood. These options would create risk, complexity and cost for global businesses. The implications would be particularly severe for smaller businesses that operate internationally. Rather than creating the uncertainty and disruption that such changes would bring, the OECD
should concentrate instead on use of tools and approaches that are better suited to addressing specific BEPS concerns.

**Attribution of Profits to a Permanent Establishment**

The Discussion Draft focuses almost exclusively on the PE standard in Article 5 of the OECD Model Tax Convention and potential changes to such standard. The Discussion Draft contains virtually no discussion of the attribution of profits to PEs and how such attribution would be affected by the options for changing the PE standard. The two matters are inextricably linked, however. Stakeholders, both global businesses and governments, cannot evaluate proposals for changing the PE standard without considering the implications of such changes for the attribution of profits. The Discussion Draft acknowledges this interconnection, noting that “[t]his is why the wording of Action 7 emphasises that the question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE.”

In this regard, we would note that changes that would lower the PE standard to create a PE for a global business where one would not be found under the current standard may not result in any significant profits being allocated to such new PE. This is because the functions in the new PE under such lower standard may not be activities that would be considered to be value-driving under an attribution of profits analysis under Article 7 of the OECD Model Tax Convention. Thus, the global business would be subject to increased compliance responsibilities, including a tax return filing obligation when it may well be that little income would be reported on such return, and the tax authorities would have increased administrative burdens, but there would be little additional tax revenue for the tax authorities.

The potential results are similar under the options, discussed below, that would change the standards for when an entity would be considered to create a deemed PE for a related entity. The first entity is compensated by the related entity for the activities it performs and is taxable in the country on the income from its activities there. The amount of compensation is subject to the arm’s length transfer pricing rules under Article 9 of the OECD Model Tax Convention. If the related entity were deemed to have a PE in the country, an attribution of profits analysis under Article 7 would be required. However, the actual activity that occurs in the country would not have changed. The attribution of profits analysis is more complicated and less certain than a traditional transfer pricing analysis, but the profits allocated to the country may not change much as a result of the deemed PE.

The advancement by the OECD of these options for changes in the PE standard without accompanying discussion of the attribution of profits implications of such changes creates a real risk of what might be thought of as dangerously unmanaged expectations. Tax authorities that see the creation of new PEs in their country where none existed before may well expect that these new PEs should translate into significant new tax revenue and may make assessments based on those expectations. Where such result is not consistent
with the attribution of profits outcome, it would be unacceptable to the tax authorities of the other country involved, with the taxpayer caught in the middle facing the risk of double taxation.

As the OECD’s work on Action 7 goes forward, we believe that it is essential that the dialogue among countries and global businesses include both the standard for finding a PE and the attribution of profits to a PE that arises under such standard. In order to have meaningful consultation with business, these two components must be discussed together. It would be imprudent for the OECD to attempt to reach agreement on changes to the PE standard without having fully considered, and fully vetted, the attribution of profits implications of any such changes.

The Dependent and Independent Agent Rules

BEPS Action 7 mandates the development of changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, specifically identifying commissionnaire arrangements. Paragraph 7 of the Discussion Draft provides an illustration of the BEPS concerns arising from a business restructuring that resulted in the conclusion of a commissionnaire contract between two related parties. In particular, paragraph 7 involves a case where an enterprise was selling products through a related party in the other state and then, pursuant to a business restructuring, the related party transferred all its fixed assets, stock and customer base to the enterprise, concluded a commissionnaire contract with the enterprise, and began selling the goods in its own name.

Business restructurings and events that occur as a result of such restructurings, such as the outbound transfer of tangible and intangible property, do not justify modification of the PE standard. It is important to ensure that there is no conflation of issues related to business restructurings and the PE rules. In this regard, domestic tax law plays an important role in the context of business restructuring transactions (for example, domestic laws that would tax the transfer of intangible property when it is migrated to another country). Changes in the PE rules is not an appropriate tool to address any concerns about business restructuring transactions.

Putting aside these questions about the justification given in paragraph 7 of the Discussion Draft for changing the PE standard to prevent artificial avoidance of PE status through commissionnaire arrangements and similar strategies (which incidentally are not defined in the Discussion Draft or the BEPS Action Plan), the alternative options – Options A through D – to modify the independent agent rules of Article 5(5) go well beyond the stated mandate. All four options use broad, undefined terms. For example, Options A and C refer to a person acting on behalf of an enterprise who “habitually engages with specific persons in a way that results in the conclusion of contracts.” It is not clear how such a rule would be applied in practice. Under these options, although the actions of an intermediary that rise to the level of “habitual engagement” would have to result in the conclusion of a contract, it would not seem to be required that the intermediary formally conclude the contract or be party to that contract. Moreover, because there is no requirement for
the intermediary to have the authority to conclude the contract on behalf of the enterprise, or even be party to the contract that is concluded, demonstrating the causal connection between an intermediary’s activities and the conclusion of a contract would be subjective and potentially subject to a diverse range of interpretations. For example, under the proposed new version of Article 5(5), and subject to any changes that may be made to Article 5(4), some countries might take the view that if Company A engages an entity in State S to assist with marketing its product in State S and State S consumers enter into contracts to purchase the Company A product as a result, Company A could be deemed to have a PE in State S. It is difficult to see the BEPS concern in such a situation. Moreover, assuming that the service provider is compensated on an arm’s length basis and properly rewarded based on its functions, assets and risks for providing those services, State S should be taxing an amount that is an appropriate return for providing such services in State S without regard to the creation of such a deemed PE.

The phrase “acting in a Contracting State on behalf of an enterprise” appears in all four Options A-D. Whereas currently under Article 5(5), a PE may be found to exist where there is an agent acting on behalf on an enterprise and that agent has authority to conclude contracts in the name of the enterprise, under these options the phrase “acting on behalf of an enterprise” would no longer be tied to having the authority to conclude contracts. It would appear that a person could be found to be “acting on behalf of” another because a contractual relationship exists between the two parties. Under Options A-D in the Discussion Draft it is not clear how the phrase “acting on behalf of an enterprise” should be interpreted and such phrase would seem to be susceptible to being broadly interpreted.

Similar to Options A and C, Options B and D also would introduce subjective standards, including the potential to deem a PE to exist when a person “negotiates material elements of contracts.” The explanation in the Discussion Draft notes that this language is intended to address situations where contracts are not formally concluded by the intermediary. Although not entirely clear, it would appear that this language could be aimed at capturing a fact pattern where the home office “rubber stamps” contracts that are negotiated but not concluded in the other country. Such a fact pattern, however, is already covered by the existing commentary. In particular, paragraph 32.1 of the commentary to Article 5 states:

Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

It is recognized that the actions of a dependent agent could, in very specific circumstances, give rise to a PE for the principal. Specifically, Article 5(5) of the OECD Model Tax Convention reflects the view that a state has a right to tax a foreign enterprise that has sufficient nexus with the state that justifies taxing a portion of the foreign business’s tax base. It has also been long recognized that it would not have been in the interest of
international economic relations to provide that the maintenance of any dependent agent would lead to a PE for the enterprise. Indeed, such treatment was to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the state concerned. However, the options contained in the Discussion Draft for changes to Article 5(5) would introduce subjective criteria that are not well defined, that would be susceptible to broad interpretation, and that go well beyond the BEPS mandate.

Moreover, the proposed narrowing of the independent agent exemption under Article 5(6) would also expand the scope of the dependent agent rule in Article 5(5). In particular, the Discussion Draft proposes changes to Article 5(6) that would eliminate the long standing principle that an agent can be independent even if it acts for one or more affiliated enterprises if appropriate criteria are met. Such a change would replace a facts and circumstances evaluation with a broad based deeming rule without justification.

The Proposed Changes to the Preparatory or Auxiliary Exception

The Discussion Draft also includes several options for changes to the exceptions from PE status for preparatory or auxiliary activities that are provided in Article 5(4) of the OECD Model Tax Convention. These options would create substantial uncertainty in this area and render the exceptions virtually unusable.

For example, Option E would add the phrase “of a preparatory or auxiliary character” as a new condition applicable to all the activities listed in Article 5(4). However, the concept of “preparatory or auxiliary” is largely defined by reference to the activities listed in Article 5(4) that serve as illustrations of the concept. Including the phrase as a condition to be satisfied by such listed activities would make it impossible to interpret Article 5(4). If the OECD is to pursue this option, a clear definition of “preparatory or auxiliary” would have to be developed and included in the commentary.

As another example, Option F would remove the word “delivery” from the exceptions for activities involving use of facilities or maintenance of a stock of goods for “storage, display, or delivery.” The Discussion Draft notes that the UN Model Tax Convention does not include the word “delivery” but does not provide any background on the reason for its omission. Moreover, the Discussion Draft does not provide any real explanation of the effect of eliminating “delivery” under this option. It is hard to make sense of such proposal because elimination of the delivery concept would seem to render ineffective the storage concept that is central to these two exceptions.

The Discussion Draft also includes Options G and H which would eliminate the exception for purchasing goods. The rationale provided in the Discussion Draft for this elimination is the conclusion reached in the OECD’s earlier work on attribution of profits that the profits for such activity should be determined under the arm’s length principle. This does not seem to provide any real basis for eliminating the exception as the two
determinations are independent, notwithstanding the fact that they must be considered together to understand the implications of any change in the PE standard.

The Proposed Changes to Address “Fragmentation” of Activities

The Discussion Draft includes a discussion of the “fragmentation” of activities that would deny the application of the Article 5(4) exceptions to PE status for preparatory or auxiliary activities in situations where a business through one or more entities carries on activities at the same place or at two places in the same country “that constitute complementary functions that are part of a cohesive business operation.” These options include no definition of what constitutes complementary functions that are part of a cohesive business operation. Without a clear understanding of such concept, the new rules would be impossible to apply with any certainty. More broadly, the options are based on a premise that there is something inherently suspicious about a global business conducting activities in different entities or different locations. This premise fails to recognize that modern global businesses operate with separate business units for myriad legal, regulatory, and commercial reasons. Finally, the effect of these options would seem to be tantamount to a reinstatement of the force of attraction principle that has been rejected by the OECD in its recent work on the attribution of profits to a PE.

The Proposed Special Rule for Insurance Businesses

The Discussion Draft includes options for special PE rules that would be applicable only to insurance activities. We believe that singling out a specific industry with special rules of this type is inappropriate as a general matter and is without justification in this particular case. Moreover, such special rules would apply to insurance businesses in addition to the potential application of the various other changes proposed in the Discussion Draft.

Insurance companies operate in a heavily regulated environment that constrains both operational and capital structures. Under the EU Freedom of Services Directive within the EU Insurance Directive, insurance companies are permitted to carry out business across the European Union through representative offices or agency models. Similar operating models also are used outside the European Union. These operating models have existed in the industry for many years. The treaty wording that is reflected in Option M also has existed for many years, as it has been included in the UN Model Tax Convention and therefore was readily available for countries to adopt. Yet, with the exception of a few treaties, modern treaties between OECD member countries do not include this wording. Moreover, this wording was specifically considered by the OECD previously in 2011 in their work reviewing Article 5 and was rejected at that time. It also should be noted that Insurance Premium Taxes are levied in most countries on insurance premiums paid, with such tax collected where the premium is paid.
The options included in the Discussion Draft would create a misalignment between regulatory and tax bases and would give rise to significant uncertainty. Implementation of Option M could result in a significant increase in the number of corporate tax filings insurance groups would be required to make, in some cases as many as three or four times the number of corporate tax filings that are currently made. However, these are likely to be returns that would show no or little taxes, meaning that Option M, if implemented, would result in significantly increased compliance burdens for insurance companies with little or no economic value to the countries.

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If you have questions or would like further information regarding any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com), Arlene Fitzpatrick (arlene.fitzpatrick@ey.com), Ai-Leen Tan (ai-leen.tan@ch.ey.com), or me (alex.postma@ey.com).

Yours sincerely
On behalf of EY

[Signature]

Alex Postma
European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on

BEPS ACTION 7:
PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS
Dear Marlies,

EBIT welcomes this opportunity to provide comments to the OECD on the Discussion Draft on “BEPS Action 7: Preventing the Artificial Avoidance of PE Status 31 October 2014 - 9 January 2015” which was issued on 31 October 2014 (hereinafter “the Discussion Draft”).

General Comments

- EBIT generally supports the OECD’s work to address artificial avoidance of PE status and to eliminate double non-taxation through PEs and ensure that tax is properly charged on activities that are valuable and integral to MNC’s business operations.

- EBIT welcomes proposals aimed at mitigating the legitimate concerns of the G20 and OECD in this context, however, they should not give rise to more double taxation and other unintended consequences for genuine cross-border businesses. The preamble of the Discussion Draft outlines that the BEPS Action Plan intended the update of the treaty definition of PE to prevent abuses of that threshold, but did not mention the widening of the definition and the wider reconsideration of the allocation of taxing rights between source and residence countries which is now also proposed by the OECD. We believe that this approach will augment the risk of “collateral damage” in particular, double taxation in non-abusive circumstances, and may well result in a proliferation of “new PEs”, the majority of which will have trivial attributable profits. There is thus a significant danger that a hugely expanded compliance burden will result for both businesses and tax authorities. The proposed solution may be worse than the current problem that is limited to those MNCs that are abusing the exceptions to PE and artificially avoid taxation, whereas MNCs not abusing PE rules currently face issues in various States due to a lack of uniformity of PE rules and interpretations (e.g.: qualification of PE by local tax authorities based on domestic law without applying treaty provisions, or interpretation of the tax treaty divergent from OCDE guidelines; in the case where a PE exists under the tax treaty, issues as regards attribution of profits and potential double taxation due to non-application or unusual interpretation of tax treaty (often linked to recent - or inexistent - local transfer pricing rules).

- EBIT therefore urges the OECD to make its proposed measures more targeted in nature, either by finding a way to limit the expansion of the PE definition to those situations which should be brought into tax; or, if it is concluded that the PE definition has to be broadened in ways similar to those outlined, then measures to “carve-out” from the extended definition of PE those PEs which would have trivial, and perhaps zero, profit attribution.

- EBIT is moreover of the opinion that it is also necessary that the OECD considers the indirect tax consequences and impacts of any changes to the definition of PEs. Not only does a PE for corporate tax purposes in many countries trigger indirect tax registration (and expensive compliance issues) but there is currently also a need for clarity between the definition of PE for corporate tax purposes and that of a fixed establishment for indirect tax purposes.
Specific comments

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

- EBIT Members note that all four alternatives have in common that they on the one hand propose a restriction of the independent agent exemption and on the other propose a broadening of the dependent agent concept. All four alternatives are aimed at defining a PE against a less objective and more subjective standard for determining whether a PE exists.

- They do so by barring the use of affiliated enterprises in commissionaire arrangements and by taking away the possibility for an independent agent to act exclusively or almost exclusively on behalf of an enterprise, combined with rewording of “an authority to conclude contracts in the name of the enterprise”.

- We believe this unduly narrows the independent agent exemption and eliminates a long standing international taxation principle that an agent can be independent even if it acts exclusively for one party or one or more affiliated enterprises if appropriate criteria are met. This restriction of the independent agent exemption will bring into the scope of the PE definition almost all agency arrangements within a group, given that such agents rarely provide same services to their affiliates and to third parties.

- We are also concerned that the proposed changes to the dependent agent test will impact not only commissionaire arrangements but also other arrangements for making direct sales or providing sales support.

- EBIT considers that there are examples where an intermediary, not carrying on an independent business, carries on activities in a country which result in regular conclusion of contracts to be performed by a foreign enterprise in cases where there is no abusive intention, where the activities have been carried on in a similar manner for a long period of time without giving rise to concern and where this is the only practical way of conducting the business. The OECD should ensure that in such cases, the activities of the intermediary should continue to be regarded as preparatory or auxiliary.

- EBIT urges the OECD to propose more targeted measures, either by finding a way to limit the extension of the PE definition to those situations which should be brought into tax by considering actual conduct of the parties rather than relying on the mere absence of agreements of an agent with third parties; or allow “carve-outs” from the extended definition of PE to those PEs which would have trivial or zero profit attribution.

- To prevent a proliferation of small/trivial PEs as a result of the proposed changes, the OECD could consider introducing a fiscal threshold with regard to the physical presence of sales from an enterprise and any affiliated entities from outside the jurisdiction in which the PE might arise, below which a company would not create a PE. Sales arising from PEs and affiliated entities within the jurisdiction in which the PE might arise should not be counted for the purposes of the threshold. Such a threshold should be set at $1m.

- In this context, EBIT Members are gravely concerned about the U.K. Government’s unilateral newly proposed diverted profits tax which may be introduced in April 2015 ahead of any BEPS agreement on Action 7 and outside the consensual BEPS process. The new rules will tax large MNCs at a rate of 25% on profits that the legislation deems they would have earned if they had set up a PE in the UK, and substantially weakens the distinction between “trading in” the UK (taxable in the UK) and “trading with” the UK (not taxable in the UK) and deeming non-UK based MNCs to be trading in the UK. We are concerned this will set a precedent for other jurisdictions to ignore the BEPS process and set their own definitions of a PE.
B. Artificial avoidance of PE status through the specific activity exemptions

- The Discussion Draft examines four aspects of Article 5 (4) in each case providing options to counter aspects that the Working Group sees as potentially triggering artificial avoidance of the PE threshold. However, EBIT Members strongly believe that it is changes in technology and business models that are driving the pressure on the PE definition in this instance, not artificial structures as such, and we have concerns around the proposed watering down of the specific activity exemptions.

- All four options proposed in the Discussion Draft are likely to lead to collateral damage and have unintended consequences in some areas. Inter-company arrangements that are entirely commercially driven and have no BEPS motive whatsoever are likely to be negatively impacted by the proposed changes to Article 5 (4), perhaps even to the extent that management would consider changing the preferred trading model in order to minimise double taxation risk. This is clearly not an intended consequence of Action 7 which seeks to prevent only “artificial avoidance” of PE status.

- EBIT Members would like to offer concrete examples of potentially unintended consequences:

  **Example 1**: In the commodities or energy trading business, typical commodities or energy trading operations will have only a few companies which enter into transactions with third parties around the world. Negotiations are carried out by employees of these companies in the jurisdiction (not a tax haven) in which they are resident and contracts are concluded by telephone or online. The trading company has no economic substance (people activity) in the majority of countries with which it trades. However, in order to satisfy the delivery of products the trading company may rent from third parties warehouses or tanks to store the products prior to delivery. The margin earned from the trading operation is taxed and should remain to be taxed in the country of residence of the trading company where all economic activity takes place.

  **Example 2**: In order to place spare parts closer to key customers Company A holds a stock of spares at the premises of one of its foreign subsidiaries (Company B). Spares are delivered from Company A’s stock (by third party freight forwarders) to customers throughout the region. Company B is remunerated by Company A on an arm’s length basis for the warehousing function. Whereas previously Article 5(4)(a) would have provided certainty that Company A had not created a PE in country B, the removal of “delivery” from Article 5(4) in accordance with Option F changes a bright line test into a subjective one and the risk that the tax authorities of country B might deem Company A to have created a PE by virtue of the Company B warehouse constituting a fixed place of business. Although the PE risk could be mitigated by Company A storing the stock in a third party warehouse in country B (which, owing to the unrelated party relationship is unlikely be considered a fixed place of business of Company A) this clearly makes no commercial sense if Company B had the requisite facilities to store Company A’s stock.

  **Example 3**: The Option G proposal of deleting the purchasing exemption would create uncertainty for MNCs that utilise regional purchasing hubs to facilitate procurement from regional suppliers on behalf of one, or a number of, group companies.

  **Example 4**: The Option E requirement for all Article 5 (4) exemptions to be preparatory and auxiliary also creates PE exposure for groups employing regional purchasing models as purchasing activities of any business are unlikely to be considered preparatory or auxiliary in nature. In addition, if the regional purchasing hub is negotiating material elements supplier contracts then this would suggest an
agency PE is created for all group entities that procure from the regional suppliers as Options A-D do not discriminate between the conclusion of customer contracts and the conclusion of supplier contracts.

- We would agree that Article 5 (4) is intended to and should only cover preparatory or auxiliary activities. EBIT advocates that any amendments to the definitions of activity within Article 5 (4) are only made where changes in business models suggest a change is needed, as in the case of warehousing, rather than qualifying the entire list.

- EBIT Members would generally prefer the approach as set out in options F-H. However, in regard to option H, in EBIT’s view, whilst technology allows far more data to be collected and stored than ever before, the mere collection of data does not, of itself, create value. Where the collection of information is a core function of the enterprise, it may be appropriate to regard the activity as more than preparatory or auxiliary. A functional analysis may be required but the exemption for the maintenance of a fixed place of business for the purpose of collecting information should not be removed altogether in our view because this would greatly increase the risk of disputes and double taxation. In our view, it is not practical to seek to attribute profit to a PE represented by third parties who are providing information for free to an enterprise.

- EBIT urges the OECD to retain the reference to ‘delivery’ in Article 5 (4). Except for facilities used for the purpose of the display of goods, any other premises that are used for storage are also used for delivery, as goods at some point in time are shipped from the premises where they have been stored. As currently drafted, removing the reference to delivery from subparagraphs a) and b) of paragraph 4 of Article 5 as currently drafted would equally and practically mean that the use of premises for the purpose of storage would also be out of the PE exceptions, irrespective of the core business of the enterprise. Importantly, if the option to remove the exemption for the delivery of goods is adopted nevertheless, the Commentary will need to specify when storage/display ends and when delivery starts, and address the case of the use of premises for storage and delivery when delivery is not the core activity of the enterprise, thus remains auxiliary.

- Where there has been artificial fragmentation of activities in order to bring an entity within the preparatory or auxiliary exclusion there may be a valid case for doing so. However, EBIT is concerned that the Discussion Draft does not distinguish these cases from the many cases where the fragmentation reflects a genuine commercial arrangement, where, for example, activities have been divided between legal entities in order to focus the business or to manage risk from a commercial perspective. This is therefore likely to prove highly contentious in practice and might offer an opportunity for adopting a more aggressive stance by tax authorities (see also section on splitting up of contracts C below).

As an example, Company A (resident in State A) has a PE in State C (successive construction projects), and related Company B (resident in State B) performs a preparatory or auxiliary activity (collecting information) in State C. Company A performs operational activity whereas Company B is its headquarter. Under the proposed Discussion Draft, if the activities are considered as cohesive business operation, Company B will have a PE in State C (this would assume that Tax Treaty B-C includes provision to qualify a PE based on the cumulated activities performed by related entities and not only by a given legal entity). Although such qualification should not apply here, local tax authorities may challenge this view (e.g. on the ground that collected information supports the business and conclusion of contracts). This being said, if B performs preparatory or auxiliary activity, the taxable income of the PE should be nil.

If Company B performs an activity which is not preparatory or auxiliary (as listed in existing Article 5.4), but does not qualify as a PE on a standalone basis, it does not
seem that the revised wording would apply, since it is inserted as paragraph 4 (1) and starts with “Paragraph 4 shall not apply to ...”.

- EBIT considers that in general, the target and impact of the rewording should be clarified.

C. Splitting-up of contracts

- EBIT considers that the proposed PPT would ensure that in cases where contracts are split up for legitimate commercial reasons the enterprise is not inappropriately deprived of the benefit of the threshold. We note that under the first proposed approach, i.e. the automatic rule as proposed under K on page 22 of the Discussion Draft, this would not be granted. EBIT therefore does not welcome the automatic rule approach. Rather, we’d advocate that the Model Tax Convention make an exception for cases where there are genuinely separate contracts either for particular genuine commercial purposes or as a result of the history of the enterprise.

- EBIT is concerned that the options proposed in the Discussion Draft could lead tax authorities to becoming more aggressive in applying the treaty PPT anti-abuse test, which would result in more uncertainty about the application of the PE definition rules as a whole. Although the Discussion Draft does explain that the PPT would apply only to tax-motivated cases and not where there are legitimate business purposes for the involvement of associated enterprises, this distinction is likely to prove highly contentious in practice, and especially under EU Law. EBIT urges the OECD to make sure that none of its proposals breach EU Law, as otherwise 23 out of the 44 BEPS countries will be unable to adopt the recommendations.

E. Profit attribution to PEs and interaction with action points on transfer pricing

- EBIT welcomes the OECD’s acknowledgment that the work on Action 4 (interest deductions), Action 7 (PEs), Action 8 (intangibles) and Action 9 (risks and capital) are all interlinked and will all need to be considered in connection before contemplating amendments to the existing profit attribution rules. The discussion on the definition of PE and profit attribution should also be linked.

- The Discussion Draft implies that the creation of a source country PE by the principal would result in the attribution of additional taxable profit to the source country. However, to the extent that the affiliate resident in the source country is already being remunerated on arm’s length terms by the principal for routine functions performed locally, it is difficult to see what additional profit (if any) should be attributed to the PE based on the arm’s length principle. Whilst the Discussion Draft acknowledges that additions/clarifications (but not substantial changes) to the existing rules and guidance is necessary, a key concern is that tax authorities could use the amended Article 5 to deem a PE of the principal had been created but deviate from the OECD standard when it comes to apportioning profits to the said PE and disregarding the profits already being taxed locally in the hands of the affiliate.

- EBIT urges the OECD therefore to take a holistic approach with regard to the reconsideration of some aspects of the existing rules and guidance on PE profit attribution.

- EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss and remain committed to a constructive dialogue with the OECD.

Yours sincerely,

European Business Initiative on Taxation – January 2015

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For further information on EBIT, please contact the EBIT Secretariat via Bob van der Made, Tel: +31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

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Milan, January 8, 2015

Ms. Marlies de Ruiter
Head
Tax Treaties, Transfer Pricing
and Financial Transaction Division
OECD/CTPA

By email: taxtreaties@oecd.org

SUBJECT: PROPOSED REVISION OF “BEPS” ACTION 7 – PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

Dear Ms. de Ruiter,

We are pleased to submit our comments on the discussion draft and to provide a few examples of unintended effects that may result from the approval of the options.

1. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

In our opinion option C seems the most suitable proposal to replace the current para. 5 of article 5 of the OECD Model Tax Convention.

1.1. It replaces the concept of “authority to conclude contracts in the name of the enterprise”, that led to several discussions from an Italian perspective (ended in the Observations to the Commentary para. 45.10), with the concept of “engages with specific person in a way that results in the conclusion of contracts”.

The OECD proposal seems to finally recognize the accuracy of the Italian position on

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1 On the basis of Italian jurisprudence the “power to conclude contracts” should not be interpreted having regard solely to the power to legally bind under civil law, but may occur even if a person is physically present to the negotiations in Italy between the representative of foreign company and their counterparts (the area of exposure in Italy already tends to be wider than in other jurisdictions).
this, focussing the attention not on the mere phase of the execution of contracts but on
the actual connection between the activity performed by the dependant agent and the
conclusion of the agreement.

The current definition generated many difficulties for the Italian Tax authority during tax
audits, in collecting the proof of the physical presence of the dependant agents in the
conclusion of the contracts.

1.2. The definition laid down in option C is certainly preferable than that outlined in options
B and D ("concludes contracts, or negotiates the material elements of contracts"), since
the concept of “material elements of contracts” is too open to different interpretations
from each of the OECD member's state. An example may expand our concern re B and
D options.

**Example 1:**

- Xco is a company resident in State A involved in the sales of goods as a worldwide
  Distributor, pertaining to a multinational group;
- Yco is a company resident in Italy acting as an Agent (in Italy) belonging to the same
  multinational group;
- Xco provides information - directly from State A - to the Italian customers on the
  timing of the delivery, on the methods of payments and, of course, the execution of
  the contracts is made in State A;
- Yco is involved in the providing of information on the price of the products, on the
  technical features of the products and on the capability of the company resident in
  State A to provide the customers with a defined volume of products.

In this case it seems unclear if the Agent negotiates the *material elements of the
contracts*.

By way of reference, in the case of sales of goods, the mandatory elements of a
contract under Italian commercial law are the agreement of the parties, the cause of
the contracts and the subject.

Therefore, on the basis of options B and D, uncertainty may arise on the fact that Xco is
forming a PE in Italy: providing of information on the price of the products and on the
technical features of the products is not a mandatory element of the contracts but Tax
authority may be willing to extend the concept of *material element of contracts* beyond
those forming the mandatory elements according to the Italian commercial law.

Both the Tax authorities and the taxpayers would have too many difficulties due to not
having a clear framework at their disposal.
1.3. In addition, option C finally tackles the concept of *in the name of*, which led to several discussions between the tax payers and the Tax authorities, replacing it with the concept of "*contracts which, by virtue of the legal relationship between that person and the enterprise are on the account and risk of the enterprise*".

We greatly appreciate the list of examples that should eliminate any possible doubts on the accuracy of the business model to be adopted. However we observe that none of the options proposed seems to cover the case of "*limited risk distributor*", also taking into consideration that this concept is often used to identify a distributor with very limited / no risks (we refer in particular to the absence of credit risk). An example may expand our concern.

**Example 2:**

- Xco is a manufacturing company resident in State A;
- Yco is a company resident in Italy, belonging to the same multinational group of Xco, acting as a limited risk distributor for the products of the group. On the basis of the distribution agreement, the distributor does not bear risks, except for a credit risk. However this risk is economically covered by-means of the provision of a remuneration based on a fixed profit level indicator to be achieved;
- In other words, the cost related to the credit loss is shifted from Yco to Xco;
- The sales with the clients are legally on the account and undertaken at the risk of Yco, but economically they are on the account and at the risk of Xco.

1.4. Our recommendation is to specify, as far as is possible, a list of business arrangements that can be deemed to create a permanent establishment in a foreign country, and in order to allow the tax payer to have the possibility to have clear tax planning, reducing the possibility of further disputes with the Tax authorities. The clearer the OECD is in this phase, the less the possibility of artificial avoidance of PE status.

2. **Artificial avoidance of PE status through the specific activity exemptions**

We consider option E the most suitable proposal to react to the modernisation of doing business in specific fields.

2.1. Now many relevant activities are not included in the current negative list, although they have a key role in the value chain of the particular business of the multinational group; adopting this new option E, in case they are not of preparatory or auxiliary nature, they will be deemed to be forming a PE. Therefore, our recommendation is to further specify – i.e. expand - the concept of *preparatory and auxiliary activities* in the OECD commentary, since it shall become the main important element to be taken into
consideration during an assessment of PE.

2.2. We refer in particular to – but not limited to - the auxiliary activity of “supply of information” laid down in para. 23 of the commentary of article 5, in which “it is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the supply of information (…)”. For instance, the supply of information may often be a part of the sales activity and, however, it may be difficult to prove that the providing of information is a preparatory or auxiliary activity. It could be the case to specify the information which is not considered to be related to the sales and, therefore, which is not an essential part of the business of the enterprise. Generally, in the activity of performing a sale, the supply of information is the first part of the business of the enterprise that will lead to the conclusion of the sale’s contract.

2.3. In conclusion, our recommendation is to provide in the commentary with a new definition of preparatory or auxiliary activity, also considering the different impact which this kind of activity may have in different fields of business (e.g. the providing of information in the sales activity could be very different from providing information in chemical research).

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Please feel free to contact us if you have any queries about this letter.

Dott. Marco Melisse and Dott. Sebastiano Sciliberto
Paris, le 9 janvier 2015

Madame,

La Fédération Bancaire Française (FBF), organisme professionnel regroupant l'ensemble des établissements de crédit en France, est heureuse de l’opportunité qui lui est offerte de présenter ses observations dans le cadre de la consultation organisée par l’Organisation de Coopération et de Développement Economiques (OCDE) sur le document de discussion relatif à l’action 7 du plan « BEPS ».

Ce document fait l’objet d’un certain nombre d’observations de notre part que vous trouverez dans la note ci-jointe, établie en anglais afin d’en faciliter la diffusion auprès des différents membres de l’OCDE et parties intéressées.

Nous restons à votre entière disposition pour tout renseignement complémentaire dont vous auriez besoin.

Je vous prie d’agréer, Madame, l’expression de mes sentiments distinguées.

Blandine LEPORCQ
Directrice du département fiscal

Madame Marlies de Ruiter
Chef de l’Unité des Conventions Fiscales, Prix de Transfert et des Transactions financières
Centre de Politique et d’Administration Fiscale
Organisation de Coopération et de Développement Economiques (OCDE)
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APPENDIX: COMMENTS FROM THE FRENCH BANKING FEDERATION ON THE PUBLIC DISCUSSION DRAFT RELATING TO THE ACTION 7 OF THE BEPS REPORT “PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS”

PRELIMINARY REMARKS

The FBF, as the voice of the French banking sector representing the interests of over 400 banks operating in France, encompassing large and small, wholesale and retail, local and cross-border financial institutions, welcomes the opportunity to provide the OECD with comments on certain questions of the proposed Public Discussion Draft relating to the Action 7 of the BEPS Report “Preventing the artificial avoidance of PE status”. It is crucial for us to have the opportunity to provide our comments as well as our input, particularly given the complexity of certain issues under this discussion. We thank the OECD for the consultative process underway and call for a continued interaction with the private sector so that the voice of business is duly taken into account.

As preliminary remarks, we would however like to express some concerns about the “BEPS project”:

First, the subjects under discussion and the issues at stake are far-reaching and sometimes extremely complex. The accelerated pace planned by Member Countries of the OECD do not allow us to analyze thoroughly the topics, to consult our members as much as necessary and thus do not allow us to contribute as deeply as we would wish to. We believe that analyzing the consequences of the proposed changes is also a great challenge for both tax administrations and the private sector, which requires more dialogue and more time. We would therefore call for a more realistic timeframe, with more reasonable consultation periods in particular. It would also be extremely useful to have a track of the different changes brought to the various reports on every action issued by the OECD after collecting the comments of the stakeholders.

Besides, we fear that the proposed changes may introduce legal uncertainty (in particular due to divergences in interpretation by different Countries) and may create even more operational complexities for taxpayers, all of which may weaken the very purpose of tax treaties of eliminating double taxation. It seems that Member Countries may be losing sight of this objective which yet contributes to economic growth.

While we support the Governments’ will to tackle abusive behaviors of taxpayers, we believe that the proposals of the BEPS plan, in particular in the area of preventing the artificial avoidance of PE status through specific activity exemptions, may constitute a disproportionate answer from public authorities as it may constitute a clear breach of decades of international tax practice.

SPECIFIC COMMENTS

2. ARTIFICIAL AVOIDANCE OF PE STATUS THROUGH SPECIFIC ACTIVITY EXEMPTIONS

We are particularly concerned that the concept of a PE may be considerably enlarged, requiring a multitude of international groups to reassess their group structures to check the status of each entity regarding PE status. This appears to be a disproportionate answer to the issue at stake.
Stability should be essential: we strongly recommend preserving the scope and purpose of Art.5(4) as it is an important feature for groups when looking to create/develop new activities in a jurisdiction and when expanding abroad. Representation offices are a particularly useful tool in this respect and there should be no modification to this concept. Limiting the scope of this exemption would hinder such international expansion of groups and may even be detrimental for developing economies as the prospect of future PE activities may drift away.

Finally, we question the opportunity to revisit the current well-established and stable PE rules as Transfer Pricing principles already provide an answer by allocating taxation to such or such a jurisdiction.
Dear Mrs. de Ruiter,

BDI\(^1\) refers to the OECD Discussion Draft “Prevent the Artificial Avoidance of PE Status” issued on 31 October 2014. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues. Before commenting on the specific provisions we would like to outline some preliminary thoughts.

General comments

The BDI acknowledges that there seem to be BEPS related concerns in the area of the Permanent Establishment (PE) definition. However, within the business community there is a strong concern that a project intended to tackle BEPS is resulting in a somewhat wider reconsideration of the allocation of taxing rights between source and residence countries. The proposed rules would potentially significantly lower the threshold at which an enterprise of the state of residence would be considered to have a PE in the other state. Therefore we feel the strong need to highlight the point that an expansion of the definition of PE poses very high risks of conflicting claims of taxing jurisdictions and will inevitably lead to an increased danger of international double taxation in non-abusive circumstances.

Another important issue that we would like to draw attention to is the question of profit allocation. Countries want to create more PEs because they want to attribute profits to them. To the extent that a PE is “virtual”

\* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 37 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.
or essentially “virtual” because functions, assets and risks of that PE are minimal, no significant profits should be attributed to that PE. Countries may, however, attempt to use these marginal PEs to attribute significant profits based on the value of the market or some other attribution theory. The Discussion Draft notes that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”\(^2\) However, broad PE rules, combined with a lack of attention to profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed. As not all countries may share this view and because of the lack of clarity companies run the risk to be caught in the middle with profits attributed to both jurisdictions resulting in double taxation.

In order to prevent this there at least has to be consensus as to the precise details of how any new approach will be applied. What is needed are objective criteria rather than subjective tests. Clear guidance is the prerequisite for the creation of legal certainty and the reduction of potential dispute sources between tax authorities and businesses. This pledge becomes even more fundamental as the rules regarding the effectiveness of the dispute resolution mechanisms under BEPS Action item 14 have not yet been tackled. The implementation of effective and mandatory dispute resolution regimes, however, is essential and needs to be treated with absolute priority.

There also is a fear of unwarranted administrative and compliance burden on taxpayer level. It must be made sure that any changes do not undermine investment and growth and do not restrict legitimate cross-border activity.

**Specific Comments on Issues Outlined in Section A of the Discussion Draft – Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies**

Commissionaire arrangements and others involving dependent agents are very common and effective commercial features of cross-border trade. However, in view of the OECD those arrangements in many cases are put in place primarily in order to erode the taxable base of the state where sales take place and therefore give rise to BEPS concerns. The four options A to D suggested by the Discussion Draft to tackle these concerns all result in the fact that for assessing the existence of a PE the focus is shifted from the legal perspective to looking at the economic result (i.e. the principal enters into a contract).

Lowering the dependent agent threshold below the ‘concluding contracts’ test is likely to widen the scope of the rule considerably and introduce greater subjectivity into the determination of whether a PE exists in any particular case. We believe that this will potentially impact adversely not only on commissionaire arrangements but also a wide range of arrangements for making direct sales or providing sales support, i.e. limited risk distributor and other principal structures. Generally, acting exclusively or

\(^2\) Discussion draft, paragraph 3, page 10.
almost exclusively on behalf of one enterprise can only serve as an indication of dependence; however, it always needs to be possible to provide evidence that this is not the case.

We therefore strongly suggest to apply the existing rules where there is no intended abuse and where arrangements, often of long standing, represent an efficient way of conducting business. Instead of broadening the existing PE definition any concerns regarding these arrangements should be tackled – as is the case today – by applying the arm’s-length-standard to the remuneration of the commissionaire.

**Specific Comments on Issues Outlined in Section B of the Discussion Draft – Artificial avoidance of PE status through the specific activity exemptions**

In revising the list of exceptions included in Art. 5 (4) of the OECD Model Tax Convention it is essential to keep in mind the purpose of these provision according to which a PE is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph: To provide some certainty around activities that are generally preparatory and auxiliary and also do not contribute significantly to the profits of an enterprise.

According to Art. 5 (4) a) and b) OECD Model Tax Convention warehouses and their respective stock are not considered to give rise to a PE. Option E provided in the Discussion Draft now aims at narrowing the activity exceptions to the extent that exemptions from PE status should generally only apply in cases where the activities are of a preparatory or auxiliary nature. Alternatively, warehouses should only be exempted from PE status if no delivery of goods or merchandise belonging to the enterprise takes place (option F).

Certainty of outcome is critically important for business. Subjecting all of the listed activities to potentially subjective tests would increase uncertainty. We also believe that the implementation of an overall “preparatory or auxiliary” condition would impact heavily in the majority of situations where the preparatory and auxiliary test is legitimately relied upon, increasing the burden faced by compliant taxpayers. As the wording of the proposed changes is not explicitly restricted to cases of misuse the suggestions would also have serious implications for the numerous (consignment) warehouses which are commonly used by businesses from all sectors.

Options G and H deal with the exceptions for purchasing offices. Option G eliminates the preparatory and auxiliary exception for purchasing goods, option H would delete the entire subparagraph d) of Art. 5 (4), ie also the exception for data collection.

However, in most cases, purchasing will make only a minor contribution to the overall profitability of the enterprise. The profits attributable and the corresponding amount of tax due in relation to these minor contributions will not justify the cost of establishing the structure necessary to produce the
financial information to comply with PE rules, or the annual compliance burden. With regard to data collection we believe that raw data has little value on its own. We therefore recommend that the exceptions for purchasing as well as data collection should be retained.

**Options I and J** aim at extending the provisions dealing with the fragmentation of activities from cases where the same company maintains different places of business in a country to cases where these places of business belong to related parties. The anti-fragmentation rule drafted in a newly added Art. 5 (4.1) of the OECD Model Convention would deny the applications of the exceptions of Art. 5 (4) where complimentary business activities are carried on by associated enterprises at the same location, or by the same enterprise or by associated enterprises at different locations.

In general, the idea of an anti-fragmentation rule can serve as a means against misuse. However, we have major concerns in relation to the basic application of the anti-fragmentation rule. Both options would hardly be in line with the concept of separate entity reporting. They would also create vastly different results for enterprises dealing with related vs. unrelated parties and would work to destabilize the arm’s length standard, which the BEPS Action Plan continues to support. Also, the interaction with the proposed options E and F needs to be carefully considered – a combination of both would easily exceed the target of combating abuse.

**Specific Comments on Issues Outlined in Section C of the Discussion Draft – Splitting-up of Contracts**

Building sites give rise to a PE if they last for more than 12 months. The aim of the proposed amendments of Art. 5 (3) of the OECD Model Convention is to prevent the splitting-up of contracts within a multinational company in order to avoid a PE by each covering a period shorter than 12 months.

**Option K** of the Discussion Draft suggests to introduce an „automatic rule“ which would add up the activities performed by associated enterprises at the same building or construction site or installation project for the purpose of the 12 month rule.

The alternative **option L** suggests to apply the general anti-abuse rule, which has been introduced in the Discussion Draft for Action 6 on “Treaty Abuse” (“Principal Purpose Test”, PPT) including a further example to clarify the application of the PPT.

The „automatic rule“ stipulated in Option K is to be rejected, as businesses must always be given the possibility of stating the economic reasons for splitting up a contract, which can be numerous. There may be diversification reasons within a group, customer requirements, or the availment of public funding for a certain project, just to name a few.

Introducing a general anti-abuse rule – which already exists with a view to Para. 42.45 of the OECD Model Commentary – would at least allow business to produce evidence to show that a contractual arrangement has been
chosen for other than tax reasons. However, any such rule will lead to increased legal uncertainty and therefore conflicts with the overall purpose of having a double tax agreement in place.

Specific Comments on Issues Outlined in Section E of the Discussion Draft – Profit Attribution to PEs and Interaction with Action Points on Transfer Pricing

We share the Discussion Draft’s recognition that the attribution of profits must be a key consideration in determining which changes should be made to the PE definition. However, we regret that the Discussion Draft in fact does not address the profit attribution implications of the potential PEs created under various options. On the contrary, the draft implicitly seems to dismiss this issue as insignificant. We therefore would like to highlight the point that the application of the attribution rules, in practice, is often subjective and uncertain. Lowering the PE threshold as the Discussion Draft suggests will inevitably lead to a rise in cases dealing with attribution issues and consequently in uncertainty. Materially improved dispute resolution practices therefore need to be implemented with high priority.

Against this background we are concerned that tax administrations implicitly overestimate the amount of profit attributable to a PE compared to the corresponding result under the transfer pricing rules. In general, there would be no difference between the respective amounts of profit.

Concluding remarks

The BEPS project has been defined as relating to the avoidance of double non-taxation. However, lowering the threshold for the creation of a PE will not specifically target double non taxation, but will instead inevitably lead to a change in the balance between source and residence taxation. We believe the relationship between the expected use of the infrastructure and resources of a country and the PE threshold should continue to exist as a fundamental principle of direct taxation. For businesses the proposals are likely to result in increased legal uncertainty and double taxation in cases that are not the intended target of the BEPS project. We are concerned that the additional burdens and the increased likelihood of disputes could have a negative impact on cross-border trade and investment. …

Please do not hesitate to contact us if you have any questions.

Sincerely,

Berthold Welling Dr. Karoline Kampermann
9 January 2015

By e-mail

To the attention of Marlies de Ruiter,
Head of Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

RE: BEPS action 7 Preventing the artificial avoidance of PE Status: draft comments

Dear Madam,

FIDAL is delighted to respond to the OECD’s request for comments from the business community in connection with the draft paper that was issued on 31 October 2014.

I. GENERAL OBSERVATIONS

We note that the Committee is particularly interested to learn about specific examples of unintended effects that might result from the options proposed as well as examples of possible avoidance that could result from each option.

We share the OECD’s observation that commissionnaire arrangements and similar strategies can be made in order to erode the taxable base of the State where sales take place.

However, to our knowledge, these strategies are also put in place for business reasons linked to:

- the evolution of the way in which enterprises selling products or rendering services abroad operate. In particular, SMEs often organize their cross-border sales through agents or commissionnaires abroad, mainly in order to save costs. MNEs generally also prefer, for organization and costs reasons, to have inventories managed by the manufacturing entity or a management entity that controls the deliveries, selling agreements, pricing policies etc., so that they frequently organize their sales processes through agents;

- this evolution is strengthened by the significant expansion of the digital economy (a local fixed place of business is less and less necessary to do business in a State);

- the legal consequences of operating through agents (in terms of liability, sales conditions, etc.).
To our knowledge, it is quite rare for companies to organize or re-organize their business via agents solely for tax purposes. It should also be noted that, depending on the circumstances, such reorganizations could trigger a "change of activity" under French tax law (which entails significant adverse tax consequences such as the taxation of capital gains and the cancellation of tax-loss carryforwards).

As specified in the public discussion draft, the current difficulties regarding PE status also concern actions 8 (intangibles), 13 (transfer pricing), 1 (digital economy) and 6. The proposed changes in the PE status should therefore take into account these actions, such as the anti-abuse or anti-treaty shopping measures, which can already address the need to prevent the artificial avoidance of PE status (see for example option L).

II. SPECIFIC COMMENTS

A. Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

It seems to us that the measures to be adopted concerning Article 5 of the model convention are not specific enough and could generate risks for the enterprises. The current criterion, i.e. to "have the authority to conclude contracts in the name of the enterprise," is precise.

This criterion was recently commented on by the French Supreme Administrative Tax Court, specifically with respect to commissionnaires (decision dated 31 March 2010, nos. 304715 and 308525, concerning the tax treaty concluded between France and the UK).

In this decision, the French Supreme Administrative Tax Court ruled that commissionnaires, as defined by French law, cannot be regarded as PEs because they act in their own name, unless the commissionnaire agreement does not comply with French law in this respect, in which case the tax administration would be entitled to challenge the nature and tax consequences of the agreement.

It should be noted that the previous (lower court) decisions on the matter were different, as the lower courts had regarded the commissionnaire as a PE, mainly because they wrongly applied the rationale of an earlier Supreme Administrative Tax Court decision (decision dated 20 June 2003, no. 224407, regarding the tax treaty concluded between France and Switzerland) and OECD comment no. 32.1 on Article 5 of the OECD model convention.

It seems that this comment mainly concerns agents as defined by Common law, not French commissionnaires.

One of the main grounds of the Supreme Administrative Tax Court’s recent (2010) decision was the need to apply a legal – i.e. a specific – criterion, as opposed to an economic – i.e. a less specific – criterion, in order to avoid raising doubts about the status of commissionnaires and of similar agents such as franchisees, exclusive distributors or dealers.
In our opinion, there are several drawbacks to correcting commissionnaire arrangements by modifying Article 5, because the proposed economic criteria are not specific enough and would therefore generate uncertainty for enterprises using commissionnaires or similar agents.

Indeed, under all the proposals (A, B, C or D), many commissionnaire arrangements in place with related entities could lead to an automatic recognition of a PE of the foreign principal in the State where the commissionnaire operates. The conditions of taxation of commissionnaire arrangements with related entities would then be aggravated as compared to commissionnaire arrangements entered into between non-related entities, and this differential treatment could be challenged in light of the freedom of establishment principle notably within the EU.

In addition, the proposed versions call for the following more general comments:

- **Options A and C**: the concept of engagement “with specific persons in a way that results in the conclusion of contracts” seems very broad and imprecise. As per the explanation given, it would require a direct causal connection between the interaction made by the intermediary and the conclusion of the contracts. However, in practice, while this link might be easy to establish in the presence of very simple and clear arrangements, we already anticipate a large grey area notably for situations in which the interaction would be viewed as necessary but not sufficient in itself to entail the conclusion of contracts. Specific and probably complex guidelines/comments would thus have to be defined to help taxpayers determine whether or not a PE would exist in the State in which the intermediary acts.

- **Options B and D**: on the other hand, the reference to the capacity to conclude the contracts or to negotiate the material elements of the contracts would appear less imprecise and less difficult to assess in practice. Indeed, the interaction required in these versions would have to be notably revealed by factual or material elements.

Therefore, if it were confirmed that Article 5 has to be modified as per one of the above versions, we are of the opinion that options A and C should be avoided in order to ensure a necessary level of legal certainty for taxpayers.

Lastly, it seems to us that the proposed options for modifying point 6 would help to clarify the definition of “independent agent” and could avoid abuses in this area, even though it is another step towards economic – as opposed to legal – criteria.

**B. Artificial avoidance of PE status through specific activity exemptions**

As regards points 1 to 3, relating to proposed modifications regarding (i) “the exceptions are not restricted to preparatory or auxiliary activities”, (ii) “the word “delivery” in subparagraphs a) and b) of paragraph 4” and (iii) “the exception for purchasing goods or merchandise or collecting information,” it seems to us that Option E would be efficient.
As regards the splitting-up of contracts, we are of the opinion that Option K would be more appropriate. Option L does not concern only the splitting-up of contracts but consists of a general anti-abuse rule proposed in the report on Action 6. It seems to us that referring to reasonability would not be safe for enterprises.

C. Insurance

Regarding insurance activities (§§ 35 to 42), we consider that Option N is by far the most appropriate.

Indeed, our comments above whereby multinational companies rarely if ever “play” with the status of their distributors to artificially avoid taxation are all the more relevant for insurance companies that both the status of the insurance intermediaries and the exercise of the insurance country in a given country are strictly regulated by specific prudential rules to which, surprisingly enough, the current comments do not refer at all.

As an illustration, where a French insurance company wants to carry on insurance business in a non-EU country, it frequently has to establish (through a branch or a subsidiary) in this country. Thus, and even though we have no precise statistics about the practical implementation of article 5(6) of the UN Model Convention, we suspect it is a rather theoretical provision which may be used by some jurisdictions to tax profits that they are not entitled to tax indeed from a business perspective.

The situation within the EU is different because of the fact that insurance companies may carry on their business under the freedom of establishment (“FoE”, via branch or sub) or the freedom to provide services (“FPS”, usually through a local distributor). In the latter case, Option M could lead the State where the premiums are collected or risks situated to seek to tax insurance profits while only distribution activities are deemed to be performed in that State from a regulatory point of view. We suspect this would lead to endless discussions with the taxpayers and between the States about which State is entitled to tax what and whether a State may interfere into the choice of the company to perform insurance business through FoE or FPS. The purpose of the OECD (avoid artificial use of the P/E concept) would very likely be missed.

Very truly yours,

Cédric Deschamps
Attorney at law

FIDAL

Cédric Philibert
Attorney at law

cc:
- Laurent Leclercq, Fidal
- Maud Méotti, Fidal
FFSA’s Comments on OCDE Discussion Draft on « BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS »

The French Federation of Insurance Companies (FFSA) is a trade association which groups together 234 insurance companies representing 90% of the French market. In particular, its purpose is the promotion of insurance, the defense of the interests of the profession and the establishment of common ethical standard.

We welcome the opportunity to participate at the consultation process on action 7 "Preventing the artificial avoidance of PE status. Our comments will focus on options regarding the insurance sector and the commissionaire arrangements.

1. Insurance (Option M)

In our view there is no sufficient reason for separate treatment of the insurance sector and the discussion paper provides no real explanation for including option M. The actual provisions of the OECD model focusing on the conclusion of contracts is appropriate for the insurance industry since the conclusion of the contract will require a decision to be made regarding risk taking which is the key element of our business.

Option M takes no account of the decision to take risk, which differs to the approach taken in the OECD Model Convention. Indeed in option M, the legal and functional approach is abandoned in favor of an analysis that is neither legal nor functional or economic. Such recognition would be "artificial" and does not reflect the level of local activity of the insurance company. In particular, it must be emphasized that the premium collection criterion is not relevant and does not characterize the place where the key functions are exercised. The agent does not bear any risk in the scenario where it is merely collecting premiums, and it will already be remunerated on the arm’s length basis for function that it does perform.

Moreover, the draft report contains little feedback on option M and it is difficult to evaluate the full impact of the new wordings. Therefore, the risk of legal uncertainty would be increased by the introduction of the option M. In fact, the contemplated amendments to the current definition will lower the threshold of constitution of a permanent establishment and will probably create a mass of “new” PEs.
Option M will also increase the case of double taxation, which the MAPs are struggling to solve efficiently and quickly. Thus, some activities could be taxed both in the country of the insurer, in which the contract was concluded and in the country of residence of the insured. However if the principles within the 2012 OECD Report on the attribution of profit to a permanent Establishment Part IV are followed then there would be little or no profit attributed to the agent as a PE of the insurer would be minimal as the KERT is not performed by the agent. Therefore, there is a risk that a significant number of PEs will be created with little or no tax revenue being generated for the state in which the agent is located. This creates a considerable additional administrative burden for the insurance industry.

Moreover, in the European Union (EU), there is a common understanding of the legal and regulatory definition of permanent establishment. The 28 EU member states have agreed on a legal and regulatory definition that allows an insurance company to carry on business in a Member State other than that in which it is installed without that it is necessary to see the creation of a new permanent establishment but rather that the activity is exercised in freedom of services. In fact, in the EU, option M would lead to a multiplication of fiscal permanent establishments in countries where there is no permanent establishment for legal and regulatory purposes and where the level of activity is too weak to incur the administrative and regulatory burden induced by the presence of a permanent establishment: keeping separate accounting records, allocation of human resources on site, filing of returns etc.

The recognition of permanent establishment for tax purposes where there is no permanent establishment for regulatory purposes, could lead to a disparity regarding the FOS Directive. Indeed it would become extremely difficult not to have a permanent establishment for regulatory purposes with all the diligences arising from the existence of a tax permanent establishment. Furthermore, in the insurance sector, these requirements will be particularly serious when the regulatory framework establishes the principle of risk pooling and requires sufficient capital in the face of commitments.

2. “Commissionnaire arrangements” (Option A, B, C, D)

We should stress that the options proposed in the draft report are not sufficiently precise. As well as details should be made on the terms "engage", "specific persons", "material elements" and "independent" for the consequences of these four options to be clearly analyzed.

For example the term "engage" is ambiguous and can mean as well starting negotiations as conclude a contract.

At this stage the introduction of one of the option could lead to an increase of legal insecurity for companies and States, with a considerable increase of double taxation issues and litigations.

In addition, the term "habitually" must be retained. Otherwise there is a risk that isolated transactions are taxed without taking into consideration the level of local activity.
Independently from the points which have been raised, if a modification of the §5 of Article 5 is chosen, our preference will go to an option that is based on functional and legal criteria such as options C or D try to achieve. But the wording of these options is not appropriate as they will have much wider implications than the stated intention of the Action Plan, Action 7, which was originally intended to catch structures such as commissaire structures. However, it is our view that Options C and D could have unintended consequences in a « risk » business such as insurance or reinsurance. Reinsurance contracts could fall within the wording for instance since the underlying risk is partly « on the account and risk » of the reinsurer. Reinsurance has genuine commercial purpose and therefore should not be caught by amendments to the PE Article of the Model Treaty.

FFSA is supportive of any appropriately targeted measure which struggles against artificial avoidance of PEs. However, we stress on the need to maintain a clear, stable, and appropriate legal framework, and upscale the current mutual assistance procedure to ensure the absence of double /multiple taxation, which is crucial for economic confidence and growth.

Yours faithfully,

François Tallon
Head of Tax Affairs – FFSA
Comments on the Public Discussion Draft of BEPS Action 7: Preventing the Artificial Avoidance of PE Status of 31 October 2014

To: Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

Introduction

The OECD released its latest draft on the public discussion of preventing the artificial avoidance of PE status on 31 October 2014 with comments invited by 9 January 2015.

The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

General Overview and High Level Concern

The PE provisions are designed to promote commercial activity through the appropriate allocation of taxing rights over international business transactions between residence and source countries. A taxpayer generally has to establish a fixed place of business in the source country and has to carry on its business through that fixed place of business before the taxpayer becomes taxable in the source country. The business has to be carried on through either the taxpayer’s own employees or its dependent agents. There are also sensible exemptions to ensure that auxiliary and preparatory activities (such as storage and delivery) are not counted as the company’s main business for these purposes. In essence a taxpayer has to trade “in” a source country and not merely “with” a source country before it is subject to tax in the source country. Whatever changes are made during this consultation process we believe that this principle should be preserved and upheld.

Let’s consider an example of an international gas trader (ABC Ltd) that sells gas and related products globally. It does not have subsidiaries or branches in every country with which it does business. In fact it only has established offices (subsidiaries and people) in, say, 10 countries out of the say 60 or so countries with which it trades. We consider that this is an entirely normal fact pattern that is adopted by most MNCs. It is simply un-commercial to be physically based in every country with which trade is conducted.

Let’s further expand the example to consider the case of a long term international gas supply contract. The related activities might look something like this:

- ABC Ltd has gas available to sell to international customers
- ABC Ltd does not have an existing presence in the potential demand markets
- Customers are indentified and marketing and sales negotiations are held in a number of locations over a period of time including the countries where the counter parties are located
• Decisions to enter into the long term contracts are made by the senior management and boards of the respective companies in their own countries of residence
• ABC Ltd agrees to sell the imported gas on a delivered basis at the buyer’s premises in the host country
• ABC Ltd therefore hires the use of third party transportation capacity and storage facilities that are required to deliver the gas. This capacity might be in a number of different transit countries. This activity is entirely sub-contracted to other parties (these could be related parties) who are fully taxable in the source countries on their transportation and storage activities. ABC Ltd has no employees in the source or transit countries that are conducting or arranging this activity.
• ABC Ltd delivers gas as promised under the contract. However it also trades financial and other products on an energy trading exchange based in the source country in order for it to hedge its risks or to increase profits through supply optimisation. This trading is conducted by ABC Ltd’s employees entirely from its own country of residence.

Under the existing PE arrangements ABC Ltd should not be taxable on the profits of the gas supply country in the demand or transit (source) countries. This is on the basis that it does not have an actual or deemed fixed place of business in any of the transit or source countries. It will in fact only be taxable in its own country of residence. ABC Ltd is trading with the source or transit countries. It is not trading in the source or transit countries. The owners or operators of the transport and storage facilities are not covered by this scenario and different considerations will apply.

We are concerned that the OECD’s desire to tax internet activities and the digital economy will adversely affect the above analysis. Any significant changes to the specific activity exemptions or rules regarding conclusion of contracts could bring into tax situations, such as the one outlined above, where a taxpayer is clearly trading with and not trading in a country. In extremis this could have significant unintended consequences and therefore should be considered very carefully indeed.

Finally, customers and consumers have an ever increasing expectation of value for money and even reducing prices. MNCs meet this expectation by, amongst other things, carefully managing overheads, supply chains and logistics. The fact that MNCs try to consolidate activities and avoid having a global footprint is commercially driven. In the vast majority of cases it is not because they are trying to avoid local taxes through PEs. Therefore we consider that only in very few cases do taxpayers artificially avoid PE status. The proposed changes should take this into consideration to avoid the risk of a disproportionate response!

Commissionaire arrangements and similar strategies

The paper offers four alternative options to amend the dependent agent PE rules and tighten up the independent agent exemption. These options are based on the premise that “in many cases commissionaire structures are put in place primarily to erode the taxable base of the State where the sales took place”.

It should be noted that most States already have transfer pricing rules which offer a means to challenge cases were the economic result is not in line with the functions and risks. The proposed
changes would only create another technical means to challenge such arrangements; however, the end result should be the same as the profit attribution should itself be based on the same transfer pricing guidelines.

We would also note that the proposed changes would equally impact commissionaire arrangements which are implemented for genuine commercial purposes and do not seek or obtain any tax benefit. A commissionaire model is just one form of operating model which a company may choose to adopt in consideration of many factors, principally non-tax, when a taxpayer is deciding how it wishes to structure commercial operations in a State. A taxpayer should be free to operate the appropriate business model and not be unduly disadvantaged from one model to another by tax considerations. It is therefore important that the changes do not adversely impact taxpayers wishing to adopt a commissionaire model for commercial reasons.

Whilst the proposals focus on arrangements where there are significant activities within a State which may be eroding a tax base, it is equally possible that a commissionaire model could be used in a situation where there is relatively low, or even no, substance in that State. It is therefore important to be clear that whilst the technical outcome in either case would be the same (i.e. under the proposals both resulting in a PE) the cases should be differentiated by the level of profit attributable to the PE which is dependent on the functions and risks.

As a result we find the proposed amendments unnecessary as they would simply inhibit commissionaire arrangements that do not seek to avoid tax. Alternatively, additional consideration should be given to ensure commercially driven commissionaire structures are not adversely impacted by the proposed changes.

We would also point out that commissionaire arrangements are to a certain extent a function of local law. Civil law (as opposed to common law) embraces the principle that an undisclosed agent cannot bind the (undisclosed) principle. This clearly avoids the PE. However it is entirely within the ability of each and every country that feels hard done by the commissionaire tax arrangements to change their own laws. As such we see no need for this one size fits all approach.

“Concludes contracts”

Whilst the scope and intent of the proposals is to address the perceived abuse caused by commissionaire and similar arrangements, all of the proposals noted in Section A (Options A-B) include changes which would expand the definition of permanent establishment for all taxpayers and not just those operating through commissionaire arrangements. We would note that the technical issue surrounding commissionaire arrangements is that they conclude contracts on their own account rather than concluding contracts on behalf of the principal. Therefore, a simpler proposal of “concludes contracts... which are on the account and risk of” should be sufficient to address commissionaire cases without having to make any additional change to the “concluding contracts” part.

The expansion of the definition from “concludes contracts” to “engages with specific persons in a way that results in the conclusion of contracts” or “concludes contracts, or negotiates the material elements of contracts” is too broad and goes far beyond what is necessary to address commissionaire arrangements and is potentially a fundamental change which impacts all taxpayers.
This amendment creates significant uncertainty to taxpayers as we move from a relatively recognised and objective test to a much more vague and subjective one. For example, it would require guidance on what are the “material elements” of contracts, who are “specific persons” and what constitutes “in a way that results in a conclusion”. There is a much greater risk of inconsistent interpretation by tax authorities across different States. The commentary to the model treaty already provides guidance on the interpretation of concluding contracts to tackle perceived abuses.

Taxpayers will enter into large volumes of contracts in the ordinary course of their business with each contract being different and requiring varying amounts of involvement by different members of the organisation. To consider the involvement of all persons involved in negotiating all of those contracts and the extent to which they are involved in the “material elements” would substantially increase compliance costs for companies. In addition, multinational companies will often have teams of people working across jurisdictions on the same contracts and the changes therefore result in a risk of potentially creating multiple permanent establishments in different States for the same activity, leading to double taxation.

Therefore, this additional expansion to the wording of concluding contracts does not address commissioner arrangements and we would therefore recommend that these proposals are removed as they create significant uncertainty and risk for all taxpayers.

Specific Activity Exemptions

Preparatory or auxiliary activities

The current specific activity exceptions were developed on the basis that storage and delivery should always be by default a preparatory or ancillary activity in a typical business model. Due to changes in business models that has evolved over time, the delivery element has become a core part of the business for certain companies that typically operate in the digital economy. However, that is only the cases for a limited number of companies and that for the vast majority of companies which still have a more traditional business model, storage and delivery remains a less contentious issue and certainly one that is not serious enough to warrant the wholesale changes proposed by this consultation document.

We would also welcome clearer guidance and examples of what is considered preparatory or auxiliary in the context of the facilities used for storage, display or delivery.

“Delivery”

Option F is based on the observation in the discussion draft that is it “difficult to justify the application of these exemptions where an enterprise maintains a very large warehouse in which a significant number of employees for the main purpose of delivering goods”. However, the general removal of the exemption would go beyond what the discussion draft is attempting to address and would affect many more taxpayers who operate using facilities in a State that has little or no local involvement other than the facility and or inventory. In such cases it is clear that simple storage of goods in a State prior to delivery, but without the need for local involvement should not in itself give rise to a PE.
It is possible to think of a company or industry for which each specific excepted activity is the main business. However, that is not to say that all the exceptions should be removed and instead it is more reasonable to make these exceptions subject to the preparatory or auxiliary condition such that the vast majority of taxpayers’ for who it’s not the main business can still obtain a degree of certainty that such ancillary activity should not result in them having a PE.

Notwithstanding the above, if a PE is created by facilities used to deliver goods where there is little or no local involvement, the resultant profit that is attributable may not be particularly significant (based on the usual transfer pricing considerations of functions, assets and risks). There is an increased risk that authorities would try to attribute more income than is justified by the activity leading to inconsistent application of the treaty and greater litigation.

**Fragmentation of activities between related parties**

We would agree in principal to proposals to prevent the fragmentation of activities where the main purpose is to avoid tax. However, guidance will be needed on the scope of the proposal, in particular in defining what constitutes a “cohesive business operation”, and to ensure it targets tax motivated cases as opposed to targeting all taxpayers.

Large multinational groups can have different sub-groups which are independently operated and controlled. The changes should be narrowly defined and should not be so broad as to capture situations whereby taxpayers are treated as fragmented merely due to an associated company with a similar business activity. A taxpayer should not be adversely impacted in a situation where its own activity would not give rise to a PE but the activities of another part of the group, which are not integrated and have not been fragmented for tax reasons, could result in it now having a PE.

**Conclusion**

We would firstly like to reemphasise the point that in our opinion the OECD is over estimating the instances where taxpayers artificially avoid PE status. As such any changes to the rules should be proportionate to the actual (rather than perceived) harm that is being done.

We are concerned that in its zeal to tax internet companies or those operating in the digital economy the OECD will change the PE rules (which have generally taxed all other companies operating outside those sectors in a fair, reasonable and well understood way) in an adverse manner. Pandora’s Box will in effect be opened and many unintended consequences could follow that will affect the vast majority of companies currently operating traditional supply chains.

As such a thorough impact analysis should be conducted before the rules are changed regarding concluding contracts and what constitutes valid specific activity exemptions. It does not appear that this has been completed yet.

Finally, depending on the outcome of the impact assessment if it is necessary to amend the rules then consideration should be given to making changes only in respect of those business sectors that
are abusing the existing rules. For the avoidance of any doubt we do not consider that the example set out at the start of our paper (ABC Ltd) is in any way an abuse of the current rules.

These comments have been prepared by:

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GFIA Comments on OECD Discussion Draft on "BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment (PE) Status"

Introduction
The Global Federation of Insurance Associations (GFIA) through its 38 member associations represents insurers that account for around 87% or more than $4 trillion in total insurance premiums worldwide. GFIA is pleased to provide comments on the OECD discussion draft on "BEPS Action 7: Preventing the Artificial Avoidance of PE Status". In general, we support the objectives of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Accordingly, we support the broad objectives of the discussion draft in combating aggressive tax planning aimed at preventing the artificial avoidance of Permanent Establishment ("PE") status. However, it is critical that any measures adopted by the OECD are workable, well targeted, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers.

Our key comments are as follows:

- **Insurance Specific Provision (Option M):** We do not believe there is a need for a specific provision that applies to insurance and the collection of premiums by an agent as outlined in Option M. Any discussion about the taxation of the insurance industry and any perceived BEPS issues needs to consider the highly regulated environment in which the insurance industry operates, which prevents insurance agents from concluding insurance contracts, and the critical role of risk and capital, as well as the impact of insurance premium taxes. Any perceived issues would be more appropriately considered as part of the discussions on transfer pricing under Action 9, rather than as part of the PE discussion draft.

- **Commissionaires Arrangements & Options A-D:** We understand the OECD's desire to address the artificial avoidance of PEs through the use of Commissionaires arrangements. However, we are concerned that the four options for revising the wording of Article 5 are very broadly worded which could have significant unintended consequences for commercial insurance operations.

- **Need for Guidance:** It is critical that clear guidance is provided for any changes to the wording of Article 5, to define the key terms and provide detailed examples of the precise situations that are caught and those that should be excluded. Otherwise, there will be uncertainty for business, an increase in disputes and an increased risk of double taxation.
Insurance Specific Proposal (Option M)
We do not believe there is a need for a specific provision for insurance and the collection of premiums by an agent as outlined in Option M. Under Option M, agents who collect premiums, but do not perform the Key Entrepreneurial Risk-Taking (KERT) function of assuming insurance risk/business\(^1\), would, if not sufficiently independent, create tax PEs. Since the agents are third parties, they should already be fairly compensated on an arm's length basis and subject to tax on that income in the jurisdiction in which they operate. Accordingly, any deemed PEs would have no or minimal additional profit attribution, and, any additional taxes would be non-existent, or minimal at most.

Deemed PEs would result in a disproportionate compliance burden, since PEs would be created for tax purposes, even though there is no PE for regulatory purposes. Given the highly regulated nature of the insurance industry, it makes sense to continue the current alignment of tax and regulatory reporting, which results from the fact that the current definition of PE for tax and regulatory purposes is quite similar. Lack of alignment, as under Option M, would put a disproportionate compliance burden on insurers (requiring tax returns to be completed and profit attribution calculations etc) without much, if any, additional tax.

The collection of premiums alone does not necessarily create value for the insurer. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) (“Part IV”) notes that sales and marketing is only one of the functions in the insurance value chain. Paragraph 117 of Part IV recognizes that if the person (i.e. agent) collecting the premiums does not make the decision to accept the risks/business associated with the insurance policy, then the collection of premiums does not mean that insured risks/business have been accepted by that person. This is an important point since, as recognised under Part IV, the KERT for insurers is the assumption of insurance risk/business (see for example paragraphs 93\(^2\) and 94). Accordingly, the KERT function rests with the entity which accepts and manages the risk/business (ie. the insurer and not the agent). Therefore, under Part IV, all or nearly all of the profit will be attributed to the insurer’s country of residence, even if there is a deemed PE by virtue of the agent’s collection of premiums. However, to the extent any income is attributed to a deemed PE, it will result in double taxation, unless the home state provides relief.

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1 Per the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance).

2 Paragraph 93 of Part IV states in unequivocal terms:

All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.
In addition to taxes paid by the agent, many countries have an Insurance Premium Tax payable by a non-resident insurer on gross premiums for risks insured that are situated in that country. When this premium tax and the tax paid by the agent on the fee are taken into account, it can be seen that there is already a sufficient tax burden where risks are insured in a country where an insurer does not have a PE.

Deeming a PE in a jurisdiction solely on the basis of premium collection is clearly inconsistent with the regime that governs the international trade in tangible goods. It would be equivalent to deeming a PE in every jurisdiction where a manufacturer’s goods are sold, even if there was no material nexus with that jurisdiction. If an insured person moves from country A to country B and the insurer facilitates premium remittances for that individual by accepting payment at a facility maintained in country B by the insurer’s affiliate that carries on a non-insurance related activity, a PE would result, even if that was the only person insured by that insurer in that country. The collection of premiums seems quite far from the minimum threshold required for a tangible goods vendor to be considered as having a PE in a jurisdiction.

Accordingly, we do not believe there is a need for a specific insurance provision as outlined in Option M.

**Commissionaires Arrangements & Options A-D**

As noted above, we are supportive of any appropriately targeted measure adopted by the OECD to address the artificial avoidance of PEs through Commissionaire arrangements. However, the options as currently drafted are overly broad, which will result in differing interpretations by local tax authorities and uncertainty for business, with the possibility of costly disputes for businesses and double taxation. Any changes should therefore be more focused on preventing the specific avoidance and should not impact ordinary commercial business structures. One way to accomplish this would be to provide sufficient guidance as to the types of transactions that are caught and those that are not.

The Discussion Draft indicates that Commissionaire and similar arrangements "were put in place primarily in order to erode the taxable base of the State where sales took place". This is not true in the highly regulated insurance business. Insurance agents are not Commissionaires. Regulatory restrictions prevent insurance agents from concluding insurance contracts. This is because insurance agents are not subject to prudential solvency and capital requirements since the agent does not assume the insurance risk. Insurers are highly regulated - they require a licence to sell in a particular jurisdiction and are subject to market conduct regulations (as are agents). Insurers are subject to prudential regulations in jurisdictions where risks have been insured/assumed requiring risk management frameworks and sufficient regulatory capital to cover those risks. Prudential regulation is only required where there is a real transfer of risk. In addition to these regulatory requirements which do not apply in Commissionaire arrangements, the nature of the contracts is also substantially different, with performance occurring in the home jurisdiction in the case of insurance (ie. where the insurer decides whether to assume the risk and if so, manages the risk etc) as compared to the local or host jurisdiction (ie. where the products are delivered) in Commissionaire arrangements.
Specific concerns for these options are as follows:

- **Option A:** This option replaces the words "concludes contracts" in the existing model tax treaty with "engages with specific persons in a way that results in the conclusion of contracts". This wording is overly broad which would result in significant uncertainty and a risk that different jurisdictions would take different interpretations, leading to disputes and potentially double taxation.

  In the insurance operating model, agents, brokers and independent financial agents are vital as they introduce clients to insurers. It could be viewed that the agent’s engagement with the client results in the conclusion of the contract. However, insurance agents do not conclude insurance contracts due to insurance regulatory restrictions which prevent them from accepting insurance risk since they are not a regulated insurer, NOT because of seeking to avoid having a PE. Insurance agents also do not have the capital at risk nor do they bear the risk of loss under the contract. The agent receives an arm’s length fee commensurate with the services provided. Furthermore, the vast majority of insurance agents are third party brokers and so the commissions are negotiated between third parties.

  If Option A is adopted, guidance should clearly indicate that regulated insurance agents, brokers and independent financial agents will not be considered to "engage with specific persons in a way that results in the conclusion of contracts".

- **Option B:** This option refers only to "negotiating the material elements of contracts". We believe the wording would be more precise if the word “elements” was replaced with “terms”. Clear guidance would be needed to ensure there is consistency in how the words are interpreted by different tax authorities. This guidance should be linked to insurers’ key activities as set out in Part IV. Without this, there is a risk that different jurisdictions would have a different interpretation leading to disputes and potentially double taxation.

- **Options C and D:** add the words "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise" *(emphasis added).* This wording would have unintended consequences where “risk” is the business, as is it is for insurance. Quota share reinsurance could fall within this wording since the contract is partly "on the account and risk" of the quota share reinsurer “by virtue of the legal relationship” (i.e. treaty) between the direct writer and reinsurer. Quota share reinsurance is a common form of reinsurance which is undertaken

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3 Quota-share reinsurance and co-insurance are common types of proportional reinsurance whereby the reinsurer reinsures a certain percentage of each of the policies written by the ceding company. Once the reinsurance treaty is entered into, the reinsurance is automatic. One reason for such treaties is if the ceding company does not have sufficient capital to retain all the business it can sell. For example, by reinsuring 50%, it can write twice as much business. The ceding company may also use reinsurance to limit its exposure to risks it has written.
for commercial reasons, including risk and capital management. Quota share reinsurance should not create a PE for the reinsurer in the territory of the direct writer, which should be clarified in guidance if options C or D are adopted.

**Dependent Agent Threshold**
All of the Options A-D propose amendments to paragraph 6 of Article 5 to strengthen the requirement of independence by excluding an agent, including an unconnected 3rd party, who “acts exclusively or almost exclusively […] on behalf of associated enterprises”. This could result in the creation of numerous inappropriate PEs in a number of situations such as:

- Where a related party has little or no third party business of its own. For example, a group parent company could negotiate outwards reinsurance contracts on behalf of the whole group, with all operating entities being covered under the same global contract, which could result in PEs being created for all the operating entities.

- A group’s service companies may have the authority to bind multiple insurance operating entities to procurement or service contracts (e.g. outsourcing for IT, claims management, or call centres; investment management or purchasing office supplies etc). The service companies would likely earn all their income from, and all of their activities would be for, related parties. Numerous PEs could be created which would create a disproportionate compliance burden for little or no additional tax.

**GFIA contact**
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**About the GFIA**
Through its 38 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 58 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.
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Comments on BEPS Action 7: Preventing Artificial Avoidance of PE Status

Thank you for the opportunity to comment on the proposed changes to the OECD Model Tax Convention (OECD Model) to address issues arising from exploitation of aspects of the provisions regarding permanent establishment.

We have responses specific to the proposed changes detailed below, but would first like to raise an additional, fundamental concept for consideration: specifically defined requirements versus overarching principals.

Business likes very clearly defined requirements in laws and regulations because (a) it is easier to know whether you are in compliance or not, and (b) because that makes it easier to find alternative approaches or structures that are not in violation. The more conceptual, or substance-based, laws and regulations are, the more individual judgment businesses must apply if they are considering straying from known, approved approaches to that law or regulation’s application. The greater the need for creative judgment, the greater the risk of mis-judgment and liability for violating the law. Therefore, including overarching principles and less clearly defined requirements has the effect of decreasing activity that is not in keeping with those overarching concepts. Ideally, for economic efficiency, drafting of this kind strikes a balance between the two extremes, providing the general principle that over-rides, followed by more specific provisions that address known issues.

When amending laws, regulations, treaties, etc., the natural tendency is to focus more on the former (those clearly defined requirements and prohibitions) than the latter (the broad, overarching principles). Business will lobby vigorously for rules that give them those clearly defined requirements. In this exercise, and in the BEPS process generally, the OECD must ensure that the overarching principles are clear and have primacy.

Our positions and comments specific to the proposals included in the PE consultation paper are as follows:

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies.
Recommendation: Of the four options presented, we recommend adoption of Option A, with some additional amendment. Those additional amendments are:

i. Delete “specific” in the phrase “engages with specific persons”. The word adds no substantive meaning to the paragraph, as no “specific” persons or classes or persons are identified within the Article as being applicable. Inclusion of the word leaves the reader wondering who qualifies as a specific type of person under this Article and the meaning of the sentence is not altered if the word is removed.

ii. Delete paragraph 6. The first sentence of paragraph 6 states that “Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of another Contracting States carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of business.” If this sentence were included, an individual could consider setting up an entity where that individual agreed with a few different foreign enterprises to sell their products, also agreeing that staff from the those foreign enterprises would be “seconded” to the company for defined periods of time (for example less than 12 months) to “advise on” the sale of the products, giving the foreign entities the effective (as opposed to legal) control they really want over the sales operations without the negative tax consequences. Paragraph 6 would prevent any consideration of the internal arrangements of the operation by virtue of the mere fact that the company is selling goods of more than one foreign enterprise, and nobody would look further into the internal arrangements of the company. The first sentence of paragraph 6 should be deleted because it is easy to circumvent and creates a shield from further inquiry. There is no need for the second sentence of paragraph 6 if the first sentence is deleted.

Additional Comments:

1. In paragraph 10 of the consultation text, you have identified the primary policy that should form the basis for interpretation of any aspect of Article 5, namely that “where the activities that an intermediary exercises in a country 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 unless the intermediary is performing these activities in the course of an independent business.” This fundamental principle should be explicitly presented at the beginning of the Article.

2. Two of the Options contain the following language, “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise.” This formulation is a concern because almost every provision of a contract represents the agreement between the parties with respect to the allocation of liability for a particular risk, and there are many, many potential risks in a business relationship that are allocated via a contract. Even pricing terms are affected by the allocation of other, otherwise unrelated, risks in the contract. As a result, unless you are very clear about exactly what risk you are referring to when you in determining which party has legally assumed “the risk”, the phrase lacks any real meaning or test.

B. Artificial avoidance of PE status through the specific activity exemptions.

Recommendation: Adopt the edits included in Options E, F, H and J.
**Additional Comments:**

1. The express modification of the entirety of paragraph 4 by the limitation that the functions must be “preparatory or auxiliary” is the appropriate approach for the reasons set forth in the text.

2. However, the OECD has also noted that without that limitation, you think it would be appropriate to delete certain activities from this safe harbor provision, also for appropriate reasons.

3. It is possible to agree with both approaches, and say that there should be no safe harbor for activities related to delivery, purchasing of goods or merchandise, or collection of information and in addition all other safe harbor provisions should be modified by the “preparatory or auxiliary” limitation. Removal of activities from a safe harbor list only changes the presumption, or burden of proof, with respect to the tax position of firms carrying out those activities, and the OECD has provided valid examples of concerns with respect to those specific safe harbors.

4. Option J is preferable to Option I. As discussed above, one of the challenges with revising a text like this is avoiding the addition of more specific language which results in a more limiting interpretation of the statute which favors a consideration of form over substance. The difference here is that Option I tends to consider more the structure (form) of the business and Option J is looking more at the substance of those operations. It is much easier to create an alternative (loophole) to form than it is to substance.

C. **Splitting-up of contracts.**

**Recommendation: Adopt the proposals included in both K and L.**

**Additional Comments:**

1. The anti-abuse rule highlighted in Option L applies regardless of the inclusion of Option K, and is not going to be removed. Option K simply makes it clear that the specific type of structuring described is prohibited, and that is a welcome addition.

2. We tend to support “economic substance doctrine” type approaches and would not object to the inclusion of the “principal purposes” proviso suggested in the Explanation for K, with the caveat that we would not support it if the language were changed from “is not one of the principal purposes” to “is not the principal purpose” or its substantive equivalent.

3. As noted, regardless of whether Option K is adopted or not, the anti-abuse rule will apply. This is an important back-stop should a clever practitioner structure around the prohibition described in K, which is always a risk when creating a provision dependent on structure/form as opposed to substance/principal as is being done in K. There is no reason not to include the new example proposed in Option L as a result. We would recommend, however, that (i) SUBCO be an affiliate of RCO because it would make the example more generally applicable (the directly
held subsidiary is the more obvious case), and (ii) reference to the contracts with RCO and SUBCO being jointly and severally liable should be deleted because it is not a necessary condition for the anti-abuse rule to be applicable in the case and could therefore be misleading.

D. Insurance.

Recommendation: Option M should be adopted.

Additional Comments:
1. For the reasons set out in the consultation paper, the clause in Option M should be adopted. We have recommended the deletion of paragraph 6, however, so the provision would end after “or insures risks situated therein.”

We hope that this submission has been helpful in your deliberations, and welcome any questions or comments you may have.

Kind regards,

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5 January 2015  

Dear Marlies,  

OECD Public Discussion Draft - BEPS Action 7: Preventing the Artificial Avoidance of PE Status  

Grant Thornton International Ltd, with input from certain of its member firms, welcomes the opportunity to comment on the OECD Public Discussion Draft entitled BEPS Action 7: Preventing the Artificial Avoidance of PE Status, issued on 31 October 2014.  

Our observations and detailed comments are set out below.  

Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies  

Preliminary observations  

*Wider economic and fiscal impact of the proposals*  

We believe lowering the permanent establishment (PE) threshold will almost certainly lead to a shift towards source-based taxation in OECD member countries. This may mean greater subjectivity in the interpretation of the proposals by individual member countries so that their application would not be consistent.  

This in turn could lead to significant uncertainty for many multinationals around the tax treatment of their established business structures and projected operating models which may have wider business and economic consequences.  

We appreciate that it is not the intention to change the balance of taxing rights in this way in cases where income is being taxed, but only to restore the position ‘where cross border income would otherwise go untaxed or would be taxed at very low rates’.1 For this reason we would caution against very widely drawn and vague drafting, as in several of the options currently presented in the Draft.  

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1 paragraph 3, p10 of the Discussion Draft
**Impact on normal commercial structures**

The discussion draft states that 'it is clear that in many cases commissionaire structure and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place'.

We note that in many cases, commissionaire arrangements are widely accepted legal structures (originally based on German civil law concepts) that have been put in place for commercial reasons. For example, such structures are acknowledged to permit the integration of sales operations over a number of European territories through economies of scale or to allow weak or new markets to be supported through revenue flows from stronger markets.

Therefore, any change to deem the attribution of (a) additional activities to such agents or (b) further profits would be likely to counteract many long-standing commercial arrangements including such arrangements that have so far been considered to be independent. This could lead to significant disruption to business where contracts may need to be renegotiated as a result or possibly even put out to tender.

**Double taxation**

There is a real risk of effective double taxation particularly where the arrangements are with third parties. This is because the proposals may result in the same profits potentially becoming taxable in the same jurisdiction if a commissionaire structure in one territory now gives rise to a PE of a company which is tax resident in another jurisdiction.

In particular, one effect of the proposals appears to be that the some of the profits earned by the commissionaire on an arm's length basis may now also be included in the taxable income of the principal's proposed PE particularly on transition to any new regime.

This would not be double taxation in the usual sense i.e. the same profits becoming taxable in more than one territory but instead different persons potentially being taxable on the same profits in the same territory. Hence, on the face of things, this situation may not be fully contemplated by normal double tax treaty principles for the relief of double taxation.

Therefore, it is requested that the OECD should if necessary propose appropriate mechanisms to relieve such double taxation including clarification that fees paid to the commissionaire would be deductible in computing the local taxable profits of any PE resulting from the proposals.

In this respect, the comments at page 8 of the discussion draft that no substantive changes are needed as to how the proposals interact with the attribution of profits to PEs may therefore be unrealistic, and this point is discussed in further detail below.

**Administration and collection of taxes**

The mechanics of enforcing and collecting additional taxes under the proposals also need to be reviewed by the OECD. In particular, some territories may under their domestic rules governing such matters, hold the commissionaire to account for any tax liabilities of the principal. Again, this could lead to commercial issues surrounding the existing terms of commissionaire agreements where there is an increased possibility of the principal becoming subject to tax in the other state.

Specifically, existing commercial agreements may need to be renegotiated to include clauses which provide additional protection to the commissionaire in this situation in terms of recovery of taxes and penalties from the principal. Commissionaires may also now seek increased levels of commission income to reflect the potential consequences of this additional risk.
Compatibility of the proposals with the commercial law of OECD member countries

The proposals appear to be aimed mainly at territories with a civil law legal system which permits the usual type of commissionaire structure whereby the commissionaire can enter into sales contracts in its own name, but on behalf of the principal, and where the commissionaire does not usually bind the principal. In this situation the principal remains the owner of the goods until they pass to the third party customer. Structuring sales arrangements in this way has meant that a PE of the principal generally does not arise as the commissionaire does not conclude contracts on behalf of the principal.

However, arrangements of this type are not possible in some jurisdictions such as the UK, for example, which has a common law legal system. Commissionaire arrangements are not generally found at arm’s length in the UK and so they are not a traditional way of selling goods. Instead, businesses that sell finished goods will often do so by buying products, holding those products as stock, promoting and selling them to customers.

In this situation, the distributor buys the products from the manufacturer (which may be based overseas) before selling them to third party customers. The distributor may bear all or at least some of the risks associated with buying, holding and selling stock along with any additional financial costs of carrying the stock. The distributor may typically also incur costs of transporting goods to the customers and promoting, marketing and selling the products.

The original manufacturer no longer owns the goods once acquired by the UK distributor and hence profits from sales to third party customers are fully taxable in the UK in the hands of the distributor.

Some multinational enterprises have used limited risk distributor structures in the UK (or other common law territories) whereby a distribution company in the UK buys goods from an overseas manufacturer or supplier and then markets and sells them to customers. Under such structures, there is usually a contract between the distributor and principal under which the principal will indemnify certain costs such as bad debts and obsolete stock while other functions and risks may also be transferred to the principal. However, unlike commissionaire structures in civil law countries, the arm’s length profit from the ultimate sale to the third party is fully taxable in the UK.

Given the above facts, it would appear that such structures are not within the ambit of the proposals in the discussion draft as there is no sales contract between the overseas supplier and the third party customer. Additionally, the contract between the supplier and the distributor would not usually constitute an agency agreement under English law. Therefore, the sale should not be regarded as being on the account of the overseas supplier. It would therefore be helpful if the Commentary could confirm that such structures are not the target of the proposals.

There are likely to be other structures where the application of the proposals is unclear e.g. because of the nature of the business structures which are permitted by local law which do not correspond to the typical civil law concept of a commissionaire.

Compliance and administrative burden

There is also a real risk that the compliance and administrative burden for business from the proposals will be substantially increased, e.g. through the need for the principal to file tax returns in the sales territory, but without any significant benefits being generated in terms of increased tax revenues or for the wider economy as far as facilitating cross-border business is concerned.

In many cases, the commission earned by a commissionaire may in reality be equal to or even exceed the amount of profits that would be taxed in a jurisdiction through amending the definition of a permanent establishment, particularly bearing in mind the requirement to attribute expenses to in computing the profits of a PE under article 7 of a double tax treaty.
Moreover, a commissionaire typically receives a guaranteed taxable profit stream in its territory of residence even when the principal is incurring losses e.g. due to difficult market conditions or start-up situations. Therefore, provided countries are consistent in applying guidance to losses as well as profits (unfortunately, often they are not) it is not entirely clear if the latest proposals for Action 7 would necessarily increase the tax burden in that territory. Where the principal incurs tax losses the tax base may be eroded where these can be utilised against other profits of the group arising in that territory e.g. in a subsidiary carrying on separate operations.

**Attribution of profits to PEs**

Given that there may be a significantly greater number of foreign PEs generated by the OECD’s proposals, it would seem appropriate for the OECD to devote technical resources to improving its existing guidance on the attribution of profits to PEs found in its July 2010 *Report on the Attribution of Profits to Permanent Establishments*. We therefore do not agree with the OECD’s views at pages 8 and 26 of the discussion draft that substantial changes are not needed to existing rules and OECD commentary on the attribution of profits to PEs. In our experience, disagreements over attribution of profits are all too common, with some tax authorities apparently adopting a force of attraction methodology such that if a PE exists it must then attract a lot of the profits, irrespective of the activity, risk, and intangibles that may or may not exist locally.

**Employment tax issues**

Consideration must also be given as to the employment tax implications of foreign employees travelling to overseas offices to negotiate contracts if such negotiation results in the creation of a PE under the latest proposal, of the employer, in that jurisdiction.

Here, the taxation of the remuneration of such employees will be dependent upon double taxation agreements. Typically, the mere fact that part of the salary of an employee is charged to a foreign PE is often sufficient to bring that amount within the foreign employment tax regime as permitted by the wording of the employment income article of many double tax treaties.

It therefore appears that the increased incidence of foreign PEs as result of the proposals is likely to have an equivalent impact on the cross-border taxation of employees leading to significant administrative complexity and potential cash-flow implications for employers and employees in terms of complying with multiple employment tax regimes. Such issues could in turn lead to wider restrictions on the global economy if they limit the natural flow of cross-border business.

**Investment fund structures**

We note investment fund structures rely extensively on contracts being negotiated in one country to a certain extent by an appropriate agent (dependent or independent). These agents may or may not be authorised to conclude contracts and payment to such agents is appropriate to the work they carry out and their levels of responsibility.

Some jurisdictions contain specific domestic exemptions for such agents from PE status. Any proposed changes in such rules are likely to have widespread ramifications for the funds industry as a whole, with increased costs being passed on to investors which would distort the market.

Pension holders some of whom may already on a fixed income may also find their returns reduced where in increased costs are absorbed by institutional investors in funds.
**Interaction with domestic law initiatives**

A number of OECD member countries are already contemplating the introduction of domestic law provisions to counter some of the structures which are the target of Action 7. For example, the UK Government has included in the 2015 Finance Bill a proposed Diverted Profits Tax, one of the key aims of which is to tax profits which it considers are diverted from the UK through the artificial avoidance of the creation of a UK PE of a foreign enterprise. Other countries like Australia have also indicated already that they are considering similar measures.

We would ask the OECD to urge its member countries including the UK to await the conclusion of Action 7 before introducing new tax rules dealing with areas which are part of the BEPS project.

For example, one issue identified with the UK's proposals for a Diverted Profits Tax is whether it could be challenged under normal double tax treaty principles because some countries may regard the new tax as being 'substantially similar' to UK corporation tax. In addition, treaty partners of OECD member countries contemplating such proposals may have objections to such new assertions over basic long-held taxing rights.

Where there is not a co-ordinated approach amongst OECD member countries to the introduction of domestic rules, considerable uncertainty together with administrative problems for multinational businesses could ensue, with the potential for disputes between tax authorities over primary taxing rights.

The interaction of domestic measure measures stemming from Action 7 such as the proposed UK Diverted Profits Tax with other anti-avoidance rules such as CFC legislation, including in other jurisdictions which may already apply CFC rules to the profits which are the target of Action 7 also needs to be reviewed to ensure there is no possibility of double taxation. Appropriate mechanisms to relieve potential double taxation in these situations should therefore be considered and put forward by the OECD.

**Alternative wording for Articles 5(5) and 5(6)**

**Option A**

We note that the four different options for revised wording for Articles 5(5) and 5(6) of the OECD Model Tax Convention are each intended to make a person a dependent agent at a level of activity below the current 'concluding contracts' test.

Option A suggests replacing 'conclude contracts' with 'engages with specific persons in a way that results in the conclusion of contracts'. Under this option, even if contracts are not concluded in the foreign principal’s name, the principal would still be deemed to have a PE if such contracts are for the provision of products or services by the foreign enterprise.

We believe this option would create significant uncertainty for many companies as it widens the scope and concept of a PE to an extent which is unacceptable. Specifically, it would potentially appear to encompass all sales contracts entered into by a foreign enterprise with any involved by a local agent (unless the latter is independent and non-exclusive as described in the revised paragraph 6 under this option).

Such a wide approach to the problem could also lead to inconsistency amongst OECD member countries as to the precise application of the definition which we assume is contrary to the overall aims of the proposals.

The phrase 'in a way' is particularly vague as it does not specify the features of the agent's activities that are considered to contribute to the conclusion of contracts which would give rise to a PE. Therefore, Option A is unlikely to be the preferred option for revised wording for this part of the OECD Model Tax Convention.
Option B

Option B is similar to Option A except it addresses persons who habitually conclude contracts or negotiate the material elements of contracts in the name of the enterprise. We believe adding ‘...negotiate the material elements of contracts...’ may also lead to significant uncertainty, particularly in situations where the board of directors of the non-resident company has considered large parts of contracts and then asked an agent to communicate on its behalf. In this situation, it is not clear if a PE would be created as the discussion draft does not elaborate any further of what 'material' means here.

However, Option B appears to be preferable to Option A on the basis that the concept of 'negotiates material elements of contracts' may be easier to define than the concept of 'in a way that results in the conclusion of contracts' under Option A. Specifically, the material elements of contracts for this purpose could be prescribed in the revised article although further work would be needed on this point to make sure any definitions of the material elements of a contract are appropriate.

Option C

Under Option C, it appears irrelevant whether the contract is in the name of the enterprise. Rather, the emphasis is on whether the contracts are on the account and risk of the enterprise as a result of the commissionaire’s legal relationship with the enterprise.

There is very little explanation of what is meant by 'on the account and risk of' and 'legal relationship' here. It is suggested by the discussion draft that it would be necessary for there to be a specific type of legal relationship between a person and an intermediary, such as a commissionaire agreement or agency contract, for this suggested revised wording to apply.

However, there may be situations where, for example a distribution-type arrangement is used as opposed to an agency or commissionaire contract so that the sale is not necessarily 'on the account of' the 'principal', ie the overseas supplier or manufacturer even though the latter is in substance on risk of the sales transactions e.g. through guaranteeing bad debts or buying back obsolete stock. For the same reasons as Option A above, we do not favour Option C, with the additional complexity and subjectivity making this option even less helpful.

In the meantime, it would be useful for the OECD to provide further details of the concepts used by Option C and how it envisages they would apply.

Option D

Option D is a combination of Options B and C. This involves a person who 'habitually concludes contracts, or negotiates the material elements of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of' the foreign principal.

Again, we do not consider the potential for complexity and confusion resulting from additional subjective wording will be helpful.

Artificial avoidance of PE status through the specific activity exemptions

We understand tax administrations are concerned that some of the specific activity exemptions listed in Article 5(4) do not expressly refer to preparatory or auxiliary activities, as they consider the original purpose of paragraph 4 was to cover only preparatory or auxiliary activities and not activities which make a major contribution to the profitability of an enterprise.

The options set out in the discussion draft for addressing this are:
• Amend Article 5(4) so that all the exception activities currently listed are subject to the condition of being preparatory or auxiliary (Option E); and/or

• Make more targeted changes to/ deletions of individual words and phrases in the sub-paragraphs, specifically the exceptions related to 'delivery' and 'purchasing goods' (Option F).

We believe the options set out in the discussion draft will need to be clarified further by the OECD Model Commentary to bring certainty rather than controversy. For example, if the option to remove the exemption for the delivery of goods is adopted, there will need to be clear guidance as to when storage ends and delivery begins. In addition, it is likely that companies may find it difficult in practice to distinguish between stock which is stored for delivery and stock which is stored for other purposes.

Removal of the exemption for the delivery of goods may result in entities avoiding the definition of a PE through adjustment to their supply chain so that customers come to storage warehouses to collect ordered goods, at a reduced price. Furthermore, some taxpayers may consider reducing the number of warehouses in a region if the exemption for warehouses was removed. This would reduce the level of activity and jobs in those locations.

Additionally, there may be situations where a taxpayer resident in Country A locates a warehouse in Country B because this is close to its markets in Countries C, D and E but there are few if any sales with customers in Country B. It would be helpful to understand how the OECD considers such an arrangement should be treated.

On balance, Option E may be preferable to Option F as it would appear to create less uncertainty dependent on how businesses are structured, although more specific definitions of the concepts of 'preparatory' and 'auxiliary' would be needed. For example, if the condition of preparatory or auxiliary is to apply to all exception activities listed in Article 5(4), taxpayers will wish to understand, eg when a warehouse should be considered as fundamental to a business.

Care is again needed here to ensure that actions designed to 'catch' very particular situations do not result in a significant increase in disputes and double taxation. We agree with the sentiment in paragraph 21 of the Draft that 'tax authorities might be led into attributing too much profit to this activity [ie. delivery]'.

Purchasing and information collection are key preparatory or auxiliary activities and the removal of these exemptions would affect a large number of start-up companies with little taxable income. Again, this could potentially restrict new business and hence economic growth in OECD member countries. Therefore, we suggest that Options G and H are reviewed and amended as necessary to provide for a more appropriate approach to new business.

Further, the option G alternative (paragraph 28) to delete all wording in relation to 'collecting information' seems to us to be another example of a potentially wide ranging change being suggested in order to counter some very specific concerns, with the attendant risk of yet more arguments and disputes. Nowadays almost all businesses will collect information about local customers; if all such situations gave rise to a potential PE argument, that would be an undesirable result.

The proposals may result indirectly in erosion of the tax base in the territory of the PE should the principal become loss-making as the latter would need to be granted access to tax relief for losses in the PE jurisdiction. In this respect, some jurisdictions allow such losses to be offset against other types of profit or profits of associated enterprises that are resident for tax purposes in the territory where the PE is located.

The interaction with the separate BEPS initiative concerning the digital economy also needs to be considered further in re-evaluating the definition of a PE here. We note the suggestion in the paper published by the OECD in September 2014 that the level of an enterprise's digital presence could be used to determine whether and the extent to which it should be taxable there. This might involve replacing the PE concept with a 'significant presence' test.
The paper of September 2014 also refers to previous work carried out by the OECD on the digital economy including at page 163 the 'Ottawa principles' which are reproduced below. We think that there could be merit in applying these principles to the BEPS initiative so that sight is not lost of the need for fair and simple rules that do not produce unnecessary compliance and administrative burdens.

Ottawa principles:

*Neutrality:* Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

*Efficiency:* Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

*Certainty and Simplicity:* The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

*Effectiveness and Fairness:* Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

*Flexibility:* The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Here, a 'significant presence' based approach may also be worth considering in respect of other types of business for the sake of a consistent and equitable approach.

**Fragmentation of activities between related parties**

We note the proposed change is to address situations where a single enterprise may divide a cohesive operating business into several smaller operations with a view to arguing each of the latter is merely engaged in a preparatory or auxiliary activity.

We are in agreement that a draft anti-fragmentation rule would deny the specific activity exemptions where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or an associated enterprises at different locations. It should however be noted that separation of certain activities may be appropriate from a legal perspective in some jurisdictions.

With regard to the options listed in the discussion draft, the approach of combining activity not just of a given legal entity but also of related parties to assert that a PE is created may lead to a material increase in uncertainty and leave considerable room for conflicting interpretation by the tax authorities of individual jurisdictions regarding what is to count as a 'cohesive operating business'. It would also give source countries an ability to pierce or ignore the separate legal personality of substantive legal entities.

For these reasons, and specifically the effective abandonment of the separate entity approach and undermining of the arm’s length standard, we do not favour either option I or J. If anti avoidance rules are needed for egregious cases, they should be narrow and targeted.

By way of example, in the Real Estate Fund industry it is common to have 'Opco/Propco' structures whereby Opco typically has a PE in a Contracting State whilst Propco does not. This commercial separation of activities for instance should be carved out where Propco genuinely does not have a PE so as to avoid situations whereby an internal Opco/Propco structure is taxed differently from an external one.
**Splitting up of contracts**

We note there are concerns over abuse of the exception in Article 5(3): 'A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months', whereby enterprises are dividing contracts into several parts, each covering a period of less than twelve months and attributed to a different company (though owned by the same group).

Proposed options for addressing this practice are as follows:

- Implementation of an 'automatic' rule that would take account of any activities performed by associated enterprises; or

- Addition of a new example in the Commentary on the general anti-abuse rule (ie the 'Principal Purposes Test' rule) proposed as a result of the work on Action 6.

We broadly agree with the suggestions in Options K and L set out in the discussion draft. It should however be noted that the separation of certain activities may be appropriate from a commercial perspective to manage financial risk. In this regard, the proposal in Option L that any new rules should only apply to tax motivated cases, and not where there are legitimate business purposes for the involvement of associated enterprises, is likely to be preferable to the approach which involves the automatic creation of a PE under Option K.

Additionally, a key benefit of a 'principle purposes test' approach is that protection should be given for tax payers through access to mutual agreement procedures to help ensure they can resolve cases with the relevant tax authorities where they feel they have not been taxed in accordance with existing treaties. A clear and detailed definition of what is meant by 'legitimate business purposes' will of course be necessary here.

Suitable protection will also need to be given to organisations with a large number of employees on short-term (less than 12 months) overseas contracts, eg oil companies and telecommunication businesses. The proposal for a minimum period of presence of up to thirty days in any twelve month period may help to address this point.

**Insurance**

Paragraph 39 of the Commentary on Article 5 suggests that insurance companies may undertake large-scale business in a state without having a PE in that state.

Proposed options for addressing this are as follows:

- A provision that would deem a PE to exist with respect to certain insurance activities (Option M). Such a provision would address cases where a large network of exclusive agents sell insurance for a foreign insurer; or

- Relying on the proposed changes to the wording to Article 5(5) and 5(6) under Options A-D set out above (Option N).

We note the inclusion of the specific proposals for insurance companies which conduct business through agents would seem to be a separate matter to the specific PE concerns raised in the original BEPS Action Plan and as such was unexpected.

We believe insurance also raises difficult issues around where profits that represent the remuneration of risk should be taxed. Typically, it has been the location of the underwriting function where the profits of an insurance enterprise are taxable as discussed in the OECD’s Report on the Attribution of Profits to Permanent Establishments of July 2010. In this respect, the OECD acknowledges that it might be more appropriate to address the BEPS concerns related to such cases through the adjustment of the profits of the local
enterprise from which the risk-remuneration is being shifted, using measures contemplated under Actions 4 and 9 and this approach seems appropriate to us.

Option M has the effect of extending the scope of the agency PE rules for insurance operations to include premiums collected and risks insured though agents (other than independent agents) even though the contracts are not concluded in that country (this is included in some double tax treaties already where they are modelled on the UN treaty) and will be attractive to some tax authorities as it will have the effect of widening the tax base for businesses structured in such a way.

However, this approach may well give rise to additional compliance costs for taxpayers and there is likely to be significant uncertainty over the extent of the PE, for example with respect to the amount of investment return allocable to the PE given the business 'written' in a particular country.

It is not clear why special provisions under Option M are being proposed for the insurance sector and not for other sectors, particularly as the alternative Option N makes no specific provisions for the insurance sector, instead relying on the more general changes being suggested for Article 5 (5) and (6). The inclusion of Option N seems to compromise the notion of there being a need for a special rule at M.

We believe the proposed modification of the PE threshold will have little impact on the relatively common commercial situation whereby risk and the associated reward is transferred though the use of (re)insurance to an associated company which does not undertake any functions in the country in question. However, this would typically be examined via transfer pricing and the Action 9 proposals will be of greater relevance here.

**Conclusions**

We believe that the proposed changes will create extensive work for many multinational businesses in seeking to establish where a permanent establishment exists, even in the absence of structures that involve commissionaires or similar arrangements. The proposals may also create barriers to cross-border business particularly in start-up situations as companies seek to avoid creating accidental PE’s, which may have wider economic consequences for business in general.

There will also be a substantial increase in compliance, audit costs and enquiries carried out by tax authorities as they seek to understand the operations of multinationals, possibly without a commensurate increase in tax revenues or redistribution of material profit between territories.

We appreciate the opportunity to contribute our comments. If you would like to discuss any of these points in more detail then please contact Martin Lambert, Partner for Grant Thornton LLP at martin.lambert@uk.gt.com.

Your Faithfully

[Signature]

Global head- tax services
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January 6, 2015

To:
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We respectfully present our comments on the above Discussion Draft.

We are an accountancy firm keen to see reasonable tax paid without harming bona fide exporters.

Background

On October 31, 2014, the OECD published a discussion draft on preventing the artificial avoidance of PE (permanent establishment) status as "action" 7 of its Action Plan on Base Erosion and Profit Shifting (BEPS) and the public are invited to comment by January 9, 2015.

These OECD proposals may be bad for bona fide exporters around the world.

What is Proposed?

BEPS
The OECD action plan, published in July 2013, identifies 15 actions to address BEPS, and sets deadlines to implement these actions. The OECD's recommendations are not binding, but they do show parliaments and tax authorities what measures to consider adopting in their own country.

Distance Selling
It is claimed that multinational concerns (MNCs) and digital enterprises have been exploiting legitimate loopholes in the detailed PE criteria found in tax treaties and the OECD's model tax treaty commentary. The internet has made it easier for MNCs to sell to clients in a country by remote control. So the OECD is now planning to...
tighten up the recommended PE criteria where "cross border income would otherwise go untaxed or would be taxed at very low rates" This is in order to "prevent abuses".

Commissionaires
The first PE loophole targeted by the OECD relates to commissionaire structures. A commissionaire sells products in its own name but on behalf of a foreign enterprise that is the owner of the products. Through such an arrangement, a foreign enterprise may sell its products in a State without having a PE. Therefore the Discussion Draft offers four alternatives targeting commissionaire and similar strategies. Each alternative relates to contracts being concluded or merely negotiated by the commissionaire for the foreign company.

Facilities for Storage, Delivery, Purchasing, Collecting Information
The second PE loophole targeted by the OECD relates to local facilities used for storage or delivery of imported goods or merchandise, or the purchase of goods or collection of information by one or more associated enterprises. The Discussion Draft offers several alternatives aimed at deeming a PE to exist unless storage and delivery activities are "preparatory or auxiliary". Another alternative would deem any purchasing office to be a PE.

Insurance
Thirdly, there are proposals aimed at certain insurance companies.

Comments:
- **Style**
  The Discussion Draft language has too much jargon and is aimed at tax professionals, not business persons.

- **Business With a Country Not Abusive**
  The techniques referred to are usually not "abuses". It has been accepted practice for many decades to distinguish between doing business WITH a country (usually not taxable there) and doing business IN a country (usually taxable there).

- **Small & Medium Enterprises Affected**
  Small and medium exporters with limited resources cannot afford to have a PE in every country where they have customers.

  There should be a de minimis exception for small and medium size enterprises.

- **Efficiency Not Bureaucracy**
Companies do not relish registering for tax in every country they have customers serviced by commissionaires or using warehouses, as this creates an administrative burden best avoided by being centralizing and being efficient. The Discussion Draft should offer an efficiency exception.

- **Onshore Traders Affected**
The Discussion Draft is too widely drafted. It probably meant to take aim only at low-taxed offshore-based enterprises, but doesn’t seem to do this. Companies based in onshore medium-high tax countries also appear to be targeted.

- **Commissionaire Overkill**
We strongly object to all four of the commissionaire proposals as they will apparently catch many normal situations in which an agent or dealer sells goods for exporters. This could dramatically reduce international trade.

> It is generally accepted that international trade increases international prosperity, so a reduction in international trade is undesirable and unacceptable.

These proposals should be scrapped.

- **"Auxiliary or Preparatory" is Vague and Dangerous**
We object to the proposals targeting storage or delivery or purchasing or collection of information.

> In practice the "auxiliary or preparatory" criterion is notoriously vague.

The taxation of purchasing offices will deter some international trade as such offices are typically used to find useful products and check they are manufactured well.

The taxation of information collection will affect, among others, news bureaus and may be used as a back-door means of censorship.

Instead we recommend deeming a point of sale to be a PE – this seems far clearer and fairer.

- **One Stop Global Shop**
We also suggest implementing a one-stop global PE registration authority similar to the one-stop VAT registrations allowed in a single EU country.
Registration and reporting should be simplified, and only necessary once very clear PE threshold criteria have been crossed by offshore-based enterprises.

Onshore enterprises should be automatically exempted from the new OECD PE proposals, as mentioned above.

Small and medium sized enterprises should also be exempted from the new PE proposals.

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We will be happy to answer any questions arising.

Yours Truly

Leon Harris, CPA (Israel), FCA(UK)

Harris Consulting & Tax Ltd
January 9, 2015

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Re: Consultation Response to Discussion Draft on Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Action Plan

Dear All,

The Taxes Committee of the International Bar Association (IBA) would like to take this opportunity to respond to the Discussion Draft on Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Action Plan.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world’s top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.

We are submitting our comments on behalf of the IBA Tax Committee which has 1037 members from around the world. This committee formed a Working Group to respond to this Consultation. The Working Group includes Albert Collado, Spain; David Shapiro, USA; Peter Utterstrom, Sweden; Leandro M. Passarella, Argentina; Francisco Lavandera, Spain; and Tiago Cassiano Neves, Portugal.

The comments made in this report are the personal opinions of the Working Group participants (the “Working Group”) and should not be taken as representing the views of their firms, employers or any other person or body of persons, including the IBA as a whole, apart from the IBA Taxes Committee of which they are a members.

Sincerely yours,

/s/ Simon Yates  
Co-Chair of the Working Group  
IBA Tax Committee  
United Kingdom

/s/ Ricardo León Santacruz  
Co-Chair of the Working Group  
IBA Tax Committee  
Mexico
Preliminary Comments

The IBA Taxes Committee wishes to congratulate the CTPA and its different sub-groups for their commendable work in framing on technical terms the vast and ambitious tasks of the Action Plan on BEPS and, in particular, in what it concerns the Discussion Draft on Action 7 (Prevent the Artificial Avoidance of PE Status) of BEPS Action Plan.

IBA Taxes Committee has long recognized that PE issues are critical to allocation of taxing rights in international tax and may give rise in certain cases to BEPS concerns. The IBA Taxes Committee is nonetheless concerned that proposals reproduced in this Discussion Draft ultimately result in an expansion of the PE threshold in a manner that may be said to go beyond technical issues previously addressed on other BEPS related reports (e.g. Digital Economy) or even the BEPS mandate.

For example, as regards the review of the language used in paragraph 5 of Article 5 of the OECD Model Tax Convention, the Discussion Draft mentions that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income”.

IBA Taxes Committee believes that the proposals (specifically the ones covering paragraph 5 and 6 of Article 5) entail a re-shaping of the allocation of taxing rights are bound to lead to tax disputes and further cases of unrelieved double taxation in an already unclear area of interpretation/application of the OECD Model.

The Discussion Draft also points out that “in many cases commissioner structures and similar arrangements were put in place primarily in order to erode the taxable base of the [source] State where sales took place”.

Although the IBA Taxes Committee acknowledges that in some occasions one of the key drivers behind the setting up such arrangements may have been tax optimisation, it is likewise important to recognize that in most cases these types of structures are based on important business considerations such as legal and management risk control as well as logistics efficiencies, e.g. intercompany invoicing, enhanced central control of inventory and management of receivables. Non-tax risks or costs (e.g. labour costs) may also be relevant considerations when setting up such arrangements.

Changing a key rule of tax treaties to address specific problems arising from business restructurings represents, to a certain degree, a “step into the unknown”, especially when in several different contexts the OECD has already provided valuable guidance under both Article 7 and Article 9 for situations in which an associated enterprises adopt
(or convert to) a limited risk structure - which the OECD defined to include commissionaire arrangements.\(^1\)

The IBA Taxes Committee also expresses concerns that this approach may lead to possible development of domestic anti-abuse measures operating outside the tax treaty, as they traditionally lead to an increased incidence of unrelieved double taxation.

In addition, it should be recognized that some business models (e.g. mobile and digital business and technological services) also do not need physical presence in a country, without this involving any type of artificiality, avoidance or aggressive position and they are bound to be impacted by an extension of the dependent agent rules combined with a limitation of the safe-harbours of paragraph 4.

Enterprises operating internationally already face significant challenges in relation to source tax issues, and a further expansion of the PE threshold with a structural review of the negative list of paragraph 4 is bound to raise compliance costs and uncertainty with unwarranted effects on cross border trade and investment. Higher penalties for PE determinations, longer statutes-of-limitation for unregistered taxpayers, increased compliance costs and litigation exposure are all factors that need to be factored in when addressing these issues.

Enterprises trading or investing cross-border seek clear safe-harbour rules, not because they represent a tax opportunity, but because they are critical for risk management decision making.

This expansion, together with the recognition that in some instances non-core source activities may generate little or no income altogether, will lead to an increase in the number of PE determinations where no or limited actual profit may be attributed in a practical or simplified manner. This expansion would eventually not be confronting BEPS problems but instead raising the bar for companies for transfer pricing determinations over non-core or low income generating activities.

The OCDE PE Report provided relevant guidance concerning attribution of income to a dependent agent PE, which was based on the existing dependent agent standard. The Authorised OECD Approach (AOA) recognized that the attribution of profits to a dependent agent PE poses unique challenges, among other things because two distinct taxable entities operate in the host jurisdiction (i.e. dependent agent enterprise and the dependent agent PE), and both must be analysed, which implicates an Article 7 and Article 9 analysis. If the OECD modifies the current standards for identifying dependent agent PEs, it will also need to revisit (preferably alongside this exercise) the guidance

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1 Regarding the analysis of dependent agent PE subject to Article 7, the OECD provided guidance in its 2008 and 2010 Report on the Attribution of Profits to Permanent Establishments ("PE Report").
concerning attribution of profits to such PEs, in order to take account of changes to the dependent agent concept.

The IBA Taxes Committee agrees that clarity on interpretation and application of the OECD Model Tax Convention should be a goal in itself, when addressing cornerstone issues of international tax as the PE threshold.

The proposals included on the Discussion Draft still require further work and consensus between business industry and tax officials to find a common ground where new approaches would not lead to situations where the effects of the proposals go beyond the intended effects it seeks to address. In our view, this requires the development of clear standards, including safe harbour rules, to minimise the likelihood of double taxation arising from these rules.

**Comments on alternative formulations of paragraphs 5 and 6 of Article 5 proposed by the Discussion Draft**

Attempting consensus on PE issues is critically important for businesses because in many cases that same PE threshold will determine whether a particular taxpayer must file a tax return and pay income tax on a net basis in a jurisdiction (or any other taxes at source).

Options A to D to deal with commissionnaire arrangements and similar strategies have far-reaching effects and providing ranking of preference is difficult, because in our view each of the proposal increases uncertainty compared to the current status quo.

- **Comments on Option A**

  The proposed wording of Option A substitutes the reference to “conclude contracts” by that of “engages with specific persons in a way that results in the conclusion of contracts”.

  As elaborated in the “Explanation” of the Discussion Draft, such situation is deemed to occur where there is a “direct causal connection between that interaction [of the intermediary with “specific persons”] and the conclusion of the contract”.

  It is not clear how an intermediary would engage with other persons in a way that “results in the conclusion of” contracts with the principal.

  The IBA Taxes Committee believes that the proposal introduces a causation standard that in our view is vague and would therefore be difficult to apply in practice.
As a matter of fact, an intermediary’s actions may always, by definition, be deemed to be ultimately aimed at concluding contracts, as such objective may be considered intrinsically its main business purpose. Thus, a certain causal nexus would almost in the entirety of the cases be deemed to be found where an eventual conclusion of a contract has happened, irrespective of the actual scope and content of the intermediary’s actions. We have some concern that such a broad standard will conflict with the historic understanding of what activities are of a preparatory and auxiliary character.

In the view of the IBA Taxes Committee, linking the assessment of whether a dependent agent constitutes a PE to the existence of a causal connection between that person’s intermediation and the final outcome of a contract being concluded, without providing further guidance and, in particular, without giving regard to the actual scope and content of the intermediary’s actions, would represent for the non-resident entrepreneur an extraordinarily high burden of proof that leads for the main rule to become that the non-resident is exposed to have a PE in the source country and the exception being the cases it has not.

The policy suggestion to go beyond the use of the term “[contracts] in the name of the enterprise” to cover in alternative contracts for sale of goods (e.g. commissionaire or other sales agent type of relationships), leasing contracts or contracts for the provision of services (e.g. contract/toll manufacturer or contract R&D type of relationships) is bound to create also an overlap with existing Service PE clauses and expose situations where service entities in local jurisdictions that currently provide routine support services (such as marketing/promotional services) expose the parent company to a dependent agent PE situation.

The IBA Taxes Committee believes that this outcome would be opposed to the well-documented history of OECD Article 5 and to several Supreme Court decisions rendered on the subject.

- **Comments on Option B**

Option B proposes to replace the reference to “conclude contracts” by that of “concludes contracts, or negotiates the material elements of contracts”.

The IBA Taxes Committee acknowledges that the current language used by paragraph 5 of Article 5, insofar as it restricts the existence of a PE to situations where the agent has (and habitually exercises) authority to “conclude contracts in the name of the enterprise”, could be seen as too limitative in order to attain the objectives inherent to this provision. We also appreciate that Option B is narrower in scope than Option A, and creates less risk of conflict with paragraph 4 of Article 5.
Notwithstanding this, the IBA Taxes Committee believes that the proposed concept of “negotiating the material elements of contracts” would expand inappropriately the current OECD Model definition of dependent agent. Essentially, it is unclear what constitutes a “material element of a contract”. The agent may have authority to discuss a specific contractual term with the customer and report back to the principal, but still lacks authority to bind the principal. This proposal would find a PE even under those circumstances. In our view, if the principal exercises real authority to approve or reject any element of the contract, and is not bound short of its own agreement, a preliminary negotiation of potential terms by a third party should not be sufficient to create a permanent establishment.

If under contract law, it is indisputable that unless all the material terms of the contract are agreed there is no binding obligation, therefore reference to “material elements” is bound to create more uncertainty on the role of the intermediary, especially when faced with standard form contracts and framework contracts (typical instruments) in agency situations.

The IBA Taxes Committee considers that guidance which is already present in the OECD Commentaries (paragraph 33), where reference is made to a person’s authority to “negotiate all elements and details of a contract in a way binding on the enterprise”, is already sufficient language, without giving rise to the undesired effects of using broad concepts such as that of the “material elements” of a contract.

In addition, the dependent agent concept should not apply in cases where the principal is merely economically linked and the use of terms such as “material elements” may place the interpreter of the treaty provision close to “substance-over-form” principles to reach outcomes similar to a mere “economic link” between principal and agent. While a “substance over form” analysis often can be appropriate, we believe that is better addressed by determining who is a “dependent agent”, as discussed in our comments to options C and D below.

- Comments on Options C and D

Option C adopts a different approach by referring to “contracts which, by virtue of the legal relationship between that person [intermediary] and the enterprise, are on the account and risk of the [non-resident] enterprise”.

Option D basically adopts Option B approach of referring to the action of the intermediary both when it “concludes contracts” and when it “negotiates the material elements of contracts” complemented with Option C approach to refer to those actions when they are for the “account and risk of the [non-resident] enterprise”.
The Discussion Draft nonetheless clarifies that such link (relationship) needs to arise from a “legal (not economic) relationship” and provides examples of agreements where this link is deemed to be created, namely: (i) agency; (ii) commissionaire; (iii) employment contract; (iv) partnership or; (v) trust.

The IBA Taxes Committee considers that Options C and D attempt to cover the so-called “fiduciary relationships” within the realm of dependent agency, namely when one person (“principal”) manifests to another person (“agent, commissionaire, employee or trustee”) that the latter person will act on the principal’s behalf and (possibly) subject to the principal’s control. That person may be said to have fiduciary obligation/duty alongside any obligations towards the principal under contract.

Nevertheless, the idea of “legal relationship” between the agent and the enterprise to be implemented into the OECD Model would require extrinsic analysis of legal relationships, a matter on which tax administrations may have distinct views based on their domestic laws and therefore bound to result in further complexities and uncertainties in interpreting concrete cases.

Moreover, the residence/home country of the dependent agent would be required to evaluate the spectrum of legal relationships deemed to arise in the source/host country, a matter on which the former generally has no expertise.

- Re-definition of the independent agent concept

All the four Options have the same provision regarding identification of an agent of independent status, i.e., “where a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises (…)”. Our comments below are thus fully applicable to any of the Options proposed under the Discussion Draft.

Implicitly, this option suggests that a numerical threshold for “almost exclusively” can be used to determine the maximum amount of business an agent can perform on behalf of the principal without triggering a source PE.

From a business perspective, this would be acceptable, depending on the level of the numerical threshold that is considered. A bright-line test should be possible to achieve. From the tax authorities’ perspective, an arbitrary numerical threshold may be not acceptable as sales agents can ensure that it has the requisite amount of business with third party customers to qualify as an independent agent, which is arguably inconsistent with the purpose of an “anti-abuse” provision.
In our opinion, the current wording of paragraph 6, complemented with the guidance provided in paragraphs 38 to 38.6 of the Commentaries as to the criteria and factors to be borne in mind in order to ascertain whether or not a person is an agent of an independent status (including, as one amongst all those factors -but not necessarily as the decisive element- the number of principals represented by the agent) may serve as a starting point to define the “agent of independent status” concept. Therefore, we do not see the need to amend this paragraph 6 of Article 5.

The “ordinary course of business test” currently applied in the framework of Paragraph 6 - to consider that independent agents binding their principal but acting outside the ordinary course of their business may still form a PE for the principal if they do this habitually – is in our view central to the limited independent agent rule. Therefore, we would suggest that the revised discussion draft expands the existing guidance on the application of this test.

Finally, the expansion of the PE threshold suggested in the Discussion Draft also raises a question if such paradigm shift should not instead pass through considering/reinforcing that certain persons operating in host countries are related parties for transfer pricing purposes (instead of deeming a PE), so as to make Article 9 always applicable, e.g. where a person in the source country depends of its foreign principal as a matter-of-fact. Under such approach, foreign company and local commissionaire/agent (even when independent under Paragraph 5) would be required to prepare transfer pricing documentation to substantiate that risks, assets and functions would be consistent with the level of income attributed to them.

- **Subsidiaries as dependent agent under the OECD Model**

Because a subsidiary company is a legally independent entity, the question is whether and under which conditions a subsidiary can be considered under the OECD Model a dependent agent of its parent or other affiliate company will likely gain further traction.

The concept underlying the current paragraph 7 of Article 5 has been to recognize that the independence as a separate taxable entity is not affected by its dependence under company law. Paragraph 41 of the OECD Commentary on Article 5 has also long indicated that “a subsidiary company will constitute a PE for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company (...) And the effects would be the same as for any other unrelated company to which paragraph 5 applies.”
The Discussion Draft fails to clarify in detail the effect and interpretation of the proposed changes to Article 5 and 6 in situations of wholly owned subsidiaries of foreign enterprises engaged in limited risk functions. Italian and the French Supreme Court cases demonstrated in early 2000 how tax authorities may be willing to challenge the fulfillment of the PE threshold in cases involving separate legal entities outside the territory of pure commissionaire structures. To ensure that any newly adopted principles are properly applied in practice, we believe that it is also important to address the impact of these principles on paragraphs 41 to 42 of the Commentary.

Comments on the formulations for Paragraph 4 of Article 5 proposed by the Discussion Draft

Some business activities do not constitute a PE even if they are performed through a fixed place of business or dependent agent, namely if they fall under a catalogue of excepted activities, the so-called "negative list" in paragraph 4 of Article 5.

A revision of the negative list, especially when motivated by concerns such as the digital economy, should be undertaken with caution not to lower excessively the PE threshold for other more traditional business models that have until now legitimately relied on this simplification measure.

The IBA Taxes Committee agrees with the principle that PE-constituting business operations should only be core business activities, i.e. the activities that are essential and significant activities within the framework of the business purpose of the enterprise (as a whole). Therefore, there are exceptions included in the negative list that play an important role in the early stages of companies operating cross-border and facilitate business decisions that otherwise would be more complex if an when a PE would always be deemed to arise in the source jurisdiction.

The Negative List also plays an important role in drawing a practical line (outside the PE determination) to cases where little or no income would be attributable to such a non-core PE and therefore may be said to be consistent with Article 7 and 9 of the OECD Model. As such, the IBA Taxes Committee considers that some of the fundamental changes proposed to paragraph 4 of Article 5 are (instead of streamlining the OECD Commentaries) bound to give rise to further disputes focusing not on whether or not a PE is deemed to exist but on how much income should be attributed to such PE.
• Considering the “exceptions” of Paragraph 4 as always restricted to preparatory or auxiliary activities

Under Option E of the Discussion Draft, all of the activities in paragraph 4 would be subject to a “preparatory or auxiliary” condition.

This proposal will put further emphasis on the concept of “preparatory or auxiliary activity” which practice has demonstrated is subject to divergent opinions. Therefore, for Option E to be an acceptable proposal concrete examples would need to be added to the OECD Commentaries in order to address the cases where the “preparatory or auxiliary” test would be satisfied by enterprises.

• Deleting the word ”delivery” in subparagraphs a) and b) of paragraph 4

Under Option E of the Discussion Draft, the word “delivery” would be deleted from subparagraphs a) and b) of paragraph 5.4.

The IBA Taxes Committee considers that deleting the word “delivery” would not only have a wider impact far beyond the BEPS related issues it seeks to address, but also would not be aligned with the OECD principles of that only core business activities should give rise to a source PE.

The potential impact of this deletion for example on warehouses situated in strategic locations for regional delivery and operated by group distributors may expand to relevant supply chain structures operating worldwide.

This raises the policy issue why such central warehouses are now core activity in the sales process and how situations where sales directed from the outset to third countries would be addressed.

The IBA Taxes Committee is again concerned of the impact of this measure on the attribution of profits to a delivery warehouse due to the lack of clear guidance on that area, namely when dealing with activities that were traditionally viewed as “cost centres” of enterprises. For these reasons, Option E is preferable to Option F.

• Deleting the words “purchasing goods or merchandise or collecting information” in subparagraphs d) of paragraph 4

Under Option G of the Discussion Draft, the word “purchasing goods or merchandise” would be deleted from subparagraph d), whilst under Option H the proposal would be to delete the entire subparagraph, including the word “collection of information”.

While we acknowledge and appreciate the intention to align Article 5 with Article 7 with respect to the “purchasing of goods and merchandise”, Option E of maintaining those cases subject to a preparatory or auxiliary condition may be preferable to the deletion of this word. Concrete situations of establishments focused on quality controls of outputs of a company may also be affected by the deletion of this word.

Extending the deletion to “collecting information” should also not be the preferred approach as this term has an increasingly wider importance in the information age and would result in the triggering of PE situations for business that engage in those non-core activities in source country as support or ancillary functions towards their core activities on the residence country (e.g. news gathering local correspondent).

The IBA Taxes Committee is concerned that if such a proposal advances, whilst in some cases it may be determined that a place of business in the source country for the collection of information may contribute to the profit of an enterprise in the residence country, in most cases the underlying activities are so inherently remote from the actual realization of profit that it will be extremely difficult to allocate any profit to such fixed place of business (e.g. gathering and supply of scientific research for a pharmaceutical company). We acknowledge that some businesses are primarily engaged in the business of collecting information, but this distinction could be addressed by subjecting to “collecting information” to a general “preparatory and auxiliary” condition.

For these reasons, Option E is preferable to Options G and H.

- Anti-fragmentation proposal to address activities between related parties

Under Options I and F of the Discussion Draft, Paragraph 4 of Article 5 would be supplemented by an exception to the negative list that would take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by associated enterprises (resident or not in the source state) at different places or at the same place.

The differences between the two Options relate to the scope of the anti-fragmentation rule, with Option F being the wider option as it applies even in a case where none of the places of business in the source country would constitute a permanent establishment but the combination of the activities would go beyond what is preparatory or auxiliary.
This represents a shift from the principle that “each place of business has to be viewed separately and in isolation for deciding whether a PE exists”.

The sole effect of this provision would appear to be to withdraw the exception provided by Paragraph 4 and the result, if not coordinated with other applicable tax treaties (namely of the associated enterprise when non-resident) would be somewhat peculiar, since both enterprises will be deemed to have a PE in the source country.

The application to cases of associated enterprises operating as subsidiaries in the source country may also be problematic, as the local tax authority will be tempted to consider that any function made by the non-resident will then be “attributable” to the PE – i.e. attempting to undertake a “force of attraction” of activities to the source country. This may also be problematic in cases where the non-resident is operating under the assumption it has no PE in the source state (e.g. third party warehouse not at the disposal) and that based on this determination the source jurisdiction also attracts the “sales factor “of the activity based on fragmentation.

We acknowledge that Paragraph 27.1 of the OECD Commentaries to Article 5 already indicates that places of business are not “separated organisationally” where they each perform “complementary functions”. In any case, we believe it would be more aligned with the principles of the PE article to use the existing words of “coherent whole commercially and geographically with respect to that business” rather than the more expanded version of “cohesive business operation”.

Comment on the inclusion of a provision for splitting-up of contracts

Under Options K and L of the Discussion Draft, two alternatives routes are proposed to address the issue of splitting-up of contracts for purposes of the 12 month-test of Paragraph 3 of Article 5 dealing with construction and installation projects.

The 12-month test is already complemented with specific guidelines included on the OECD Commentaries (Paragraph 19) for start and termination of 12-month period and references to abuses of dividing their contracts up into several parts (paragraph 18).

Practice has nonetheless demonstrated that references on the OECD Commentary are far from being precise and clear as regards the first day of counting and end of a construction business (or aligned with a fixed PE case) and therefore, the IBA Taxes Committee suggest that further work may also be done on this matter.

On the actual wording or the Options, the IBA Taxes Committee considers it preferable to leave this concern to be addressed by general anti-abuse rule (either of the treaty or domestic law as already suggested by Paragraph 18). This would address cases where
for example there is clearly no intention to fragment contracts by the enterprise but merely after closing one construction project there is a new opportunity for a new an unrelated construction project (even if at the same site) in the source country. In our view, if a bright-line rule is added to the treaty, it could be read to weaken the general anti-abuse rule.

Comments on the inclusion of an insurance provision in Article 5 proposed by the Discussion Draft

Under Options M and N of the Discussion Draft, either a specific provision would be added treating a PE as existing with respect to certain insurance activities or alternatively such a determination would be left for the application of the expanded dependent agent/limited independent agent concepts as proposed in Options A to D.

In contrast to the UN model, the current OECD Commentary on Article 5 only suggests that inserting a provision into the OECD Model specifically targeted to in-country insurance activities was not advisable and therefore the outcome may be that if neither the fixed place of business or the dependent agent test are fulfilled the profits of the insurance business will be taxed exclusively in the residence country. This outcome was validated in two recent court cases of an OECD Member State dealing with insurance businesses operated through agents.

The policy rationale for adding a new proviso for insurance is limited as it merely refers to the existing Commentary to the UN Model, specifically the references to “nature of the insurance business”; “risks situated within the country claiming tax jurisdiction”; “difficulty to distinguish between dependent and independent insurance agents” and “no reason to treat differently from activities such as the sale of tangible commodities”.

The IBA Taxes Committee understands that in the framework of readjusting the dependent agent concept as proposed in Part A of the Discussion Draft that insurance business activities will likely need to be revaluated, but fails to understand why the introduction of an insurance proviso (following the lines of the UN Model) would address BEPS concerns.

In fact, the IBA Taxes Committee points out that no insurance industry BEPS-related concerns have been identified from the outset of the OECD BEPS work, besides the particular captive insurance issues to be addressed specifically by Actions 3 and 4 of the BEPS Action Plan.

The IBA Taxes Committee fails to understand the connection between the need for the insurance PE provision (essentially an Article 7 issue) and the potential issues of “transfer of risk” and “remuneration of risk shifted through payment of insurance or re-insurance premiums” (essentially an Article 9 issue).
In the view of the IBA Taxes Committee, the re-insurance activity - as a contractual mechanism through which insurers shift or cede part or more of insurance portfolios to foreign reinsurers in exchange for payment of premiums – in practice is not directly related to the avoidance of PE status by the reinsurer (even when undertaken by an associated enterprise). The mere fact that the reinsurer is ultimately covering “risks situated within the country” should not be considered a connecting factor for claiming a potential PE of the reinsurer. Therefore, if such a provision as proposed would advance the current exclusion of “re-insurance” ultimately would need to be maintained.

As such, the IBA Taxes Committee believes that the best course of action would be Option N - no specific rule for insurance enterprises would be added to Article 5 - and that identified or specific insurance related issues enterprises be dealt either through changes to the independent agent concept or through other Action Plan proposals.

Again, if Option M is to be implemented, additional guidance under Article 7 would be necessary in order to address the issue of calculation of income and the computation of profits attributable to a dependent agent insurance PE.
Submission on the OECD discussion draft on ‘BEPS Action 7: preventing the artificial avoidance of PE status

9 January 2015
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9 January 2015

Ref: OECD public discussion draft on preventing the artificial avoidance of PE status

Dear Ms de Ruiter,

I am pleased to communicate the views of Ibec and its members on the public discussion draft published by the OECD on ‘preventing the artificial avoidance of PE status’. Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations work with government and policy makers at national and international level to shape business conditions and drive economic growth. Ibec is also a member of BIAC and Business Europe and broadly supports the views communicated by these partners in their submissions on the OECD discussion draft.

General comments

At a general level, Ibec supports the work of the OECD in this area and understands that some changes are required to Article 5 of the OECD Model Tax Convention to prevent the artificial avoidance of PE status. Action 7 of the BEPS Action Plan indicates that the aim is to ‘develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS’, including through the use of commissioner arrangements and the specific activity exemptions. We are concerned, however, that the proposed changes in the discussion draft will result in a lowering of the PE threshold that goes far beyond the aim set out in Action 7. Irish business is particularly concerned that the proposed changes would lead to further uncertainty for business and would ultimately result in a sharp increase in the number of PEs with resultant administration and compliance costs for business, and this is of particular concern where the establishment of a PE will produce little in the way of tax revenue for the jurisdiction in which the PE is located in accordance with the principles of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments (“2010 OECD Report’). There is also concern that, the proposed changes would lead to greater subjectivity in tax rules which lead to increased disputes between tax administrations and greater incidences of double taxation, particularly where Tax Authorities are unwilling to follow the principles of the 2010 OECD Report.

Businesses may decide that the uncertainty and administrative costs associated with the extension of the PE rules mean that investment in a territory or territories is no longer attractive and if taken in aggregate, across all businesses and industries, such restrictions could have a considerable impact on cross border trade and availability of products for consumers.
Ibec therefore believes that any amendment to the PE Article to prevent abuse needs to take account of the administrative costs, complexity and uncertainty created for taxpayers and the potential negative impact on global trading. In addition, Tax Administrations need to understand the potential increased administrative burden that they will face if the PE definition is extended more widely than intended and consider their ability to manage the disputes that will arise as a result. This needs to be balanced with the lack of additional revenue that would arise to Tax Administrations if the activity in the PE is of low value and/or is already factored into fees paid to the local agent. As a general principle, we suggest that the proposals should seek to recognise a PE in a manner which achieves the same tax outcome in the source country for the same functions – whether the commercial arrangements take the form of a commissionaire or an undisclosed agency/disclosed agency structure.

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The proposed changes in this section are too broad and while targeted at commissionaire arrangements and other arrangements that are designed to artificially avoid the presence of a PE have the potential to have a much wider impact with the result that transactions that happen for genuine commercial reasons are also caught by the revised provisions.

Paragraph 10 of the Discussion Paper states that “as a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should 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 our view this statement is far too broad and goes well beyond the stated intentions of BEPS. Based on such subjective principles, both high and low value activities could be considered to ultimately lead to the negotiation of a contract. Any activity that was carried out by an agent could be said to directly or indirectly result in the conclusion of a contract. This principle also ignores the fact that the agent is already remunerated on an arm’s length basis for any services that it provides to the enterprise. The concept of the causal connection required between the intermediary interaction and conclusion of the contract, though founded in tort law, is entirely new to tax law, and is naturally untested within this context, hence it could lead to uncertainty and dispute.

As Options A to D seem to extend the definition beyond that originally intended, there is concern that the changes could give rise to a significant number of additional PE’s, creating an administrative burden for both taxpayers and tax authorities. In addition many of these PE’s would not create more than a minimal tax revenue for the PE State, if the principles within the 2010 OECD Report are followed as the activities performed in that State are of low value, the high value Significant People Functions (“SPFs”)/ Key Entrepreneurial Risk Taking (“KERT”) are carried out in the other State. However, the broader PE scope will also likely result in double taxation where States can’t agree the appropriate attribution of profit and this in turn will result in the requirement for more timely and robust dispute resolution. This subjectivity would create uncertainty and a hostile environment to cross-border trade due to the potential tax controversies and disputes with foreign tax authorities.

Therefore, proposals to change the wording “conclude contracts” is concerning, especially the wording proposed in Option A and C. Options A and C contain the wording “engages with specific persons in a way that results in the conclusion of the contracts” and this seems to be extremely broad and potentially targets all sales arrangements where a local entity provides support to a foreign entity that then concludes the contract with the local customer. Such support services including marketing, customer relationship management etc could all ultimately result in the
conclusion of contracts but not in all cases and it is of concern that such routine support services could be viewed as having a direct causal link to the conclusion of contracts, even in cases where the intermediary has absolutely no authority to bind the enterprise. Such services would also already be appropriately remunerated under arm’s length principles and it is unclear why the OECD thinks that this remuneration is not sufficient. Therefore, there is concern that Options A and C would lead to any local sales and support activity resulting in a PE exposure if Options A or C are adopted.

Options B and D instead replace the conclude contracts wording with “concludes contract or negotiates the material elements of the contract”. This wording is preferred on the basis that there is a clear need for the intermediary to have the ability to conclude contracts in the name of the enterprise, or at least to negotiate the material elements of the contract”. Therefore, sales and marketing activity of itself would not normally result in an intermediary negotiating the material elements of a contract, although “material elements” would need to be more clearly defined. However, Option D also proposes to replace the expression “contracts in the name of the enterprise” with the wording “contracts which, by virtue of the legal relationships between that person and the enterprise, are on the account and risk of the enterprise”. This wording causes concern as it is felt that this will have unintended consequences and capture not only commissionaire structures but also situations where risk is the business of the entity in question. Reinsurance would be a good example of an arrangement which could potentially be caught by such wording as the underlying insurance risk could be said to be partly “on the account of and risk of” the reinsurer by virtue of the legal relationship between it and the reinsurer. Reinsurance is a genuine commercial transaction which should not be caught by BEPS.

Further clarity would be welcome on the meaning of the Option B words ‘concludes contracts or negotiates the material elements of a contract’. We would be concerned that the suggested language could be read to imply that any negotiation of the material terms of a contract in a State could give rise to a PE, even if the material terms are not concluded through these negotiations. Guidance would be welcome to confirm that this phrase is only intended to cover the negotiation of the final material terms of a contract in a State and not situations which can commonly occur in business to business transactions where preliminary or interim discussions of terms of a contract occur in a State which do not reflect the final agreement of terms. Any text included to specifically address commissionaire structures should include a precise definition so as not to impact companies which use a central entity for invoicing purposes.

B. Artificial avoidance of PE status through the specific activity exemptions

Ibec members are very concerned by the proposals to ‘delete delivery from Art. 5(4) subparagraphs a) and b).

Ibec believes changes to the PE exemptions in Article 5.4 are unwelcome. This represents a retrograde step whereby some or all of the bright line rules for PE exemptions will be replaced with more subjective facts and circumstances determinations, with far more inherent subjectively and uncertainty. This again will not create a good environment for cross-border trade, as there are particular risks arising to a business from a PE assertion, specifically in certain countries with potential criminal prosecutions for directors of a company found to be operating an undisclosed PE, in addition to civil proceedings. Therefore care must be taken that these proposals do not stifle entrepreneurial expansion due to fear of criminal implications.

We believe that the unintended consequences of the proposed changes will create major issues for multi-nationals operating a lean centralised business model. The changes will result in requirements to make significant regressive changes to IT Systems and logistic planning functions in order to avoid
the risks of incurring PEs of the central entrepreneur in the countries of sale. If such changes are not made to IT systems and logistics planning then it will result in multiple PEs in the countries of sale and a significant increase in accounting for PEs and tax filing and compliance costs in the various countries.

Many multi-national companies have moved to a centralised supply chain model and synchronised their IT systems to facilitate centralised planning and inventory management and controls. In this model there is visibility by supply chain management of the logistic flows throughout the business. IT planning systems are integrated and result in local country customer orders automatically generating inter-company orders for delivery of products to the final destination. Under the proposed changes, the automatic generation of inter-company orders and the shipment of products from outside the country to the customer with flash title ownership by the local distribution entity will create a PE. The only way to avoid this is for the products to be physically located and owned in the country by the local distribution entity. This will result in significant duplication of efforts and the additional costs of maintaining the inventory in the local countries.

The removal of “delivery” from the PE exempt activities would mean that a centralised warehouse used for the supply of products to multiple countries will create a PE in the country where the warehouse is located. Once again this creates an obstacle to the efficient management of supply chain operations rather than the intended closing-off of a loophole in Article 5. The same scenario applies to the proposed changes to Art. 5(4) d) relating to the proposed deletion of “purchasing goods or merchandise”.

Many multinationals using a central entrepreneur or principal company model operate in the local sales markets through the use of limited risk distributors (LRDs). The strategic management of the distribution function takes place at the principal company level with the functions, assets and risks of the local distributor being limited to those required to execute the sales. The net operating margins of the LRDs are set based on benchmark analysis using comparable companies. Our view is that the determination of the profit attribution to the local sales country should be based on transfer pricing analysis and that Action 7 should not be the tool used to determine what profits should be taxed locally.

We suggest that the concerns above might be addressed by adopting a variation to General Option E which would be to have a presumption inserted into the lead in statement in paragraph 4 of Article 5 that the specific activities in subparagraphs (a) to (d) in article 5(4) could continue to be eligible for exemption unless those activities are core to the business activities of the enterprise - perhaps using wording such as ‘form a significant and essential part of the enterprise as a whole’.

Actions 8-10 on Transfer Pricing is the more appropriate BEPS tool to ensure that profit shifting should not take place. It should look at the totality of operation by the multinational in the country and provide guidelines on profit allocations. The modifications proposed to Article 5 on PEs has the unintended effect of either causing multinationals to revert back to inefficient decentralised structures or else incurring the increased administration burden of creating multiple PEs in the countries where it trades.

Changing the wording of Article 5 provides some guidance to multinational companies where potential PEs may exist. It does not provide guidance on what profits should be allocated to the PEs. The proposed changes would therefore be likely to create many additional PEs with very limited taxable income.
We would also be opposed to removing the exemption for the collection of data which seems to be a drastic step in order to avoid the perceived avoidance mentioned in the discussion draft. A Tax Authority should be able to examine the facts and determine that such arrangements “to disguise what is in reality collecting data for other enterprises” fall outside the exemption, instead of removing an exemption which allows business to collate sufficient market intelligence to make the best informed business decisions.

The BEPS Digital Economy deliverable states that data collected from various sources are key to value creation in the Digital Economy. Some countries would seek to attribute value to data. Assigning value on an objective basis is problematic – as many others have said raw data has little or no intrinsic value - rather, value derives from aggregating data and applying analytics through people and technology.

C. Insurance

The discussion draft does not make it clear why the insurance industry has been identified as requiring specific measures. The draft expresses concern about some insurance companies doing large scale business in a State without being taxed in that State. In the EU this is consistent with the ability to write business on a freedom of services basis and it is difficult to see why the business should be subject to tax in the host state when the regulator of the same State has no regulatory oversight.

Option M as currently drafted would result in agents with no authority to take risk on the insurers behalf and who do not bear any insurance risks themselves to create a PE of the insurer, merely by collection of premiums locally. These agents are third parties, already remunerated on an arm’s length basis which is subject to tax locally.

This will result in a high compliance burden for insurers and the creation of a PE for tax purposes, where there is no PE for Regulatory purposes. Insurance is a tightly regulated industry and it makes no sense to bifurcate the definitions for Regulatory and Tax purposes. To do so would create a high compliance burden for the insurance industry without creating much, if any, additional tax of the PE State.

The collection of premiums would normally be a low value activity as far as the insurer in concerned and in line with the principles set out in the 2010 OECD Report, much of the value associated with the insurance activity is attributed to the location in which the KERT is carried out. The KERT in the insurance context is normally the assumption of insurance risk and the mere collection of the premium does not mean that the insurance risk has either been accepted or borne by that person. Instead the KERT rests with the entity that accepts the risk and manages the risk i.e the insurer in their country of residence. Therefore under Part IV of the 2010 OECD report all (or almost all) of the profit will be attributable to the insurer in their country of residence, but there will be a considerable administrative burden. To the extent any profit is attributed to the PE, double taxation will arise unless the insurers country of residence is prepared to offer double tax relief. This is likely to lead to an increased number of disputes.

We are therefore not supportive of a specific carve out for insurance and would suggest that any concerns around the taxation of activities in a host state be dealt with as part of the general changes to Article 5.
Ibec appreciates your consideration of these concerns and would welcome the opportunity to engage further on the issues addressed in the discussion draft.

Yours sincerely,

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ICAEW welcomes the opportunity to comment on the Public Discussion Draft BEPS Action 7: Preventing the artificial avoidance of PE status published by OECD on 31 October 2014.

This response of [date] has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.
ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW’s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
RESPONSES TO SPECIFIC QUESTIONS
Section A – Artificial avoidance of PE status through commissionaire arrangements and similar strategies

1. We are concerned that the proposals start from the premise, which we do not believe is always true, that commissionaires are inevitably used as part of an avoidance strategy.

2. Whether that is the case, or not, has been thoroughly examined by the highest courts of a number of European countries whose legal systems contain the commissionaire concept (French Conseil d'État (Supreme Administrative Court) in Société Zimmer Ltd v Ministre de l'Économie, des Finances et de l'Industrie; Norwegian Supreme Administrative Court in Dell Products(Europe) BV v Skatt Øst;) All these courts have systematically rejected the argument that this is an abuse.

3. Similarly, in cases where abuse has not been argued, supreme courts have concluded that a commissionaire in itself does not give rise to a permanent establishment (Italian Supreme Court in Boston Scientific v Italian Revenue Agency).

4. The example set out at paragraph 7, is the Zimmer case.

5. The statement in paragraph 10 is that in many cases commissionaire structures and similar arrangements are put in place primarily in order to erode the taxable base of the State where sales take place. The assumption is that such arrangements are always for tax avoidance purposes so that some change is necessary to paragraphs 5 and 6 of Article 5 of the OECD Model Convention. There are then four separate proposals for such change, examples A to D.

6. Notwithstanding what we have said above, if there is to be a change in Article 5 (4), then of the proposals put forward we have less objections to proposal A.

Proposal A

7. If there is to be a change then we are concerned that the expression "specific persons" is too vague to have any real meaning. Article 5(5) has always and should continue to deal with PEs that arise by reason of contractual relationships. This makes the parties identifiable.

8. We are concerned that the phrase "engages… in a way that results in the conclusion of contracts" is too vague and will give rise to considerable uncertainty.

9. Automatic exclusion of associated enterprises from Article 5(6) as independent agents is bound to result in a proliferation of permanent establishments that runs contrary to the practical allocation of taxing jurisdiction. Article 9 ought to address issues of associated enterprises. Proper application of the arm's-length principle will therefore mean that there will be little profit, if any, for such permanent establishments once the local agent has been properly remunerated, but considerable administrative cost.

10. We are concerned by the automatic exclusion from qualifying as an independent agent under Article 5(6) of persons who act exclusively or almost exclusively for one person. This will have an adverse impact particularly on start-up agents. Any person who sets up an agency in relation to an initial customer will inevitably be a PE under the proposed language until they have managed to secure sufficient work acting for other principals. This will inhibit the activity of start-up agents and will favour established agents thus creating a significant barrier to entry, and will consequently probably be contrary to the TFEU (formerly EC) treaty freedoms
Proposal B
11. Our concern is that if this proposal were adopted, it will be too vague and it will be inherently uncertain making it difficult to administer. This would act as a brake on international trade and would particularly inhibit smaller businesses which might otherwise start to trade in a particular country.

12. In terms of detailed drafting we think that treating an intermediary as constituting a PE when they ‘negotiate the material elements of contracts’ is again too vague and uncertain to be capable of practical application.

Proposals C and D
13. We are again concerned that the language is very uncertain and wide in scope.

14. A simple solution for countries that do recognise commissionaires in their law would be to include a provision that deems the commissionaire under the relevant law to be a person with authority to conclude contracts and so within Article 5(5).

Section B- Artificial avoidance of PE status through the specific activity exemptions

Proposal E
15. Under the current provision certain activities, such as “the storage, or maintenance of a stock, of goods for delivery” are automatically treated as being activities of a preparatory or auxiliary character which do not create a PE. The proposal is to redefine the test to be whether the activity itself “is of a preparatory or auxiliary character”.

16. We believe that introducing a general test, as to whether the activities are of a preparatory or auxiliary character, is the best of the options put forward and we would, therefore, support Proposal E.

17. As an alternative to a general rule which would subject all the listed activities to a “preparatory or auxiliary character” test there are then three alternative suggestions as to how to address BEPS concerns.

Proposal F
18. This option would remove “delivery” as being an activity that could be considered to be “preparatory or auxiliary”.

Proposals G and H
19. These proposals would remove the possibility of purchasing goods or merchandise (Option G) from being “preparatory or auxiliary” or in the case of Option G both the purchasing and the collection of information as being “preparatory or auxiliary”.

20. We consider that all of these specific proposals (F,G &H) are too draconian. We would favour E i.e making these exceptions expressly subject to the requirement that the activity be demonstrated to be auxiliary/ancillary to the other activities of the enterprise.

Fragmentation of activities between related parties
Proposals I,J
21. In new paragraph 4.1 b) we believe there should be a requirement that the enterprises should be acting together rather than merely exercising “complementary functions that are part of a cohesive business operation”. We are concerned that the proposed formulation is too vague and would have the result that functions that are genuinely carried on independently could be aggregated whereas the aim is to prevent businesses being artificially split into separate parts.

22. We also note that fragmentation of activities is sometimes occasioned by a particular countries inward investment rules e.g. it is not generally possible for a loss-making foreign parent company to open a branch in certain countries because branch office approval is only given to
companies with a profit-making track record. In such a case the foreign group would have to open a subsidiary which might then be caught by these new rules.

Section C – Splitting of contracts
23. We have no comments on these proposals.
APPENDIX 1

ICAЕW TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax-tax-faculty/~media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)
Dear Ms. de Ruiter:

ICI Global,\(^1\) on behalf of our collective investment vehicle (CIV)\(^2\) industry members, urges that the final Base Erosion and Profit Shifting (BEPS) Action 7 Report\(^3\) not impact several rules, discussed below, for determining whether a taxpayer has created a permanent establishment (PE). These well-established rules provide CIVs, their investors, and their managers with tax certainty.

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\(^1\) The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.2 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

\(^2\) A CIV is defined for this purpose consistently with the OECD’s Report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (the “CIV Report”) – http://www.oecd.org/tax/treaties/45359261.pdf. Specifically, CIVs are defined as “funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.” CIV Report, page 3, paragraph 4. Funds that are not treated as CIVs in the CIV Report (and that are not addressed in our comments) include “investments through private equity funds, hedge funds or trust or other entities that do not fall within the [Report’s] definition of CIV.” Id.

\(^3\) The OECD public consultation document to which these comments relate is entitled “BEPS Action 7: Preventing the Artificial Avoidance of PE Status” – http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf.
Support for OECD’s BEPS Initiative

Base erosion and profit shifting concerns, we have stated repeatedly,⁴ should be addressed globally on a consensus basis. As the OECD is uniquely positioned to achieve this goal, we support strongly the OECD’s leadership of the BEPS project.

Summary of ICI Global’s BEPS Action 7 Concerns and Specific Recommendations

The PE rules contained in Article 5 of the OECD Model Tax Convention on Income and on Capital (the OECD Model Tax Convention)⁵ were crafted to implement sound tax policy. Most specifically, the PE rules strike a balance between a business’ tax responsibilities to a jurisdiction and the benefits that the business receives from its activities within that jurisdiction.

The current PE rules prevent a business with limited activities within a jurisdiction (and little revenue from those activities) from incurring the substantial administrative and compliance costs associated with a PE. Instead, the current rules limit the incursion of these costs to situations in which the expected tax revenue to the PE-asserting jurisdiction is significant. We submit, for the reasons explained below, that any possible tax revenue from expanded PE rules will be substantially less than the incremental costs imposed on the CIV industry.

We acknowledge, of course, that governments should be concerned if wholly-artificial structural arrangements can be crafted to avoid paying tax that fairly is due. The appropriate solution, however, would be targeted fixes rather than the more fundamental changes being advanced in the discussion draft.

Our specific recommendations, which address only legitimate arrangements with respect to questions asked regarding the OECD Model Tax Convention, are that:

- BEPS Action 7’s option H should be rejected –
  - (i.e., Article 5, Paragraph 4(d) – relating to information collection – should be maintained);
- BEPS Action 7’s option E should be rejected –
  - (i.e., Article 5, Paragraph 4 should not be amended to condition its application in all cases on activities being preparatory or auxiliary); and
- BEPS Action 7’s options I and J should be rejected –
  - (i.e., separate entities created for sound business reasons, as provided in effect by Article 5, Paragraph 7, should be respected).


More generally, we recommend that any changes to the PE rules be accompanied by:

- clear and appropriate rules for attributing income and expense; and
- enhanced dispute resolution techniques and tools including mandatory binding arbitration.

Overview of the CIV Industry

Our PE recommendations are informed by CIV industry experiences in the global marketplace and the resulting tax controversies. In the BEPS Action 7 context, it is instructive to consider the nature of a CIV, the reliance on third-party service providers, the roles and responsibilities of these service providers, and the organization of the CIV manager.

The Nature of a CIV

A CIV is a pooled investment vehicle widely used by individuals to cost-effectively access the securities markets. The important advantages provided by CIVs include professional management, asset diversification, liquidity, and robust governmental regulation and oversight.

All functions of the CIV, which does not have employees of its own, are performed by third-parties. The asset manager that has created the CIV often will perform many of these services. A CIV’s officers typically will be employees of the asset manager. The typical CIV is overseen by a board of directors or trustees responsible for ensuring that the CIV is operated in accordance with its organizational documents, local law, and the best interests of its investors.

A CIV’s investment objective (e.g., stocks or bonds; country-specific, regional, or global; etc.) is prescribed in its offering document. Most CIVs disavow any interest in exercising any control over a company in which they invest. The CIV’s portfolio management team decides which specific securities to buy and sell and initiates the securities trades.

Investors’ interests in a CIV are acquired either directly from the CIV (with the purchase reflected directly on the CIV transfer agent’s/recordkeeper’s books) or through a third-party distributor. All CIV investor transactions are effected at the CIV’s net asset value (NAV), which is determined each day by calculating the CIV’s assets and liabilities and dividing by the number of outstanding interests. Because of this precise calculation requirement, certainty regarding a CIV’s tax liabilities is essential.

CIVs may be organized for distribution to one or more specific types of investors (e.g., individuals, pension funds, corporates, etc.). Depending on the type of targeted customer, different methods will be utilized for promoting the CIV and distributing CIV interests. Intermediaries (e.g., banks, broker dealers, financial planners) typically are heavily involved in the distribution process.

The tax treatment provided to CIVs effectively recognizes that CIVs do not carry on business activities. To ensure that CIV investors receive tax treatment comparable to that provided to direct investors, for example, countries typically provide some mechanism to exempt a CIV’s income from tax; the exemption mechanism may be an express tax exemption or a targeted tax deduction for amounts distributed to investors. The only tax
borne by the typical CIV on its portfolio transactions is any withholding tax that may be imposed when the CIV is a nonresident investor.

A CIV is separate and distinct from the asset manager that created it. The CIV and the asset manager have different owners, their assets are totally separate, and they bear no responsibility for each other’s liabilities (including tax liabilities).

Management Companies and Other Service Providers to CIVs

The typical CIV asset manager offers its customers a wide range of financial products and provides them with an array of valuable services. The products may include CIVs, other investment pools (e.g., hedge funds) that are not widely-held, insurance, and banking services. The services provided, in addition to offering these products, may include distribution, investment education, investment advice, wealth management, and/or estate planning.

The services that an asset manager may provide to a CIV could include:

- portfolio selection (which may involve portfolio managers (PMs), analysts, and research assistants);
- asset acquisition and disposition (often through multiple securities dealers);
- assistance in arranging asset custody (typically through a global custodian and regional/local subcustodians);
- regulatory compliance;
- investor recordkeeping (through a “transfer agent”); and
- investor communications (including transaction confirmations and periodic account statements).

Many asset managers create separate entities to distribute CIV interests. These distributors may contact investors directly or work through unrelated third-parties (e.g., broker-dealers). Because the global CIV industry is highly intermediated (i.e., CIV interests typically are acquired through third parties), arm’s-length pricing comparables are available for “in-house” distribution activities.

Many management companies operate globally – although their specific activities may vary widely. Companies may distribute their products locally, regionally, or globally. Some may invest globally – even if they distribute only locally or regionally. Still others may consolidate various functions in one (or more) locations to achieve economies of scale. The manner in which a management company is organized and/or structures its operations also may vary widely. Even within one country, a company may create separate entities; different business lines subject to different regulatory regimes and/or supervised by different regulators frequently will be placed in separate entities. Operations in multiple countries likewise often will be performed by separate companies.

 Particularly within the heavily-regulated financial services industry, regulatory considerations often will be the primary (if not exclusive) driver for structuring decisions. Local regulatory requirements, for example, frequently require that a locally-organized CIV be managed by a local management company. To the extent that one country’s regulatory regime applies to an entire entity, companies often will establish separate subsidiaries so that the applicable regulatory regime will apply only to the relevant business activities. When different jurisdictions have different, and potentially inconsistent, regulatory requirements, it often is necessary to set up separate entities (e.g., distributors) in each
jurisdiction. Separate entities become even more important when country-specific securities licenses or other permissions are required.

**CIV Industry Competitiveness**

The CIV industry is extremely competitive. CIVs routinely advertise their performance (investment return) both in real terms and relative to their competitors. Independent research firms (e.g., Morningstar) often are a primary source for the data required to make these comparisons.

Performance and reputation are key for CIVs and their asset managers. CIVs that generate strong returns and outperform competing investment products are rewarded with shareholder investment inflows. CIVs that underperform face shareholder redemptions. Because an asset manager’s fees are calculated based upon assets under management (AUM), managers are incentivized to generate strong performance.

Perhaps the biggest driver on performance (other than portfolio management) is the fee paid by a CIV to its manager. Because all fees paid by a CIV come directly from the CIV’s assets, fees have a direct and negative impact on performance. The more a CIV pays in management fees, the lower its investment return. The CIV industry, therefore, is extremely price-sensitive.

Management companies also are incentivized to keep fees low. The lower the CIV’s expenses, the higher the returns, and the greater the investor demand for the CIV. The larger the CIV, the higher the gross management fee.

**Management Company Expense Considerations**

Management companies seek to control all of their expenses. Business efficiency, including consolidating functions operationally and/or geographically, play an important role in cost containment. Costs between related parties are charged by applying the arm’s-length standard.

All management company operations, importantly, do not have the same impact on profitability. In the CIV industry, a management company’s reputation and success are driven largely by the attractiveness of the CIVs it offers to investors. Developing innovative products (e.g., exchange traded funds) or identifying new investment opportunities (e.g., micro cap stocks) can generate growth. Because performance is key, however, portfolio management (e.g., stock picking) is a key profitability driver. Administration and infrastructure costs (e.g., regulatory compliance such as legal services and accounting, transfer agency, custodial, and information technology costs) are very important to a successful operation and may constitute a significant portion of a CIV’s operating costs – but they have less impact on a CIV’s performance.
CIV Industry Concerns with the BEPS Action 7 Public Consultation Document

**PE Rules Appropriately Limit Unproductive Tax Liability Assertions**

Tax controversies, while inevitable, can result in significant time commitments and expense. The PE rules embodied in the OECD Model Tax Convention provide an important check against expensive and ultimately unproductive assertions of tax liability. Any proposed changes to the PE rules should be targeted at artificial constructs. If an entity has such limited contact with a country that assertions of taxing jurisdiction, and the resulting compliance costs, would make it uneconomic to enter the country in the first instance, a PE should not be created.

Any expansion of the PE rules, as discussed below, must be accompanied by fair and administrable profit attribution rules. We are particularly concerned that tax administrators aggressively asserting taxing jurisdiction under any expanded PE rule also will aggressively and inappropriately assert that revenues (and taxable profits) are arising within their borders. These assertions almost surely will result in double taxation of a business’ profits.

**The Information Collection Exception Should be Retained**

First, for the reasons discussed below, we recommend that paragraph 4(d) of Article 5 of the OECD Model Tax Convention – relating to information collection – be retained. Hence, BEPS Action 7’s option H should be rejected.

The process of collecting information is precisely the type of “contact” with a country that is too insignificant to justify PE assertions. The information collection activities of CIV asset managers provide an apt illustration of this point.

Fund managers routinely collect information regarding investment opportunities for CIVs that they manage. The collected information is transmitted back to the manager’s investment office along with information collected from other countries and regions. This information then is analyzed closely, often by a team of investment professionals with diverse responsibilities, before a portfolio manager makes any decision to buy or sell securities.

This information collection activity often will not involve a fixed place of business. Portfolio managers and/or analysts routinely visit operating companies and meet with senior employees to understand better a company’s business activities, growth opportunities, etc. Publicly-available financial information also will be collected (sometimes from the internet rather than a visit).

While information has some intrinsic value (otherwise, companies would not incur the costs of collecting it), information-collection activities bear little relationship to management company revenues. Without the detailed examination of the information and data collected, and the rigorous comparisons of different investment opportunities, CIV’s investors would not benefit from any information collected. In the CIV industry, profitable activities are the ones that benefit CIV investors.

Moreover, were a PE inappropriately asserted because of this information-collection activity, any small amount of revenue more than likely would be offset by the expenses (including employee compensation) of collecting this information. The limited amount of potential tax revenue – and the substantial burden of complying with potentially a hundred
or more different tax regimes (for a CIV manager investing globally) – help explain why information collection does not create a PE under Article 5 today.

One consequence of inappropriate PE assertions might be a fund manager’s decision to curtail or eliminate its information collection efforts and thereby minimize tax assessments and the resulting controversies. This result would be particularly unfortunate for source-country issuers and for a source country’s growth potential.

Any perceived abuses regarding the exception for collecting information should be addressed instead through narrowly-targeted rules.

The Collection-of-Information Exception Should Not Be Limited to Preparatory or Auxiliary Activities

Second, for reasons similar to those discussed above, we recommend that paragraph 4(d) of Article 5’s information collection exception not be limited to preparatory or auxiliary activities. Hence, BEPS Action 7’s option E should be rejected.

Information collection activities, as discussed above, are too insignificant relative to the compliance burdens that would be imposed on a business conducting them. While these activities fairly should satisfy any preparatory or auxiliary activity requirement, adding this subjective requirement to the information collection specific activity exemption would eliminate the objective nature of the standard applied today. Adding a preparatory or auxiliary requirement would invite tax disputes that would generate substantial costs but little if any additional tax revenues.

Before any preparatory or auxiliary requirement is imposed on the specific activities presently covered by Paragraph 4 of Article 5, careful consideration should be given to the meaning of “preparatory or auxiliary” and the specific situations that would not meet this new standard. Given the pace at which the BEPS initiative is being undertaken, the likelihood of successfully completing this careful consideration within the time provided seems remote. Consequently, we urge that any changes in this area be considered more thoroughly post-BEPS (similar to the consideration given to PE issues by WP1 over the past few years).6

Separate Entities Created for Sound Business Reasons Should Be Respected for PE Purposes

Third, we recommend that the PE rules be applied by respecting separate entities created for sound business reasons. Hence, BEPS Action 7’s options I and J should be rejected.

In the financial services industry generally, and the CIV industry in particular, regulatory obligations routinely cause firms to form separate business entities to perform specific functions and/or to operate in specific countries or regions. These separate entities should be respected.

PE Rules Never Should Attribute Activities of a CIV Manager to a CIV

Critically importantly, PE rules never should attribute activities of a CIV manager to a CIV. As discussed in detail above, a CIV and its manager are neither owned by the same people

6 See, e.g., the OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment), dated 19 October 2012.
nor involved in the same activities. A CIV is owned exclusively by its investors; a CIV manager typically will not invest in a CIV it manages (other than possibly to invest “seed money” that is used to “start up” a CIV; this money then is withdrawn after the CIV attracts investors). Similarly, while a CIV manager is an operating business, a CIV is merely an investment pool; the securities held in a CIV’s portfolio are non-controlling interests that do not in any way constitute a “business.”

Our concern on this point relates to the different requirements that countries impose on CIVs seeking to benefit from CIV-specific tax regimes; these regimes are necessary, as noted above, so that CIV investors are taxed only once (at either the CIV or the CIV investor level) on the CIV’s income and gains. If a CIV is treated as having a PE in a country simply because its CIV manager conducts activities in that country, the CIV most likely would incur substantial inappropriately-applied tax. This tax liability concern arises because any CIV not offered to investors in that market would not have been structured consciously to meet that country’s requirements for any CIV-specific tax rules.

**PE Rules Should Respect Separate Business Entities Created by a CIV Manager**

Separate business entities created for legitimate business reasons also should be respected when only the activities of a CIV manager and its various related entities are considered. CIV managers, as discussed above, create separate entities to limit securities-law regulatory requirements to the relevant business unit. The portfolio management activities of a CIV manager are subject to such sufficiently-distinct requirements, for example, that they often are conducted by a separate entity.

Within the CIV industry, it is not necessary to expand the PE rules to collect the appropriate amount of tax from activities conducted within a country’s borders. Other than information collection, the separate activities addressed in Article 5 paragraph 4 typically are not carried on within the CIV industry.

Moreover, because most activities performed within the CIV industry are offered by third parties, any activities performed by an entity related to the entity managing CIV portfolios are ones for which arm’s-length pricing comparables are available. Hence, any underlying transfer pricing considerations that might arise in the CIV industry context already can be addressed adequately.

Fund distribution is one example of separate entities being created within the CIV industry. Securities distributors typically are subject to stringent requirements designed to protect investors. One way in which CIV managers can control for these requirements is to set up separate distributors. Establishing pricing comparables is not difficult, however, as third parties are used widely to distribute interests of unrelated CIVs. These comparables will ensure that a CIV manager’s distribution activities within a country are taxed appropriately – without subjecting entities conducting other activities outside the country to tax within it.

Investor recordkeeping/transfer agency and compliance are other situations in which separate entities often are created. As with distribution, third-party comparables are available for these types of activities. Independent companies provide many different types of businesses (including CIV managers) with customer-service facilities such as “call centers.” Because third-party comparables are readily available for these types of entities, a CIV manager cannot create separate entities to manipulate the pricing of services and “hide” revenue that should be attributed to activities within a country.
The business fragmentation proposals – which involve disregarding separate legal entities to address situations in which conglomerates arguably fragment activities to access inappropriately the specific activity exemptions – would set a dangerous precedent. This precedent would be particularly problematic if applied to CIV industry because regulatory considerations routinely lead CIV asset managers to perform business functions within separate entities.

Any Expansion of the PE Rules Should Be Accompanied by Clear and Appropriate Rules for Attributing Income and Expense and by Mandatory Binding Arbitration

Any expansion of the PE rules creates the potential for substantial tax controversy. The potential compliance burdens associated with PE status are a primary reason that the PE rules have been crafted to apply only when sufficient contact with a jurisdiction has been established.

The CIV industry in some jurisdictions already experiences very challenging tax administration difficulties. Highly aggressive interpretations of tax laws and principles – that ultimately are rejected by the courts – are far too common. The costs of defending against these unwarranted tax assertions can be substantial.

To limit the negative impact of any expansion of the PE rules, two separate steps should be taken. First, clear and appropriate rules for attributing income and expense are necessary; these issues are being considered in the context of BEPS Actions 8-10.

These clear and appropriate rules would result in profits being taxed by the jurisdiction in which the activities giving rise to them occur. In the CIV industry context, the investment management function generally is much more important to the CIV manager’s success than are the other activities performed by the manager and/or related entities.

Second, mandatory binding arbitration should be available to allow business to resolve unwarranted tax assertions. Other measures, such as advance pricing agreements (APAs) and safe-harbor rules regarding pricing margins between tax treaty partner countries, also will be beneficial. The CIV industry is deeply concerned that the BEPS Action 14 discussion draft on making dispute resolution techniques more effective does not call for mandatory binding arbitration.

* * *
Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) at your convenience if you would like to discuss this issue further or if we can provide you with any additional information. My colleagues Karen Gibian (at kgibian@ici.org or 001-202-371-5432) and Ryan Lovin (at ryan.lovin@ici.org or 001-202-326-5826) also may be called upon for assistance.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

cc: taxtreaties@oecd.org
Dear Ms. De Ruiter,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below the comments to the Public Discussion Draft on Action 7 of the BEPS Action Plan – “Prevent the Artificial Avoidance of the PE Status” (the “Draft”).

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies.

A.1. Paragraph 5.

<table>
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<th>Current status</th>
<th>Alternative proposals</th>
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<td>5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts</td>
<td>5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting on behalf of an enterprise and in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts [Alternatives A &amp; C]</td>
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and in doing so, habitually concludes contracts or negotiates the material elements of contracts
[Alternatives B & D]

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<th>in the name of the enterprise,</th>
<th>a) in the name of the enterprise, or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise, [Alternatives A &amp; B] which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, [Alternatives C &amp; D]</th>
</tr>
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<tbody>
<tr>
<td>that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.</td>
<td>that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.</td>
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A.1.1. Alternatives A & C vis-à-vis Alternatives B & D.

Alternatives A & C of the Draft are very broad and could catch situations escaping the rationale of triggering a permanent establishment (“PE”) on the country of source. The foregoing because the scope of the intermediary’s interactions to be deemed as directly resulting in the conclusion of contracts is undefined and, in fact, it would be impossible to define such a scope given the undetermined number of facts and circumstances that would need to be foreseen in such definition. The result of this would be to generate more confusion and gray areas on the analysis of PE exposure. Therefore, Alternatives B & D are preferable over Alternatives A & C.

A.1.2. Alternatives A & B vis-à-vis Alternatives C & D.

The current wording of Article 5(5) foresee that the conclusion of contracts must be done in the name of the enterprise.

Paragraph 32.1 of the Commentaries to Article 5(5) of the Model Tax Convention provides that “(...) the phrase ‘authority to conclude contracts in the name of the enterprise’ does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise (...).”

Such paragraph of the Commentaries was added at the request of common law countries where agreements signed by the agent in its own name actually bind the enterprise directly. In civil law countries, agreements signed by the agent in its own name do not bind the enterprise directly, but it is the agent who is bound directly while the enterprise is bound with the agent. However, the Commentaries have generated confusion on courts decisions at civil law countries because some
have interpreted them in a more functional way\textsuperscript{1} while others have interpreted them in a more juridical way\textsuperscript{2}.

Alternatives A & B and Alternatives C & D of the Draft both seek to eliminate the difficulties described above arising from the phrase “contracts in the name of” from two different approaches. Alternatives A & B address the issue by focusing on what is the object of the contract entered into by the agent (i.e., property or services to be provided by the enterprise), regardless of whether such contract was entered in the name of the enterprise or in its own name. Alternatives C & D address the issue by focusing on whether the contract entered into by the agent is on the account and risk of the enterprise, regardless of whether such contract was entered in the name of the enterprise or in its own name.

In our opinion, to avoid any confusions, the phrase “\textit{a) in the name of the enterprise}” should be deleted from Alternatives A & B so that it effectively focuses only on what is the object of the contract entered into by the agent. Therefore, Alternatives A & B should read as follows:

\begin{itemize}
  \item a) in the name of the enterprise, or
  \item b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
  \item c) for the provision of services by that enterprise,
\end{itemize}

We consider more appropriate to deal with the issue through Alternatives A & B (adjusted as proposed above) because Alternatives C & D could pose an additional difficulty on the interpretation of the phrase \textit{“on the account and risk”}. In addition, Alternatives C & D require to demonstrate the existence of a legal relationship between the agent and the enterprise while Alternatives A & B focus only on the object of the contract.

\textsuperscript{1} A commissionaire acting in its own name could trigger a PE at source because, although the enterprise is not bound directly through the agreement signed by the commissionaire, it is bound indirectly through the agreement entered into between the enterprise and the commissionaire.

\textsuperscript{2} A commissionaire acting in its own name cannot trigger a PE because the enterprise is never bound directly through the agreement signed by the commissionaire.
A.1.3. Conclusion.

In our opinion, the most appropriate wording of Article 5(5) to deal with the commissionaire issue would be as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting on behalf of an enterprise and in doing so, habitually concludes contracts or negotiates the material elements of contracts

a) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

b) for the provision of services by that enterprise

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.


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<td>6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.</td>
<td>6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of that business. Where, however, a</td>
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A.2.1. First sentence of alternative proposal.

The phrase “independent agent acting on behalf of various persons” could lead to confusion and inappropriate assessment on the existence of a PE. Indeed, according to the proposed wording of Article 5(6), and in particular according to such phrase, paragraph 5 would continue to apply for purposes of assessing the existence of a PE if an independent agent acts on behalf of only one independent person, but it would not apply if the independent agent acts on behalf of various independent persons (i.e., two or more).

In this regard, we are of the opinion that such phrase should be deleted from the proposed wording. The foregoing because paragraph 5 should still be deemed not to apply regardless of whether the independent agent acts on behalf of only one independent person. In other words, whether the independent agent acts on behalf of only one independent person should not be by itself determinative on the analysis because otherwise cases where independent agents legitimately act on behalf of only one independent person (i.e., where the independent agent has only one client) would trigger PE exposure for such independent person.

Our proposed wording would be as follows:

6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent acting
on behalf of various persons and acts for the enterprise in the ordinary course of that business.

A.2.2. Second sentence of alternative proposal.

Being consistent with the adjustments proposed to the first sentence, the second sentence should be adjusted to make clear that paragraph 5 will continue to apply where the agent acts on behalf of one or more associated enterprises, as follows:

6. (...) Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

A.2.3. Conclusion.

In our opinion, the most appropriate wording of Article 5(6) to deal with the commissionaire issue would be as follows:

6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

B. Artificial avoidance of PE status through the specific activity exemptions.

B.1. Specific activity exemptions.
The Focus Group suggests amending Article 5(4) regarding the activities exemption by restricting its scope through the qualification of all such activities being of a preparatory or an auxiliary nature as per Alternative E of the Draft.

We are of the opinion that Alternative E of the Draft should be adopted as it is consistent with the original intent of the Model Convention in that all exempted activities have the common feature of being of an auxiliary or preparatory nature (Vid. Paragraph 21 of the Commentaries to Article 5(4) of the Model Tax Convention).

Moreover, besides adopting Alternative E, we also suggest further clarification within such alternative in the sense that information collection by a newspaper bureau qualifies as having a preparatory and/or auxiliary nature.

If Alternative E is not adopted, the Focus Group suggests taking measures suggested on Alternative F together with Alternatives G or H.

Alternative F should be avoided in any case because removing reference to “delivery” in subparagraphs a) and b) of paragraph 4 of Article 5 may give rise to unintended scenarios of a PE. For example, enterprises engaged in a building site, construction or installation project, will typically make deliveries in connection with such activities and whilst such deliveries could be viewed as having a preparatory or auxiliary nature, they would trigger a PE if Alternative F were adopted.

In Alternative G, the exception for “purchasing goods or merchandise” is deleted from subparagraph d) of paragraph 4 of Article 5 thereby leaving the exception pertaining to “collecting information”. In Alternative H, the full exception included on subparagraph d) (i.e., “purchasing goods or merchandise” and “collecting information”) is deleted.

We are of the opinion that, assuming Alternative E is not adopted, Alternative G, rather than Alternative H, should be adopted. The foregoing because removing the exception for “purchasing goods and merchandise” would be in
accordance with the arm’s length principle, while leaving the exception for “collecting information” is appropriate given that the latter’s scope is already limited pursuant to the Commentaries of the Model Tax Convention (Vid. Paragraph 22 of the Commentaries to Article 5(4) of the Model Tax Convention). In this regard, we also dissent with the Commentaries of the Model Tax Convention that collecting information is an extension of “mere purchasing” (collecting information could well be an independent activity) and additional commentaries are needed as well for clarification purposes.

B.2. Fragmentation of activities.

According to the Draft, to prevent the artificial avoidance of PE status there are certain concerns about the application of Article 5(4), where preparatory or auxiliary activities are fragmented between related or associated parties. In this regard, two alternatives of a rule (Alternatives I and J) are proposed to address this issue.

In our opinion, Alternative J better addresses BEPS concerns, as it does not necessarily require triggering of a PE by one of the associated enterprises for the rule to apply, which is a sine qua non requisite pursuant to Alternative I.

Indeed, from the wording of Alternative I the fixed place or places of the enterprise or the associated enterprise shall be considered a PE (on an individual basis), in order to consider that the overall activities carried out by the two enterprises at the same place or other place, qualify as a PE under the provisions of article 5. However, it may be the case that the fixed place or places mentioned above may not qualify as a PE on an individual basis and hence, the business activities carried out by the two enterprises would not be considered as a PE even though they constitute complementary functions that are part of a cohesive business operation. Therefore, as previously mentioned, in our opinion Alternative J shall be considered rather than Alternative I.

Also, in our opinion, Subparagraph 4.1.a) should be deleted and reference to the “two enterprises” should be amended to include “two or more enterprises”.

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Moreover, clarification is needed as to who would trigger the PE. Although we read it as all involved enterprises would severally trigger a PE, this issue needs to be clarified to avoid unwanted misinterpretations of the wording.

Based on the foregoing, in our opinion, the most appropriate wording for an additional paragraph 4.1 dealing with the fragmentation of activities issue would be as follows:

4.1. Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise carries on or any associated enterprises carry on business activities at the same place or at another different places in the same Contracting State and the overall activity resulting from the combination of the activities carried on by the such enterprise or two associated enterprises at the same place, or by the same enterprise or associated enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the such two enterprises at the same place, or by the same enterprise or associated enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

By adopting the suggested language for Paragraph 4.1. (i.e., eliminating Subparagraph 4.1.a)), an enterprise having a PE in a Contracting State, and/or its related enterprises, may still carry out activities of a preparatory or auxiliary nature without automatically triggering a PE, provided said activities do not constitute complementary functions that are part of a cohesive business operation, which is still consistent with BEPS.

Further Commentaries clarifying what constitutes a “cohesive business operation” should be included.

C. Splitting-up of contracts.
The Draft proposes two alternative solutions (Alternatives K and L) to deal with the issue related to splitting-up of contracts and the circumvention of the restrictions imposed by Article 5(3). Alternative K comprises dealing with this issue through an “automatic” rule that takes into account any activities performed by associated enterprises without consideration of the nature of these activities, or the circumstances and/or conditions that led to splitting-up them. Alternative L comprises dealing with this issue by merely relying on the general anti-abuse rule (Principal Purpose Test) proposed as part of the work on Action 6.

Alternative K may give rise to situations in which a PE is deemed to exist in undesired circumstances. Such is the case, as mentioned in the Draft, where a foreign resident is sent for a minimal number of days to perform some work at a building, or installation site, where the bulk of the work is provided by a local contractor. Another example is whether for legitimate business, or contractual reasons, a MNE group performs building or installation contract through various subsidiaries in a particular country, being one of them specialized in the analysis of the project, another one in a portion of its execution, a third one in a different part of its execution and so on; none of them lasting more than 12 months in its performance of work.

Although the language being proposed (“For the sole purpose of determining…”) would partially address these circumstances, we consider that it is not comprehensive and there may be situations in which the provision is not applied strictly to the situations intended to be covered.

Bear in mind that some building or installation contracts could be very complex in nature, requiring several dependent, or independent contractors to participate; thus, the “automatic” addition of time may result in undesired circumstances creating a PE to a foreign resident, where the 12 month period is for legitimate business reasons not exceeded.

Bear also in mind that the current rule requires the 12 month period in the performance of a building, or installation contract to be exceeded; thus, an anti-
abuse provision that determines the existence of a PE even though such time threshold has not been met should be an exception where the provision is being abused, and not the general rule.

For all what expressed above, we consider that the “automatic” approach for time addition should be avoided and instead, an anti-abuse rule proposed as part of Action 6 should be relied on.

D. Insurance.

Considering insurance companies could conduct large-scale business in another country without being taxed on the relevant profits, the Focus Group proposes as Alternative M to include a paragraph dealing with this issue that would deem a PE to exist for the insurance company where insurance premiums are collected or where risks are insured through a dependent agent. Another possible approach would be Alternative N which involves merely relying on the changes to Article 5(5) and 5(6) per Alternatives A to D described above.

Although it does make sense from a BEPS perspective to include such specific provision, bear in mind that there could be local law restrictions on the particular countries involved that would restrict foreign insurance companies to collect premiums and insure risks anyway, meaning that the PE concern would not exist in any case. This is why paragraph 39 of the Commentaries to Article 5(6) recognize the following:

“(…) The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.”

In Mexico, for example, a provision like the one proposed on Alternative M would make sense considering the current legal situation. Indeed, today foreign
insurance companies are allowed to insure risks located in the country provided
that the agreement is executed abroad, and, as of April 2015, the same rule will
continue to apply in the same way when the insurance is hired by an individual.
However, it could be the case that local law restrictions of other jurisdictions forbid
foreign insurance companies from insuring risks occurring within such jurisdictions
in which case there would not be a possible PE scenario arising from a collection
of insurance premiums in said jurisdictions’ territories or from insuring risks
occurring within said territories.

In our opinion, it would make more sense to include the proposed wording of
Alternative M within paragraph 39 of the Commentaries to Article 5(6) as an
example for countries wanting to adopt an approach as the one described on
Alternative M rather than including the wording directly on the Model Tax
Convention. Moreover, even if such wording was not included either on the text of
the Model Tax Convention (per proposed on Alternative M) or on the
Commentaries (per our proposal), we are of the opinion that said paragraph 39
already deals with this issue fairly enough and, in any case, it will depend on the
countries negotiating a Tax Convention whether they include or not a particular
provision pertaining to insurance companies.

*   *   *

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf
exclusively as an IFA Branch, and in no case in name or on behalf of Central IFA
or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours
for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano A.C.
19 December 2014

Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

via e-mail: taxtreaties@oecd.org

Dear Ms de Ruiter,

Base Erosion and Profit Shifting (BEPS) Action 7

PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT (PE) STATUS

Informa plc (Informa) welcomes the opportunity to comment on the OECD’s consultation paper on Action Point 7 – Preventing the artificial avoidance of PE Status – issued on 31 October 2014.

Informa previously responded to discussion documents on the challenges of the digital economy (Action Point 1). Background information on the company is included as an appendix to this document.

We are pleased to provide input as follows:

Summary

Informa wishes to comment on two of the four instances covered in the document, being:

- the artificial avoidance of PE status through *commissionaire* arrangements and similar strategies and;
- the artificial avoidance of PE status through the specific activity exemptions.

We recognise that the OECD is seeking to ensure that tax is properly charged on activities that are valuable and integral to an enterprise’s business. This is an entirely legitimate goal. However, Informa is concerned that in both the instances mentioned above, the OECD is seeking to achieve this goal by widening the definition of PE to such an extent that many
situations, that are not considered abusive will be brought into scope. A great number of “new” PE’s will be created, the majority of which will have trivial attributable profits. There is thus a significant danger that a hugely expanded compliance burden will result for both businesses and tax authorities, and the proposed solution may be worse than the current problem. The proposals may even have the effect of deterring businesses from exploring activities in new territories, and causing inward investment opportunities to be lost.

The measures need to be more targeted in nature, either by finding a way to limit the expansion of the PE definition to those situations which should be brought into tax; or, if it is concluded that the PE definition has to be broadened in ways similar to those outlined, then measures to “carve-out” from the extended definition of PE those PE’s which would have trivial, and perhaps zero, profit attribution.

*Artificial avoidance of PE status through commissionaire arrangements and similar strategies*

The proposals to prevent the avoidance of PE status through commissionaire arrangements focus on widening the scope of a “dependent agent” arrangements and narrowing the definition of an independent agent. Four separate proposals for wording are set forward.

Whilst all and any of the proposals may succeed in restricting the use of commissionaire arrangements, all move from defining a PE against an objective and identifiable point in the business process to a more subjective standard.

In our businesses, we will often work with local third parties who, to a greater or lesser extent, assist us in delivering information products and services to our customers. This assistance is generally what we would regard to be in the nature of a service to us, such as identifying suitable locations for an event. We would take the view that such services are routine in nature and are fully remunerated by any payments we make to the local partner.

However, under each of the PE definitions proposed we would likely have to consider whether those services created a PE. We also anticipate that tax authorities would be much more inclined to take the view that such activities create a PE than under the current rules. However, profit attributions to such PE’s would be small, if not negligible. The outcome for both Informa and tax authorities would be increased compliance for little or no difference in tax paid.

In certain circumstances, working with third parties is a way of exploring new markets for us, before we determine whether to invest fully. If such exploration is going to become subject to tax or at least substantial tax administration requirements, we are likely to undertake less of it, particularly in more marginal markets.

Ideally we would like the OECD to consider whether it can more attack more precisely the arrangements it considers abusive. However, if it cannot, any of the proposed solutions should be qualified by a statement that no PE will be created where a third party provides routine services to an enterprise, is remunerated at an arms-length rate and where if any PE was created any profit attribution would be immaterial.
**Artificial avoidance of PE status through the specific activity exemptions**

We would agree that Article 5 (4) is intended to and should only cover preparatory or auxiliary activities. It is our view that it is changes in technology and business models that are driving the pressure on the PE definition in this instance, not artificial structures as such, and we have a number of concerns around the proposed solutions.

The first solution (option E) is attractive in some ways; however, it appears to us that the activities mentioned in Article 4 were activities that were considered to be “preparatory or auxiliary” when the article was originally drafted, and such a statement of “preparatory or auxiliary” activities is useful. Qualifying the list in the way suggested risks losing any clarity around what a “preparatory or auxiliary” activity may be. This is likely to lead to instances of debate around whether a PE exists when the likelihood is that any profit attribution to such a PE would be negligible.

As noted above, our view is that the issues that are arising around the specific activity exemptions are driven by changes in technology and business models. For example, in the past warehousing would be seen as a passive activity, not of itself creating value. However, with the rise of on-line retailing this may no longer be the case. We agree that it should be possible for tax authorities to be able to investigate whether something such as a warehousing activity that appears integral to the supply chain is a driver of value in the enterprise in question. Such investigations should not be prevented by Article 5, paragraph 4. We would propose the amendments to the definitions of activity within paragraph 4 are made where changes in business models suggest a change is needed, as in the case of warehousing, rather than qualifying the entire list.

In general, therefore, we would prefer the approach set out in options F-H. We would however, argue that option H goes too far in broadening the scope of what constitutes a PE. Whilst technology allows far more data to be collected and stored than ever before, it is our position that the mere collection of data does not, of itself, create value.

We can illustrate this from our business. We have a number of products that use publicly available data, some or all of which our customers may already have. However, by applying analysis to the data, presenting it in searchable forms and in a way it can be manipulated by customers we create a valuable product.

It is the work we do to the data, not the data itself which creates value. The mere collection of data itself should not be drawn into the PE net, and for that reason we would strongly argue against option H.
Risk of greater frequency of disputes

We are also concerned that trying to tackle perceived PE recognition problems simply through broadening the scope of the PE definitions will result in a greater number of disputes about which territory some profits should be taxed in. This will lead to more disputes to be resolved through mutual agreement procedures, with consequent additional work for tax authorities and taxpayers.

We trust these comments are helpful.

Yours faithfully,

GLYN FULLELOVE

Group Tax Director, Informa PLC
APPENDIX

Information on Informa plc

Informa plc is a broad based, resilient business to business media group. We operate in three main areas; Global Events, which incorporates a range of face to face media businesses, including exhibitions, conferences and awards; Business Intelligence, which delivers high value proprietary content to a number of industries including healthcare, pharmaceuticals, financial services, maritime, commodities, telecoms and insurance and the legal profession; and Academic Publishing, which produces books and journals for the academic market, including university libraries.

We have over 6,000 employees in over 100 offices in 25 countries; we also run events and sell digital products in many more countries.

We pride ourselves on our digital expertise, which runs across all our businesses. The vast majority of our publishing products have now transitioned to digital platforms and approximately three-quarters of our publishing revenues are from digital product. In the Events business, we have seen social media becoming a powerful marketing tool, and have invested in technology used “within events”.

We see our mission as Bringing Knowledge to Life: Businesses, professionals and academics worldwide turn to Informa for unparalleled knowledge, up-to-the minute information and highly specialist skills and services. Our ability to deliver high quality knowledge and services through multiple media channels, in dynamic and rapidly changing environments, makes our offer unique and extremely valuable to individuals and organisations.
I. Introduction and Summary of Recommendations

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS)\(^1\), which consists of global insurance and reinsurance companies, in response to the public Discussion Draft released on 31 October 2014 by the OECD entitled “BEPS Action 7: Preventing the Artificial Avoidance of PE Status.”

The Discussion Draft proposes options for addressing arrangements entered into by taxpayers that raise OECD concerns about potential artificial avoidance of PE status. Our comments can be summarized as follows:

- The Working Group believes that the operations of the insurance and reinsurance industries are not structured in order to artificially avoid PE status.

- In fact, the Working Group is deeply concerned that the several “options” described in the Discussion Draft that would broaden the definition of a Dependent Agent PE fail to recognize the established business practices of insurance companies and conflict with business structures and practices mandated by insurance regulators. Insurance companies typically rely on agents, brokers and representative offices for a variety of regulatory and business reasons. These commercial arrangements could be threatened by the options presented in the Discussion Draft because the options could, either purposefully or inadvertently, create PEs for insurance companies in cases that are not appropriate and are not driven by BEPS activities.

- The Working Group agrees that any concerns that the OECD may have with respect to insurance and reinsurance would best be addressed as part of the discussions around Actions 4 and 9 of the OECD’s BEPS Action Plan, relating to adjustments to transfer pricing rules or by other "special measures," although the Working Group also asks that any proposed changes in the application of transfer pricing and other rules to insurance be considered only in light of the regulatory and other restrictions to which the insurance industry is uniquely subject and which limit the ability of insurance and reinsurance

\(^1\) The members of the Working Group are AIA Group Limited; American International Group, Inc.; MetLife, Inc.; Prudential Financial Inc.; Prudential plc; Swiss Reinsurance Company Limited, and XL Group plc
companies to engage in activity of a type that would give rise to BEPS concerns.

- The OECD has done considerable work relating to the insurance industry and the appropriate considerations in attributing profits to PEs. Specifically, Part IV (Insurance) of the OECD’s 2010 paper on attribution of profits to PEs provides a thorough discussion of these issues. We believe that the options included in the Discussion Draft would introduce vague and uncertain standards under which PEs may be created for insurance companies, creating a confusing and potentially inconsistent message to insurance companies and tax authorities. In this regard, we believe that such standards should not be created until a clear articulation of any PE concerns in regards to insurance is provided by the delegates. Significantly, as discussed further below, the Discussion Draft’s proposed options for changing the rules relating to PEs will result in a disharmony between the tax definition of a PE and the regulatory rules that apply to cross-border activities in the insurance space. Current rules that govern when an enterprise should be subject to regulation and when an enterprise should be subject to tax work together smoothly, in part because their goals are so similar. The proposals set forth in the Discussion Draft could result in two arms of the same government applying the same basic concepts differently.

- We therefore request that recommendations under Action 7 be accompanied by draft language for the Commentary on the OECD Model Tax Convention that would clarify that the recommended changes to Article 5, which are aimed at BEPS concerns, are not applicable to insurance arrangements that are aligned with regulatory rules and are not tax-motivated.

II. Summary of Action 7 options and implications for insurance businesses

The stated policy problem being addressed by these Discussion Draft options is presented as follows: “[I]n many cases, commissioneer structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place.” This is not the case in the insurance industry, where sales through agents and brokers have always been the market norm for commercial and regulatory reasons.

- Option A would create a PE of a remote seller when (1) an intermediary habitually engages with potential customers in a way that results in the conclusion of contracts that are in the name of, or require performance by, the remote seller, and (2) the intermediary is not independent, i.e., it is not acting in the ordinary course of a business in which it acts on behalf of various persons including non-associates of the remote seller.

- Option B would create a PE when (1) an intermediary negotiates the material elements of contracts that are in the name of, or require performance by, the remote seller and (2) the intermediary is not independent.

- Option C would create a PE when (1) an intermediary habitually engages with specific persons in a way that results in the conclusion of contracts that are “on the account and risk of” the remote seller by virtue of the legal relationship between the intermediary and
the remote seller (e.g., agency, employment, partnership, or trusteeship) and (2) the intermediary is not independent.

- Option D would create a PE when (1) an intermediary negotiates the material elements of contracts that are on the account and risk of the remote seller by virtue of the legal relationship between the intermediary and the remote seller, and (2) the intermediary is not independent.

As explained in further detail below, in many countries, applying any of these four options to insurance operations would create a misalignment with structures established by insurance companies that are required for insurance regulatory purposes. Implementation of any of the four options in the context of the insurance business would also run counter to the policy objectives of the EEA Freedom of Services directives, which were intended to encourage and facilitate the operation of insurance groups across borders throughout the EEA without having to establish a branch or subsidiary in each jurisdiction.

Moreover, implementation of any of these options could dramatically increase compliance burdens for insurance groups, without creating much increased revenue for tax authorities. Groups would be required to file tax returns which in many cases would show little or no taxable income. This is because the PE functions would not be key or value-driving under a KERT analysis (based on Article 7 guidance, detailed in Part IV (Insurance) of the OECD’s 2010 paper on attribution of profits to a PE). This could result in a significant increase in tax administration costs, for what may be very little or no additional tax revenue to the jurisdiction.

It is also important to note that many jurisdictions levy insurance premium taxes (IPT), which are ordinarily levied depending on where the underlying risk is situated and not where the insurer is based. This conforms with longstanding practice to base income taxation on the location of KERT activities. Jurisdictions wishing to tax on a source basis can do so through insurance premium taxation, which is relatively easy to administer. The creation of PEs of nonresident insurers would be duplicative of the imposition of such premium taxes, and would result in effective double taxation in many cases.

### III. Insurance industry practices, regulation, and potential application of the proposed options

#### A. Insurers' Current Business Models Are Largely Dictated by the Regulatory Environment, and Would Be Disrupted by the Discussion Draft's Proposed Changes

Insurers' current business models are a direct result of the applicable regulatory environment. For example, insurers commonly use a local sales representative or broker that acts exclusively or almost exclusively for a foreign insurer, provides information on insurance products to potential customers, and assists them in purchasing insurance via communications with the foreign insurer. These structures are a consequence of the regulatory environment, but would likely create a PE under the options in the Discussion Draft.
Insurers also routinely establish internal claims handling companies that provide claims handling services to group companies. Currently such activities would not create an insurance PE as long as the insurer was the ultimate decision maker in agreeing to pay any claims. The options might also be interpreted to create an insurance PE in this case although there has never been any effort to artificially avoid PE status.

These are common business models in the insurance industry, driven by the regulatory framework of the industry. Importantly, regulators require that staff in a regulated insurance company only provide services to that particular company, and not to other companies that are part of the same group. Regulators require any group services to be provided through a separate service entity, which may have a branch or subsidiary in the country in which a particular licensed insurance affiliate is located. The purpose of this regulation is to protect policyholders of the insurance company from the “contagion risk” that could arise from liability for other activities.

In many jurisdictions it is also required that the insurance contract be written on “local paper” and issued by a local agent. Again, these are regulatory requirements, and structures that comply with them are designed for the protection of policyholders and are not intended as tax planning arrangements in order to achieve local country base erosion.


The options proposed in the Discussion Draft are particularly problematic to insurance companies operating in the European Union because they are inconsistent with the business operating model currently followed by insurers under the EU’s principles of Freedom of Services and Freedom of Establishment.

The principle of Freedom of Services ("FoS") allows, and is intended to encourage, an economic operator in one EU Member State to offer services in another Member State without having to establish a licensed branch or subsidiary in that Member State. A service provider and an insurer in the same controlled group are not ordinarily required to file separate regulatory returns in the host jurisdiction.

Alternatively, the principle of Freedom of Establishment ("FoE") allows a company to carry on economic activity in a stable and continuous way in one or more Member States. Any permanent presence in a Member State is treated the same way as an agency or branch, even if the presence is merely an office managed by the undertaking’s own staff or an independent person. See Title 1, Article 3 of the EC 2nd Non-Life Insurance Directive (1988) as well as relevant case law.

The distinction between a branch established under the FoE and the provision of services under FoS relates to the extent of control, the ability to commit the insurance undertaking and the permanency of the arrangement. See EC(1999)5046 of 2 February 2000. The flexibility afforded
by the FoE / FoS model is vital to ensuring group-wide efficiency of capital (through diversification and aggregation of risk) and enabling insurers to cover global risks for global clients. For these reasons, insurance groups operating in the EU are encouraged to structure their operations in reliance on FoS. The existence of tax rules creating taxable PEs in countries where an insurer is not considered to have an establishment for regulatory purposes would run counter to the regulatory structure in which insurers operate.

Under EU law, an insurer operating under FoS would be viewed as only providing services and thus by definition would not involve a permanent presence from a regulatory standpoint, and under current law the insurer would not have a permanent establishment for tax purposes.

The options proposed in the Discussion Draft would disrupt the FoE/FoS model by creating a taxable permanent establishment even in circumstances where the insurer was merely providing services under the FoS principle with no permanent presence and no filing obligation for regulatory purposes in the country where the policyholder is resident. We note that any OECD proposals that restrict or constrain insurers’ ability to operate under the EU directives could be seen as contrary to EU law.

Finally, as generally noted above, many EU jurisdictions impose insurance premium taxes (IPT). The imposition of IPT in the EU was designed to ensure that appropriate taxes are collected on the income of insurance companies that operate across EU jurisdictions. Thus, the creation of PEs where none had existed before would result in a duplicative tax regime that would serve no purpose but to impose additional compliance burdens on insurance companies.

C. The Options Described in the Discussion Draft are Excessively Vague

In its effort to capture what the OECD perceives as inappropriate avoidance of tax, the Discussion Draft proposes an excessively vague standard which is inconsistent with the OECD's overarching goal of creating an international tax regime which fosters certainty and clarity.

Specifically targeting commissionnaire and similar arrangements, the Discussion Draft states that an enterprise should be considered to have a taxable nexus where the activities that an intermediary exercises in a country are "intended to result in the regular conclusion of contracts to be performed by a foreign enterprise," unless the intermediary is performing these activities in the course of an independent business.

However, finding a PE based on whether local activities are "intended" to result in a contract is overly vague, and the statement that there would be no PE found unless there was a “direct causal connection” does not clarify matters significantly. The fact that a contract could not have been made without the interaction between the intermediary and the local customer does not mean that the interaction caused the contract to be made. There might be numerous instances of identical interactions that did not result in the conclusion of contracts. A test that creates uncertainty is not good policy and is contrary to the purpose of the PE standard, which is to define a minimum level of connection to a country which is required for taxation by that country.
Such uncertainty may not be acceptable under the domestic law of some EU countries, and may be inconsistent with constitutional requirements.

Such uncertainty would ultimately lead to considerable disagreement between a jurisdiction seeking to tax a deemed PE and the residence jurisdiction of the taxpayer, which is likely to consider that no PE exists in the first jurisdiction, and hence it retains full taxing rights. Resolving such disputes is likely to be a lengthy and potentially inconclusive process, and hence likely to generate double taxation.

D. The Potential Impact of Options A Through D Should Be Considered in Light of Option H, which Would Potentially Create a PE Merely for the Collecting of Information

Option H would significantly increase the scope of activities that would create a PE by treating the mere collecting of information for use in the taxpayer’s business as not "preparatory or auxiliary". This proposed change is targeted largely at enterprises with multi-sided business models such as those addressed in the BEPS Action 1 Discussion Draft relating to the digital economy. However, because the collection of risk-related information is so crucial to the insurance business, the combination of Options A through D with Option H would mean that insurers would likely find themselves subject to tax in jurisdictions where there was only the most tenuous connection between the collection of information and the execution of contracts, even where the insurers were in the risk management business and not the information business.

Option H in the section of the Discussion Draft relating to “preparatory or auxiliary” activities would eliminate the explicit rule preventing a nonresident business from having a PE in a country due to its having a fixed place of business there solely for the purpose of collecting information for the business. Yet, in the insurance industry, data collection is a critical element in the derivation of pricing models and risk-based models.

Insurers generally need to collect a wide range of data from around the world in order to effectively underwrite risks. For example, a UK auto insurer may be interested in collecting claims data on a certain make of car in Germany even if the auto insurer is only underwriting UK risks because such data could inform the amount of losses likely for that make of car. This is particularly true for smaller countries where there may not be sufficient data available to provide a statistically significant enough base for underwriting. Similarly, a foreign insurer or reinsurer may send a risk expert to the local jurisdiction where the risks reside to gather information about the risk exposure. For example, an insurer seeking to insure a major factory, oil refinery or pharmaceutical plant may visit that site and assess the level of risk management undertaken by the potential insured. Similarly, a representative of the reinsurer may visit the local insurance company to assess the robustness of its underwriting function. This forms part of the risk assessment, but the visitor is not performing the KERT function locally.

Application of Option H, therefore, could lead to disputes over the tax position of a representative that merely relayed information about the local market back to the head office.
Most importantly, insurance companies do not sell the information to third parties, which appears to be more of the business model being targeted by the Discussion Draft.

If Option E were to be adopted, we believe that the information collection activity of a local representative of a nonresident insurer or reinsurer for use in the nonresident’s insurance business would properly be considered to be activity of a preparatory or auxiliary character. An explicit recognition of this in the Commentary to the Model Tax Convention would help to provide certainty in this regard.

IV. The apparent target of the Discussion Draft is significantly different from cross-border insurance operations

The Discussion Draft states that the OECD’s intent is to target commissionnaire arrangements. However, what the OECD apparently finds objectionable about such arrangements is absent in the two traditional means by which a foreign insurer or reinsurer might assume risk arising in the local country: the use of a local broker or intermediary and a fronting arrangement.

Unlike in the commissionnaire arrangement, an insurance or reinsurance intermediary has no contractual relationship with the local customer. In a fronting transaction (in which the local fronting company is almost always both legally and economically independent from the foreign insurer or reinsurer), the fronting company is "on risk"; by contrast, a commissionnaire bears no risk. A fronting company, being a regulated insurance company, has an obligation to policyholders which it cannot novate. Fronting arrangements are typically used to access markets in which the foreign insurer is not licensed and therefore these arrangements are almost always required for local regulatory or business reasons, and are not motivated by tax avoidance.

It would be inappropriate to cause the foreign insurer or reinsurer in a fronting arrangement to have a local permanent establishment, because to do so would require ignoring the legal form of insurance and reinsurance (which case law in many territories has tested), the separate existence of the fronting company, and the economic relationship between the fronting company and the reinsurer.

Nevertheless, Option C and Option D could arguably result in a permanent establishment in the case of either the use of a broker or a fronting arrangement, merely because there is a "legal relationship" between the foreign insurer or reinsurer, and the local broker or fronting company. Without an explicit carve-out for insurance or reinsurance, this provision has the potential to do great damage to the industry.

It is common for local insurers to use off-shore reinsurers (both related and unrelated) to increase the local insurers’ capacity in the local market to absorb risk. Application of the options in the Discussion Draft could mean that any insurance contract entered into by the local insurer results in the reinsurer assuming a portion of that risk “by virtue of the legal relationship” created by the reinsurance contract. For example, if a large reinsurer provides some cover for the entire global book of business of an insurance group, that global reinsurer could then have a PE in every jurisdiction where the insurance group writes business. The potential application of this rule is particularly pernicious because it is the very breadth of the risks insured that provides proper
diversification that will result in great administrative and tax burdens. Without foreign reinsurance, local markets would see a substantial drop in capacity and a resulting increase in insurance premiums or unavailability of coverage.

V. Proposed changes to the OECD Model Treaty specific to insurance

The Discussion Draft proposes to include language in the OECD Model treaty based on the UN Model paragraph creating a PE for an insurance company that collects premiums in the country or insures risks located there “through a person other than an agent of independent status.” Inclusion of this language does not appear to be justified by BEPS concerns. Among other things, this approach is troubling because it represents, for one industry only, a deviation from “existing international standards on the allocation of taxing rights on cross-border income” between source and residence countries.2

The possibility of using such a paragraph is already mentioned in the Commentary to the OECD Model. Therefore, countries have made a conscious decision not to include the paragraph in most treaties, presumably because they do not believe that there is a problem that needs to be addressed in that way. Furthermore, OECD draft proposals on Article 5 in 2011 included an example of activities of insurance agents which looked at whether activities of local insurance agents who refer contracts for final approval by the foreign insurance company should create a permanent establishment. The recommendation by the Working Party at that time was that the issue is a policy question for Member States to consider when negotiating a treaty. Paragraph 137 of the 2011 report noted “Since few countries included such a special provision in their treaties, it was agreed that no changes should be made to the Commentary with respect to this issue”.

The Discussion Draft suggests that a number of tax treaties already adopt the UN model treaty language but, in fact, there are only a few modern treaties (post 1977) between OECD Member States that include this wording. We must stress the point that the absence of the provision in most modern treaties is quite significant. In the event that such a provision was implemented in treaties between EU Member States, as set out above, this could be viewed as contradictory to EU directives. Furthermore, to the extent that this provision was implemented it would be unlikely to result in any collection of income tax for the reasons set out above and therefore would merely represent an additional compliance burden.

Moreover, as noted above, many countries impose IPT on premiums collected in their country in order to deal with the above point. Creating a PE with income tax liability in addition to the IPT would cause a double tax problem. IPT is also a much more easily administrable method of collecting tax on the same economic activity targeted by this provision.

2 See Action Plan on Base Erosion and Profit Shifting (OECD, 2013) at p. 11: “This Action Plan is focused on addressing BEPS. While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”
Finally, any proposal to change the OECD Model Treaty to create a PE merely for collecting premiums or insuring risks in a country should be considered in light of Part IV of the OECD Report on the Attribution of Profits to Permanent Establishments. A good deal of thinking about the PE implications of the insurance business went into the preparation of Part IV, and the final product is widely regarded by governments and taxpayers as providing a workable framework. The concerns raised with respect to the insurance business in the Discussion Draft may predate Part IV, but Part IV is now a well-established feature of the international taxation of insurance enterprises. Any changes to the definition of a PE in the insurance context should take care not to reach a result inconsistent with Part IV or require revision of Part IV, which would create substantial uncertainty. We therefore suggest that the recommendations under Action 7 be accompanied by draft language for the Commentary on the OECD Model Tax Convention that would clarify that the recommended changes to Article 5, which are aimed at BEPS concerns, are not applicable to insurance arrangements that are aligned with regulatory rules and are not tax-motivated.

VI. Conclusion

For the insurance industry, a more appropriate discussion relating to the nature of the business and where business functions should be taxed must take into account the allocation of risk and capital in the business, and the regulatory environment in which the industry operates. While we do not agree that BEPS concerns arise from the use of agents or brokers, or from the transfer of risk and capital within a multinational insurance group through reinsurance arrangements, we agree with the statement in paragraph 41 of the Discussion Draft that any issues should be addressed under Actions 4 and 9, and insurance operations should not be subject to the various options included in this PE Discussion Draft, for the reasons noted above.
Insurance Europe comments on the OECD’s Discussion Draft: Preventing the Artificial Avoidance of the Permanent Establishment (PE) Status (Action Point 7)

I. Executive Summary

- In the insurance sector in determining attribution of profits to a PE, the key focus is on establishing where the key entrepreneurial risk-taking ("KERT") functions are undertaken. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments\(^1\) Part IV recognises that the KERT is with the person that assumes the risk (underwriting). The KERT as described in Part IV of the 2010 OECD Report has provided a framework that is considered to effectively work for tax authorities and the insurance sector. Therefore, anything that decreases the effectiveness of Part IV should be approach with caution.

- In the insurance section, the definitions of a PE for regulatory and tax purposes are largely aligned and should remain so. Misalignment of PE definitions for tax and regulatory purposes, as under Option M, would generate an additional compliance burden e.g. there might be a need to determine premium investment income separately for regulatory and tax purposes).

- There is no need for a specific provision for the insurance sector (Option M) according to which an insurance company would be deemed to have a permanent establishment in country where premiums are collected by a dependent agent. If this proposal is adopted insurance companies would be faced with disproportionate administrative burden as numerous – possibly hundreds PEs would be created resulting in increased compliance burden in terms of corporate income tax obligations. Furthermore, if the principles within the 2010 OECD Report on the Attribution of Profits to a Permanent Establishment Part IV were followed, then these PEs would have little or no profit attributed to them on the basis

that the KERT function is not being carried out in the PE and the profit would therefore be limited to a
fee for intermediation services. Therefore, the tax generated in the host state would be minimal.

- The OECD proposals on commissionaire arrangements should not be applicable to insurance sector
because the objective of these arrangements and insurance are substantially different. The insurance
agent, unlike a commissionaire, is acting purely as a point of contact for clients seeking to purchase
insurance, including the collection of premiums and therefore even an agent who has the
characteristics of a dependent agent should not create a PE of the insurance enterprise. Insurance
agents are not permitted to accept insurance risk as they are not regulated entities and do not have
the necessary capital that is required by the regulator to accept insurance risk.

- The OECD’s overall approach of lowering the dependent agent threshold below the “concluding
contracts” test is likely to introduce greater subjectivity into the determination of whether a PE exists
in any particular case. This can lead to various interpretations across tax authorities resulting in costly
disputes for business and the possibility of double taxation. Guidance in this area needs to be clear
and tax authorities need to apply the guidance sensibly and consistently.

II. Introduction

Insurance Europe welcomes the opportunity to provide comments to the OECD Discussion Draft on preventing
the artificial avoidance of the PE Status in the context of the BEPS project.

Insurance Europe supports the aim of the OECD BEPS project to address weaknesses in the international tax
environment and recognises the OECD’s concerns that some PE definitions can lead to base erosion. However,
we are concerned that that the OECD proposals might have significant unintended impacts on the insurance
business model. This being said, in our comments we propose workable and proportionate measures which
would enable the OECD to target concerns relating to the PE definition and at the same time avoid unwanted
consequences affecting the insurance business model.

As a general point, we would like to point out that any discussion regarding taxation of the insurance sector
and any perceived avoidance should take into account the assumption of risk and the role of capital. Insurers
exist to take over the risks faced by policyholders and to aggregate them into a risk pool which offers
protection against a potential future negative event. Insurers are rewarded by premiums determined
according to the specific profile of the risks they insure. Each policyholder should pay a fair premium according
to the risk of loss that they bring into the pool. Generally, the relevant “risk assumption” activities will fall
within the category of underwriting activities as these are most important to the decision to accept a particular
insured risk. Therefore, underwriting and the capital that is needed to support the risks assumed is core to the
carrying out of insurance business.

Notwithstanding the above, Insurance Europe believes that there is no need for a specific provision for the
insurance sector (Option M) according to which an insurance company would be deemed to have a permanent
establishment in a country where premiums are collected by a dependent agent. The dependent agent
involved in the collection has no independence in accepting and managing the risk as he is acting purely as an
intermediary between the insured and the insurer.

In addition, Insurance Europe is concerned that even if the insurance specific proposal is not adopted, the
OECD proposals on commissionaire arrangements, specific activity exemptions and fragmentation of activities
might have a significant impact on insurance companies’ business model and their customers.

In this view, in our comments we discuss the following points:

- Insurance Specific Proposal (Option M)
- Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies
- Specific Activity Exemption
- Fragmentation of Activities
III. Insurance Specific Proposal (Option M)

Insurance Europe believes there is no need for an insurance-specific provision as proposed under Option M according to which an insurance company would be deemed to have a permanent establishment in a country where premiums are collected by a dependent agent. Under such provisions, insurance companies would be faced with a disproportionate administrative burden as numerous – possibly hundreds of PEs resulting in increased compliance burden in terms of corporate income tax obligations. Furthermore, such an increased compliance burden would result in nil or minimal profit being attributed to the tax PE which would be limited to a fee for intermediation services.

Assumption of risk is decisive

Carrying out insurance business fundamentally involves the assumption of risk from policyholders in exchange for an insurance premium determined on the basis of that risk. In practice, risk can be underwritten by a headquarter or local entity. Multinational insurance groups will typically have a review process in place for assumption of large risks throughout their business. This often means that after a local insurance entity has decided to underwrite risks, such a decision must be referred to a headquarter for approval. A similar issue arises when it comes to underwriting specialised risks, as an insurance group may concentrate their expertise on certain risks in a small number of locations.

However, in case the local underwriters are sufficiently experienced and knowledgeable as to underwrite the risk themselves, it is understood that decisions regarding the underwriting those risks are made in the local territory.

In the insurance sector in determining attribution of profits to a permanent establishment, the key focus is on establishing where the key entrepreneurial risk-taking (“KERT”) is undertaken. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV recognises that the KERT is with the person that assumes the risk. The KERT approach considered in Part IV of the 2010 OECD Report has provided a framework that is considered to effectively work for tax authorities and the insurance sector. Therefore, anything that decreases the effectiveness of Part IV should be approach with caution.

Role of premium collection

With respect to the role of collection of premiums in attributing profits to the PE, the OECD report states that:

"The collection of premiums does not mean that the depended agent PE is accepting the insured risk, if the decision to accept the risks associated with the insurance policy is made by the dependent agent."

With this point, the OECD recognises that collection of premiums by the dependent agent cannot be regarded as KERT. The dependent agent involved in the collection has no independence in accepting and managing the risk. In this role, the dependent agent is acting purely as a point of contact for clients seeking to purchase insurance, including the collection of premiums. Agents are not permitted to accept insurance risk as they are not regulated entities nor do they hold the necessary capital.

Regulatory definition of the PE

The current definition of the PE for tax is very close to the PE definition for regulatory purposes, thereby ensuring that tax and regulatory reporting requirements can be aligned. The PE definition for tax purposes does not need to follow the PE definition for regulatory purposes, but if aligned complexity and compliance costs would be minimised. For example accounting information reported for regulatory purposes can also be used to determine taxable profits.
Considering that the dependent agent is not carrying KERT function, in consequence any amount attributed under the 2010 OECD Report (as explained under Part IV) to such a local PE related to the collection of premiums would be limited to a fee for intermediation services. In this context, attribution of profits to a local PE beyond arm’s length fee paid to the third party agent would result in a double taxation considering that the income of the insurer is already taxed in its home country. The risk of double taxation could be removed if the home state offers relief, however even if such a relief exists, the procedure is often complex, costly and uncertain. Finally, according to the option M, the insurer would pay taxes even if there would be losses in the PE – country of the agent.

**Tax contribution of the insurance sector at place of risk location**

In the European Union currently 24 member states are applying taxes on insurance premiums payable by insurance companies in the country where risk is located. Those taxes include Insurance Premium Taxes (IPT), stamp duties and a long list of parafiscal charges and levies. It is worth noting that since the beginning of the financial crisis there has been a trend among European governments to increase the level of taxation of taxes on insurance premiums. For instance, since 2008-09, Bulgaria, the Czech Republic and Slovenia have introduced IPTs, and Denmark, Finland, France, Hungary and the Netherlands have increased their IPT tax rates.

This being said, when all these taxes on insurance premiums are taken into account insurers are already paying substantial amount of taxes at place of risk location.

Furthermore, Europe’s insurers experiences with IPT compliance requirements proved that taxation at the place of risk location can be very burdensome. Current place of risk location rules create difficulties for many insurance companies writing cross-border business. Where a double taxation occurs, insurance companies are obligated to pay both taxes until such time (if ever) one member state backs down. The ensuing negotiations with individual tax authorities can often be complex and costly, and may eventually require referral to the European Court of Justice.

By way of example, the Second Non-Life Insurance Directive contains four tests to determine the member state where the risk is situated. Test three includes the wording "where the policy-holder took out the policy", which is interpreted in one of two ways: either as the location of the establishment or where the insured resides.

Another example of discrepancies that may arise from the current interpretation of the location of risk rules on the IPT relates to cross-border ex-pat medical insurance. While certain tax authorities determine location of risk based on where the employer is established (as the entity that procures the insurance on behalf of the employee), others interpret location as where the employee actually works. This can also lead to cases of double taxation.

**IV. Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies**

The OECD proposals on commissionaire arrangements should not be applicable to the insurance sector because the objective of these arrangements and the insurance business model are substantially different. The role of an insurance agent, unlike a commissionaire, primarily consists of providing a point of contact for clients seeking to purchase, including the collection of premiums. In this role, agents are not permitted to accept or manage insurance risk as they are not regulated entities with necessary capital.

The four proposals to replace the wording "concludes contracts" are too broad and should be clarified, otherwise this can lead to various interpretations across tax authorities resulting in costly disputes for business and the possibility of double taxation.

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2 Article 2(d) of the Second Non-Life Insurance Directive (88/357/EEC)
General comments

The Discussion Draft proposes four alternative options (A-D) to amend the dependent agent PE rules (Art 5(5) of the OECD Model) in order to deal with tighten rules on the commissionaire arrangements.

Insurance Europe believes that the OECD proposals on commissionaire arrangements should not be applicable to insurance sector because the objective of these arrangements and insurance are substantially different.

The main differences are the following:

- (The role of the insurance agent) Unlike commissionaire, primarily consists of providing a point of contact for clients seeking to purchase, including the collection of premiums. In this role, agents are not permitted to accept or manage insurance risk as they are not regulated entities with necessary capital which makes them distinguishable from agents in commissionaire type arrangements.

- (No legal contract with the agent) The commissionaire is acting in his own name, but on behalf of and at the risk of the principal. In this respect, the insurance model differs from commissionaire arrangements as the customer/insured has no legal contract with the broker. It is with the insurer.

Having regard to these differences, in our view the insurance business model should not be impacted by provision on the commissionaire arrangements. However, we are concerned that the proposed wording on the commissionaire arrangements goes beyond the "commissionaire model" as all of the proposed options widen the dependent agent threshold by excluding an unconnected 3rd party agent who "act exclusively or almost exclusively...on behalf of associated enterprises". This potentially has wide consequences on creation of a PE for tax purposes, as it can be interpreted that a related party can never be independent if it has little or no third party business of its own.

For example, this might impact a wide range of non-KERT activities performed by an in-house service company, such as back office supplies, claims handling or consultancy services. For example, an employee of one of an in-house service company operating for an insurance company usually has the authority to bind different insurance entities of an insurance group in relation to procurement contracts, such as IT outsourcing. The in-house service company would charge all of their costs on an arm’s length basis to the group’s insurance entities using its services. According to the proposed OECD wording on commissionaire arrangements, in such a case a PE would be created.

Therefore, Insurance Europe believes that the OECD wording on the commissionaire arrangements needs to be more precise and targeted.

Option A

The Option A proposes to replace the wording "concludes contracts" by a test of whether the agent concerned "engages with specific persons in a way that results in the conclusion of contracts". In Insurance Europe’s view, this wording is too broad and should be clarified.

Insurance Europe is concerned that through this extended wording might cover sales and marketing activities. This would result in having separate definition of A PE for regulatory and tax purposes. As indicated above having a substantial number of PEs, without there being a corresponding regulatory PE would generate an additional compliance burden and potential double taxation due to different tax authorities having different interpretations what constitutes a PE. Clear guidance is therefore essential.

Option B

This version limits the definition of the PE to "negotiating the material elements of contracts". In the context of insurance, the benefit of this wording is that a PE would be created in the host country only if all material
elements were negotiated in this country. This being said, in the insurance context activities such as sales, marketing or initial research should not create a PE.

However, the wording “negotiating the material elements of contracts” need to be clarified in guidance including the statement, that ALL material elements and details of a contract must be negotiated by the intermediary, in a way binding on the enterprise. Furthermore, there should also be a link to key activities as set out in Part IV of the OECD, otherwise there is risk that different tax authorities might have different interpretation of what constitutes a PE.

**Option C & D**

These options propose to replace the wording “concludes contracts” to “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”.

The discussion draft explains that the intention behind the proposed wording is to cover “commissionaire selling arrangements”. However, Insurance Europe is concerned that this proposal might also catch commercial insurance transaction, such as quota shares reinsurance\(^3\). It is not uncommon for insurance companies to use quota-share reinsurance in order to reduce exposure on a particular risk or to reduce premium volume and total liabilities to levels appropriate to capital accounts.

Furthermore, similarly to our comments on Option A and B Insurance Europe believes that there is a need to clarify the wording. In this case, clear guidance on the meaning of “on the account and risk of” should be provided.

**V. Specific Activity Exemptions**

The option H, which removes the “collecting of information” from the list of specific activity exemption, should not impact business collecting information for preparatory and auxiliary purposes.

With regard to the specific activity exemptions, Insurance Europe believes that options E, F and G should not have a material impact on the insurance business model considering that the preparatory and services are covered by the exemption.

However, we are concerned that option H removes the “collecting of information” which might have unintended consequences for the insurance sector. In particular, we believe that the collection of information has to be regarded in principle as a preparatory or auxiliary activity and therefore this criterion would be generally not appropriate to justify the creation of a PE. Moreover, even if this activity would create a PE, the income which would need to be allocated based on functions and risks would not be material. Thus, the administrative burden for the company would not justify the additional taxable result.

Therefore, the collection of information should not be deleted from the list of exceptions. As a minimum requirement the exemption should be better targeted, for example by recognising that collection of information by businesses whose primary activity is not data collection (e.g. insurance) should always be regarded as preparatory and auxiliary.

**VI. Fragmentation of activities**

Insurance Europe supports option I on the basis that it excludes preparatory and auxiliary activities from the PE definition. However, in order to ensure this option is applied consistently across all jurisdictions, it is necessary to provide clear commentary and guidance on the meaning of “constitute complementary functions” and “cohesive business operation”.

\(^3\) Under a quota share reinsurance, a fixed percentage of the insurance policies written by the insurer is automatically ceded to the reinsurer.
VII. Splitting of Contracts

Insurance Europe believes that a company should be free in determining its business and project structures. The current OECD draft would shift the burden of proof to the taxpayer to demonstrate that project structures are not tax driven. To ensure a central oversight and tax compliant management companies would have to implement an additional system for monitoring such agreements causing unnecessary additional administrative burdens. Furthermore, it is currently unclear how the tax authorities should test whether a fragmentation has been done by the taxpayer not driven by business reasons.

Overall, the proposals concerning the “splitting of contracts” seem to us not sufficiently balanced and might lead to an increase in legal uncertainty. Therefore, in case the OECD would persist on their position, as a minimum requirement sufficient guidance on the documentation requirements should be given.

VIII. Profit attribution to PEs and interaction with actions points on transfer pricing

The issue of profit distribution to PEs in the insurance sector was considered in detail in Part IV of the OECD Report. The development of Part IV involved a significant amount of work and it is considered to effectively work by both tax authorities and taxpayers. Therefore, anything that lessens the effectiveness of Part IV should be approach with caution.

For further information and/or clarification please contact:

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Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe’s economic growth and development. European insurers generate premium income of more than €1 100bn, employ almost one million people and invest over €8 500bn in the economy.
To: Marlies de Ruiter,
Head, Tax Treaties,
Transfer Pricing and Financial Transactions Division
OECD/CTPA

(sent via email to taxtreaties@oecd.org)

18 December 2014

Dear Marlies,

**BEPS Action 7: Prevent the Artificial Avoidance of PE status**

IHG welcomes the opportunity to submit comments on the OECD Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE status (‘The Discussion Draft’).

IHG is supportive of the BEPS Action Plan in general and of the specific Action 7 objectives of preventing the artificial avoidance of PE status. As noted below we are in particular supportive of the need to amend the specific activity exemptions so that they are all subject to the overriding condition of being preparatory and auxiliary in the context of the particular business model concerned. To our mind that is merely reinstating previous expectations by recognising that implicit assumptions concerning business practicalities, which underlay the current Article 5 (4) wording, no longer hold as a result of technological change.

We are however concerned that the broader proposals set out in The Discussion Draft would result in a very significant expansion in the number of PEs which need to be recognised, with the major proportion of these new PEs having little or no taxable profits properly allocable to them. That would be highly undesirable from a Taxpayer and Tax Authority perspective, and also from a broader economic perspective, as it would produce a significant layer of redundant cost in the form of complex and costly allocation and compliance requirements which result in little or no tax. There would also be a significant increase in uncertainty and dispute concerning where taxing rights lay.

We strongly urge the OECD to consider whether more proportionate and better targeted measures may be available to address BEPS concerns in this area. We believe that particular consideration needs to be given to whether or where BEPS outcomes arise as a result of the lack of any taxable presence at all in a jurisdiction, and where the BEPS outcomes may best be seen as resulting from an inability or failure to allocate an appropriate level of taxable profits to taxable presences which are recognised (whether in the form of PEs or local subsidiaries). Only where the root cause of the BEPS problem is indeed the lack of any taxable presence should a PE solution be considered.
About IHG

IHG (InterContinental Hotels Group) [LON: IHG, NYSE: IHG (ADRs)] is a global organisation with a broad portfolio of nine hotel brands, including InterContinental® Hotels & Resorts, Hotel Indigo®, Crowne Plaza® Hotels & Resorts, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites®, Candlewood Suites®, EVEN™ Hotels and HUALUXE® Hotels and Resorts.

IHG manages IHG® Rewards Club, the world’s first and largest hotel loyalty programme with over 82 million members worldwide. The programme was re-launched in July 2013, offering enhanced benefits for members including free internet across all hotels, globally.

IHG franchises, leases, manages or owns over 4,700 hotels and 697,000 guest rooms in nearly 100 countries, with almost 1,200 hotels in its development pipeline. InterContinental Hotels Group PLC is the Group’s holding company and is incorporated in Great Britain and registered in England and Wales.

Our Comments on the Proposals

Our summary comments are set out in the introductory section above. We expand on these below, although, recognising the volume of comment which will be received by the OECD, we have kept these comments as concise as possible. We have also presented the comments in the sequence which we feel is most logical and constructive in the context of the analysis, rather than following the precise sequence in The Discussion Draft.

Our key comments are that:

1. The impact of the proposals would be to create a very substantial increase in the number of PEs which need to be recognised.

2. This is undesirable from both a Taxpayer and Tax Authority perspective where a PE is created but little or no profits are properly attributable to it. All that results is a significant increase in complex allocation and compliance requirements (including new Country by Country Reporting requirements) and not any material change in tax payable. Unless the proposals are significantly narrowed and targeted we believe that there will be a very significant majority of new PEs where this would be the case.

3. Such extensive changes also significantly increase the risk and likelihood of double taxation. Whereas the focus of the BEPS review is double non taxation it does still need to be borne in mind that double taxation remains a significant problem—and one which is increasing as source and residence jurisdictions compete for taxing rights.

4. It is therefore essential to narrow the proposals so that they are better targeted on BEPS risks. For that purpose it is important to consider whether or where the perceived BEPS problem results from the absence of any local taxable presence (whether via a PE or a group subsidiary) and whether or where it results from a failure or inability to properly allocate the right amount of profits to an already recognised taxable presence. A solution creating new PEs should not be used where the underlying problem is one of profit attribution rather than of there being no taxable presence.

5. We highlight (and agree with) the comment in paragraph 3 (page 10) of the main body of The Discussion Draft that ‘these actions [i.e. the BEPS actions] are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.’ In our view Action 7, unless better targeted, will go beyond this remit and will change previously agreed allocations rather than reinstating them.
6. Better targeting requires careful consideration of the impact and effect of properly applied profit allocation rules (both those for allocating profits to PEs and broader transfer pricing provisions relevant to local subsidiaries). It is not clear to us that, for a substantial proportion of the perceived problems, it is necessary to create a substantial raft of new PEs, rather than just clarify and properly apply existing transfer pricing rules and principles. For example, in practice, do existing functional analyses properly consider whether functions are core or peripheral functions in the context of the global business model concerned and, for core functions, properly consider pricing aspects associated with the lack of short term market alternatives for those core functions?

7. As indicated, we do recognise and accept that change is needed to make the listed exceptions for preparatory and auxiliary activities all subject to the condition of the activities concerned being preparatory and auxiliary in the context of the particular global business model concerned. What that means needs to be clearly explained in guidance but to our mind it is a question of whether or not the activity concerned is a core function which plays an integral role in generating profits from the jurisdiction (and a significant comparative role in relation to the scale of other functions or activities necessary to generate such profits) or whether it is a peripheral activity which could, for example, be relatively easily outsourced without significant risk to the global business model, and is, in any case, an incidental local activity in connection with the primary value creating activities carried on outside the jurisdiction.

8. Such a change to the Article 5 (4) exceptions would of course increase uncertainty for some functions and business models and would thus have to be accompanied by both clear guidance and good mutual agreement and arbitration processes.

9. As previously indicated, we recognise that such a change is necessary to address unforeseen changes in the impact of the preparatory and auxiliary exclusions resulting from technological change. The change can thus be justified as resetting the PE (and taxing right) lines to where they were expected to sit, and where they should sit, if taxing rights are to be allocated in accordance with value creation. We believe however that the changes suggested to address concerns in relation to commissioner structures would not have a similar targeted effect but would be likely to apply more broadly and inappropriately.

10. Our particular concern is that the changes are expressed as applying broadly to both goods and services and without any express consideration of how significant the local activity is, in the context of the particular business concerned, in driving profits relative to other current or future activities required to generate those profits (and carried on outside the jurisdiction). When this is taken together with the very broad wording suggested to be used such as ‘engages with specific persons in a way which results in the conclusion of contracts’ or ‘by virtue of the legal relationship between that person and the enterprise’ we believe that the scope will extend well beyond the intended targets.

11. Indeed on a literal interpretation the changes proposed would seem to risk creating a PE of a subsidiary entity in the jurisdiction of a parent (or global function) even where the subsidiary had no sales or other activity in the parent or global function jurisdiction at all. Parent companies, or functions with a regional or global remit, will frequently enter into discussions with similar functions in a counterparty group, with a view to entering into broad multi-jurisdictional trading relationships or other transactions with the counterparty group. Any such umbrella discussions or agreements then need to be translated into actions and agreements to be considered and, if approved, implemented by entities who carry out the relevant jurisdictional business. As currently worded, if the parent or global function [‘the person’ in the context of Option A] was based in jurisdiction A and there was a translated subsidiary action which involved a subsidiary in country B [the ‘enterprise’ in the context of Option A] making either domestic sales in country B or sales to a third country C, that would seem to result in a PE of the subsidiary in Country A. The same would seem to be the case under the other
options.

12. We assume that this is unintended but it illustrates the fact that an attempt to deem nexus by reference to the type of language proposed is likely to draw in much more than is intended. The distinctions between BEPS arrangements and genuine commercial ones are not just (or primarily) to do with form but are to do with the misalignment of substance with form. In our view such misalignments are generally more susceptible to being addressed in an appropriately targeted fashion by transfer pricing or similar measures.

13. To consider a different type of example, if the contracts concerned are long term contracts for the delivery of services (where those services will be delivered from outside the jurisdiction) then, whereas finding contractual opportunities may be valuable, it is not what predominantly drives profit or loss (that is the performance of services under those contracts). A local activity of finding such opportunities should thus be remunerated, but should not create a PE for the enterprise which actually delivers services under that long term contract. If any profit were allocated to such a newly deemed PE, then that would result in a misallocation of taxing rights to the source country and away from the jurisdiction which actually generates the profits when considered in value creation terms.

14. We recognise that the converse may sometimes be true for short term contracts in other business models (e.g. that securing customers for some online services may be very significant in terms of driving profits compared to relatively routine service delivery requirements). It seems to us that the problem here (if there is one) is however one of profit attribution to the taxable presence already recognised in the jurisdiction (e.g. the commissionaire or similar subsidiary) rather than the need for an additional taxable presence.

15. It may be that the intention of The Discussion Draft is to provide a prospect of excluding circumstances where a PE would be created but no material profit would be attributable to it, by using the ability to rely on Article 5(4)(e) if the activities concerned would be preparatory and auxiliary. If that is the case then substantive expanded commentary and mutual agreement procedures will be required- as that would probably involve stretching the existing interpretation of Article 5(4)(e) so as to limit the extended scope of paragraph 5. We believe that that would inevitably lead to substantial uncertainty and dispute.

16. We also question whether problems arising from fragmentation (i.e. as proposed to be addressed by Options I and J) are most appropriately addressed by significantly extending the scope to recognise PEs rather than by considering issues of profit attribution to existing presences, and perhaps some minimum standards of targeted anti-abuse provisions.

17. We think it is important to recognise that fragmentation of functions between different legal entities and locations is a normal aspect of modern commercial operations and not something which, taken in isolation, is indicative of abuse. It is also quite normal and desirable (from both a Taxpayer and Tax Authority perspective) to try and isolate activities giving rise to a taxable presence in a given jurisdiction, and isolate associated profits, in one entity, and separate them from activities carried on outside the jurisdiction. Otherwise multiple registration requirements, and complex allocation requirements, arise- as do inter-jurisdictional disputes concerning taxing rights. Provided that profits aren’t thereby misallocated there is nothing objectionable in that.

18. We also think it is important that it should remain the case that the separate legal status of different entities is only over-ridden and ignored in truly exceptional circumstances. Otherwise the door is open for a free-for-all where multiple jurisdictions compete to tax the same profits. The anti-fragmentation proposals (and in many respects the anti-commissionaire proposals) risk significantly weakening the protections against that type of international free-for-all.

19. The concept of ‘complementary functions that are part of a cohesive business operation’ is likely to be interpreted in very different ways in different circumstances and jurisdictions giving
rise to significant uncertainty and dispute. For example some jurisdictions may take the view that any activities which are carried on by a multinational would fit within this definition simply by virtue of being carried on by that multinational—even if being genuinely distinct operationally. There is also nothing in this proposal which would limit or prevent multiple PEs being held to exist even where no or negligible profit would be allocated to that PE.

20. The fragmentation option which requires consideration of whether activities are preparatory or auxiliary at least has the virtue of paying some recognition to these issues of significance. It does it however in a way which considers the combined significance rather than the incremental significance of what is not already recognised [e.g. if the relevant associated enterprise is an existing tax paying subsidiary in the jurisdiction]. Similar issues of uncertain interpretation of ‘preparatory and auxiliary’—and perhaps needs for extended interpretation in context—to those discussed in relation to commissioner or similar local intermediary structures also arise. We therefore consider this to be a disproportionate approach which will result in large levels of redundant costs of dealing with uncertainty, compliance and dispute. And

21. We recognise that each of the fragmentation options I and J also require that that there is a fixed place of business, and that that may place some limitations on the extension. We note however that each encompass circumstances where two distinct places of business can be viewed together— with option J not even requiring that there be any criteria for viewing those places together other than the existence of associated enterprises.

We have not commented on other matters addressed in the discussion document, which are niche ones such as construction and insurance which are of less relevance to our primary hotel franchise and management business.

We hope that these comments are of constructive assistance to the OECD’s considerations.

Yours faithfully,

C.P. Garwood
Head of Tax
January 9, 2015

Ms. Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy & Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75016 Paris
France
taxtreaties@oecd.org

Re: Comments on Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. de Ruiter:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, entertainment, software, IT systems, publishing, and electronics. The group’s purpose is to promote the development and application of international tax rules and policies based on

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1 The current membership of the IAPT is made up of the following companies: Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; A.P. Møller-Mærsk A/S; AstraZeneca plc; Baker Hughes, Inc.; Barrick Gold Corporation; BP plc; Chevron Corporation; Cisco Systems, Inc.; ExxonMobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Microsoft Corporation; Procter & Gamble Co.; Reed Elsevier plc; Repsol S.A.; Sony Corporation; Texas Instruments, Inc.; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD with respect to its Discussion Draft on Preventing the Artificial Avoidance of PE Status (Discussion Draft) released on October 31, 2014. Our comments are set forth in Annex 1 to this letter.

As you know, the IAPT submitted comments on Action 7 of the July 2013 BEPS Action Plan on October 16, 2013, and we include copies of those comments as Annex 2 to this letter for reference.

As outlined in our attached comments, we believe that any potential changes to the PE definition should take into account: (i) whether the definition provides adequate certainty as to whether a PE exists; (ii) whether it strikes an appropriate balance between a host State’s taxing rights and the need for taxpayers and tax administrations to avoid incurring administrative costs that are disproportionate to the amount of profit or tax at issue; and (iii) the enforceability and practicality of the PE threshold and the related profit attribution. Unfortunately, we find that many of the Options put forward in the Discussion Draft fare poorly against these evaluation factors and that they are likely to introduce untested and ill-conceived standards which will lead to considerable disputes, not only on the question of whether a PE exists on certain facts but also on the question of what profits, if any, are attributable to that PE. We have made every effort to provide constructive suggestions on how we believe the Discussion Draft can best be improved and to set forth the rationale for our suggestions.

Once again, the Alliance appreciates the opportunity to comment on this important element of the BEPS project and stands ready to respond to any questions or to provide further input as the work of the OECD on this item continues. As previously indicated by e-mail, I would appreciate the opportunity to speak on behalf of the IAPT on this topic at the public consultation to be held on January 21, 2015.

Sincerely yours on behalf of the Alliance,

Mary C. Bennett
Baker & McKenzie LLP
Counsel to the Alliance

Annex 1: Comments on the October 31, 2014 Discussion Draft
Annex 2: October 16, 2013 comments on Action Item 7 of the July 2013 BEPS Action Plan
ANNEX 1

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON OCTOBER 31, 2014 DISCUSSION DRAFT ON BEPS ACTION 7,
PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

JANUARY 9, 2015
IAPT Comments on the October 31, 2014 Discussion Draft on BEPS Action 7, Preventing the Artificial Avoidance of PE Status

1. Executive Summary

Introductory Comments

1. Potential changes to the permanent establishment (PE) concept need to be evaluated in light of the critical role the concept plays in treaties, the policy considerations that are relevant to the PE definition’s design, the specific focus of Action 7, and the close relationship between the principles for attributing profits to PEs under Article 7 and the definition of PEs under Article 5.

2. The PE definition affects the application of not only Articles 5 and 7 of the OECD Model, but also numerous other Articles throughout the Model (including Articles 10, 11, 12, 13, 15, 22, 23, and 24), and as such it is important to both Contracting States, the enterprise itself, and the enterprise’s investors, creditors, and employees.

3. Among the policy considerations that should be taken into account in evaluating PE definitional changes are:
   - Whether the definition provides adequate certainty as to whether a PE exists;
   - Whether it strikes an appropriate balance between a host State’s taxing rights and the need for taxpayers and tax administrations to avoid incurring administrative costs that are disproportionate to the amount of profit or tax at issue; and
   - The enforceability and practicality of the PE threshold and the related profit attribution.

4. The Action 7 focus is squarely on addressing “artificial” avoidance of PE status, and it explicitly rejects having as its purpose changing the international standards on the allocation of taxing rights over cross-border income. We question the appropriateness of proposing changes under Action 7 that go beyond addressing artificial avoidance cases, that would shift taxing jurisdiction across the board in response to concerns which have been raised only in relation to the digital economy, and which do not result in “reasonable, administrable” rules for applying a new PE definition.

5. In evaluating the appropriateness of a proposed change to the PE definition, one should ask: (i) have the profit attribution consequences of that particular change been considered?; (ii) are the profit attribution consequences sufficiently clear, and is there a sufficiently reliable consensus among governments as to those consequences, that introduction of the change will not lead to a substantial increase in disputes?; and (iii) is the potential profit to be attributed to the PE (in addition to any profit already being taxed by the PE State) material enough to justify the added compliance burden of the new form of PE for taxpayers and governments?
6. Our analysis of many of the Options put forward in the Discussion Draft leads us to conclude that they fare poorly against the above evaluation factors and that they are likely to introduce untested and ill-conceived standards which will lead to considerable disputes, not only on the question of whether a PE exists on certain facts but also on the question of what profits, if any, are attributable to that PE. These Action 7 proposals, standing alone, are evidence enough that the OECD will have to make major, rapid and concrete advances in improving international dispute resolution if the BEPS Project is to avoid having as its outcome a crippling proliferation of hard to resolve disputes, widespread risks of double taxation, and a substantial adverse impact on international trade and investment. Having seen the December 2014 Discussion Draft on BEPS Action 14 (Improving Dispute Resolution), we are very concerned that the needed improvements will not materialize, which is all the more reason the OECD should approach Action 7 with a sharp focus on providing clear, administrable, consensus guidance on the issues of the PE definition and related profit attribution.

Comments regarding Options affecting Article 5(5) and 5(6)

7. Each of Options A through D proposes a change to the wording of Article 5(5) regarding so-called dependent agent PEs. The proposed new wording in each of them introduces unfamiliar and vague new concepts. They each appear to cover situations that go well beyond circumstances involving artificial avoidance of the existing PE definition. Depending on how they are interpreted, they could result in the creation of PEs in many situations involving buy-sell distributors or even pure marketing activities. They appear to represent a significant shift in the boundary between source and residence State taxation, and their vagueness presents substantial risk for the creation of disputes. We note in particular there needs to be a clear confirmation that foreign enterprises can sell into a country by using a local distributor without creating a PE, and a clear understanding of the circumstances in which that is possible. Without that clarity, there is liable to be tremendous disruption to normal commercial arrangements across the globe.

8. If notwithstanding their serious flaws the OECD felt compelled to adopt one of these options, we believe that Option B may be marginally the least damaging, as it at least seems to focus on the familiar agent activity of negotiating contracts and its description of the contracts at issue seems arguably more tied to the contracts concluded by commissionnaires than the description found in Options C and D. Nevertheless, as indicated above, we believe Option B is fundamentally flawed due to its vagueness and potential over breadth.

9. On the other hand, we believe that a better approach altogether, and one that would respond to the governmental concern about the use of commissionnaires while at the same time providing necessary clarity for taxpayers and tax authorities, would be to draft an amendment to Article 5(5) that would specifically identify commissionnaires, by reference to the relevant statutory provision governing them, as creating PEs for their foreign principals.

10. The proposed change to the independence standard in Article 5(6) is wholly unwarranted by the scenario cited as its justification and is unwise, given the extent to which it could result in the widespread
proliferation of potential PEs around the world for groups dealing on a wholly commercial basis with agents acting on their behalf.

Comments regarding Options affecting specific activity exceptions under Article 5(4)

11. Having exceptions for preparatory and auxiliary activities is a sensible mechanism to avoid triggering compliance obligations and revenue disputes with respect to operations that are necessary to conduct business but do not typically reflect value drivers attracting material returns. Businesses across all sectors have relied on Article 5(4) exceptions for decades, and the availability of those exceptions will continue to be important to them.

12. We recommend against pursuing Option E (subjecting all activities to the “preparatory or auxiliary” exception) because: (i) it would risk too much uncertainty about many routine business activities due to the fundamental ambiguity about what it means for an activity to be “preparatory or auxiliary”; (ii) no identifiable concerns have been cited for subjecting most of the listed activities to that condition; and (iii) it would put great pressure on determining whether the activities are conducted at a fixed place of business of the foreign enterprise.

13. We also recommend against the Option F proposal to delete “delivery” from Article 5(4)(a) and (b) because: (i) deleting “delivery” could eviscerate the exception for “storage”; (ii) no clear standard exists for determining whether delivery is “preparatory or auxiliary”; (iii) deletion of the exception for delivery is likely to affect business sectors far beyond digital economy (the cited justification); (iv) serious questions exist about how to attribute profit to a “delivery” PE and whether attributable profit would be enough to justify the change; and (v) deleting the delivery exception would put great pressure on determining whether the use of facilities or maintenance of a stock of goods for delivery is taking place at a fixed place of business of the foreign enterprise.

14. We also recommend against the Option G proposal to delete the “purchasing” exception because: (i) the examples cited in support of Option G do not justify the change; (ii) the deletion of Article 7(5) cannot logically serve as justification for Option G; (iii) deletion of the purchasing exception is likely to impact business sectors far beyond the digital economy (the cited justification); (iv) and deletion of purchasing exception is likely to harm the host State economically. If the OECD does pursue the deletion of the purchasing exception, they should do so only in conjunction with clear guidance on when purchasing is a “core” business activity (as opposed to preparatory or auxiliary), when premises owned by a separate enterprise that may perform some purchasing functions for the foreign enterprise constitute a fixed place of business of the foreign enterprise, and how profits should be attributed to the resulting PE, particularly in cases where a local enterprise has already been compensated at arm’s length for carrying out purchasing activities on behalf of the foreign enterprise.

15. In addition to the reasons cited above for our reservations about Options E-G, we have similar strong reservations about Option H’s proposal to delete the exception for collecting information for the enterprise, because there is no need to delete the exception for collecting information to address the
concern cited, and any concerns about collecting information for repackaging and sale to other enterprises could be addressed by a much more targeted change.

16. Regarding the anti-fragmentation rules of Options I and J, we find that the standard for triggering aggregation is very unclear, it could result in PE status arising in surprising circumstances, and it presents serious compliance challenges and serious issues about profit attribution. In light of the fundamental anti-aggregation principle that the OECD has promoted to date in its approach to defining a PE, we believe any change in this area should be considered very carefully and should be very properly targeted to likely cases of concern.

Comments regarding Options to address the splitting up of contracts

17. While we also have strong reservations about the proposals under Options K and L for addressing the splitting up of contracts, if forced to choose, we would recommend the objective trigger of Option K rather than the subjective trigger of Option L, provided, however, that Option K is amended to incorporate specific safety valve provisions (including both a minimum presence threshold and a purpose test) and that the treaty text itself guarantees that the aggregation is allowed solely for purposes of applying the treaty time threshold and not for purposes of profit attribution.

Comments regarding the attribution of profits to PEs

18. Given how important the factor of the extent of potential profit attribution to a particular type of PE should be in determining whether that type of PE should be included in a treaty, we find the Discussion Draft defective in not including a serious discussion of the PE profit attribution implications of the potential PEs created under the various options presented, particularly those that involve little or nothing in the way of functions, assets, or risks of the foreign enterprise allocable to the host State beyond those already compensated as a result of the use of agents or other parties in that State.

19. We are struck by indicators throughout the Discussion Draft that suggest countries believe there is a “pot of gold” to be obtained in making many of the proposed changes to the PE definition discussed in the document. We think any serious analysis of how the Authorised OECD Approach (AOA) applies to the proposed new forms of PE would lead to exactly the opposite conclusion.

20. Our experience has been that some governments who are already asserting the existence of PEs in circumstances covered by some of the proposals outlined in the Discussion Draft have had a tendency to attribute far more profit to the alleged PE than is justified under a proper allocation of the AOA.

21. We perceive a substantial risk that a failure on the part of the OECD to analyze seriously the specific profit attribution implications of each of the various options for amending the PE definition will inevitably lead to unrealistic expectations on the part of a number of governments as to the revenue to be potentially derived from those changes. That will in turn lead to ill-considered decisions about whether to make those changes and ultimately to a long period of costly disputes.
2. Introduction

22. Tax treaties have played a critical role in eliminating barriers to cross-border trade and investment over a number of decades, thereby contributing to economic growth, productivity, jobs, and prosperity in jurisdictions across the world. The PE concept in tax treaties is central to their operation, and its importance and function should be a guide to any effort to examine critically the appropriate features of the PE definition under Article 5 of the OECD Model.

23. As an introduction to our remarks about the specific options described in the Discussion Draft, we would like to put forward a framework for evaluating those options. In order to do so, we believe it is necessary: first, to recall the important role the PE definition plays in the OECD Model; second, to articulate the policy considerations that should inform any decisions about the design of the PE definition; third, to recall the specific focus of Action 7 of the Action Plan; and finally, to highlight the close relationship between the principles for attributing profits to PEs under Article 7 of the Model and the definition of the PE itself under Article 5.

24. Our analysis of many of the Options put forward in the Discussion Draft leads us to conclude that they are likely to introduce untested and ill-conceived standards which will lead to considerable disputes, not only on the question of whether a PE exists on certain facts but also on the question of what profits, if any, are attributable to that PE. These Action 7 proposals, standing alone, are evidence enough that the OECD will have to make major, rapid and concrete advances in improving international dispute resolution if the BEPS Project is to avoid having as its outcome a crippling proliferation of hard to resolve disputes, widespread risks of double taxation, and a substantial adverse impact on international trade and investment.

2.1 Role of the PE definition

25. The primary role of the PE definition is that it establishes the threshold for a source State’s entitlement to tax the business profits of a foreign enterprise under Article 7 of the Model, and by doing so it triggers an obligation on the part of the enterprise’s residence State to provide relief from double taxation under Article 23 of the Model. It also plays a critical role in determining the extent of the source State’s taxing rights (and the residence State’s double taxation relief obligations) with respect to business profits, since Article 7 authorizes the source State to tax only those business profits that are attributable to the PE. Similarly, it is critical to the determination of the boundary line between a source State’s ability to impose either net or gross basis taxation on certain categories of a foreign enterprise’s business profits, such as dividends under Article 10(4), interest under Article 11(4), and royalties under certain treaties.

26. The PE definition plays an important role in the application of other parts of the Model as well. For example, it can affect whether one Contracting State is entitled to tax dividends paid by a corporation resident in the other Contracting State under Article 10(5) of the Model, since that taxation is authorized insofar as the holding in respect of which the dividends are paid is effectively connected with a PE situated in the taxing State. This is obviously relevant to the dividend-paying foreign company, which
may have resulting withholding obligations, as well as to its shareholder receiving the dividends, and their respective tax authorities.

27. The PE definition can determine whether interest paid by a foreign enterprise may be considered to arise in a Contracting State, and thus whether it may be subjected to tax by that State pursuant to Article 11(5) of the Model, as well as the rate at which that tax may be imposed. This, too, has relevance to the interest-paying foreign enterprise, the interest recipient, and their respective tax authorities. The PE function may play a similar role with respect to royalties in treaties that, unlike the Model, authorize a source State to impose a positive withholding tax on royalties arising in that State.

28. The PE definition can also affect whether a Contracting State has taxing rights over a foreign enterprise’s gain from the disposition of movable property under Article 13(2), since that provision applies to an alienation of movable property forming part of the business property of a PE (including an alienation of the PE itself). Article 22 uses a similar standard for determining a State’s rights to impose a capital tax on the movable property of an enterprise of the other Contracting State.

29. The PE definition plays a hugely important role in determining whether a host State may tax an individual employee resident in the other Contracting State on his employment income, since Article 15(2)(c) effectively provides that such a taxing right exists with respect to remuneration borne by a PE which the employer has in the host State. This provision obviously has serious implications for both the employer and the employee.

30. Whether a PE exists can also affect whether a Contracting State has certain nondiscrimination obligations vis-à-vis its taxation of an enterprise of the other Contracting State under Article 24(3).

2.2 Policy considerations regarding PE definition

31. Bearing in mind the important function of the PE definition in treaties, it is also important to examine the policy considerations underlying the PE definition in deciding on any changes to the definition.

32. Of tremendous significance is the ability of the PE definition to provide certainty, to taxpayers and tax authorities (from both Contracting States) alike, about the circumstances in which the PE threshold has been crossed. The functions outlined above amply demonstrate that the PE definition has potentially serious consequences affecting the tax obligations of a foreign enterprise, its lenders, investors, and employees, and affecting the taxing rights and obligations of the PE State and the other States involved. A lack of certainty about when the threshold has been met can lead to costly and difficult to resolve disputes between taxpayers and tax authorities, and among tax authorities themselves, with the ever present risk of double taxation when such disputes cannot be resolved. It can lead to inconsistent treatment of taxpayers, which undermines respect for the tax system. It can render the burden of complying (and verifying compliance) with the tax law much more difficult and expensive, as taxpayers and tax authorities must track and analyze a much more varied and nuanced array of facts in trying to
determine whether the threshold has been met. It can act as a real barrier to cross-border trade and investment.

33. A lack of certainty about the PE definition is of great concern to businesses that are trying to comply in good faith with their tax obligations in many countries around the world. A PE threshold that is clear and predictable in its application serves the purpose of protecting businesses from having to analyze and apply the domestic law taxation rules existing in scores of countries touched by their operations, with all of the problems that can entail due to differences in language, legal systems, accounting standards, etc. The risks of a mistake in applying the threshold go far beyond the potential host State income tax liability involved, as they can include exposure to interest, civil and even criminal penalties, VAT obligations, withholding obligations and resulting fallout vis-à-vis employees, lenders, and investors, treatment of taxable years as open due to non-filing of returns, restatements of financial results, reputational risk, and double taxation. If the PE definition leaves too much uncertainty about the level of exposure to these risks, it fails to fulfill its function in the treaty of facilitating international trade, as it will discourage commercial operations the treaty is intended to foster.

34. Besides certainty, another important policy consideration is that the PE threshold strike an appropriate balance between a host State’s taxing rights and the need for taxpayers and tax administrations to avoid incurring administrative costs that are disproportionate to the amount of profit or tax at issue. As suggested above, a finding that a PE exists can trigger meaningful administrative burdens in the nature of compliance with local filing obligations which requires familiarity with the local tax rules and accounting standards. This typically requires engaging local advisers. There may be VAT administrative and substantive obligations that are triggered as well. The business’ accounting systems may need to be adjusted to enable compliance with the local obligations. From the tax administration’s perspective, there are also costs involved in processing returns and verifying compliance. In many situations, the costs triggered can approach or exceed the tax potentially involved on the profits attributable to the PE, or even those profits themselves. Where this kind of disproportionality exists, the PE standard itself can operate as a barrier to the kind of commercial interactions treaties are intended to encourage. It is therefore entirely appropriate and sensible that the PE definition be designed with an eye on the calculation of profits that would be attributable to the type of PE at issue, and with a view towards avoiding defining PEs in such a way that the compliance and related costs are disproportionate to the tax on the potentially attributable profits.

2 We note, however, that the standards for what constitutes a PE for income tax purposes and what constitutes taxable nexus for VAT purposes are not identical, so that it cannot be automatically assumed that having nexus for one purpose necessarily implies having nexus for the other.
35. A policy consideration which goes hand in hand with those described above is the enforceability and practicality of the PE threshold and the related profit attribution. There is virtue in defining a PE as a sufficient nexus with a State that the State’s enforcement of taxing jurisdiction over the enterprise will be enforceable as a practical matter. Having laws that are incapable of effective enforcement in practice (e.g., because of a lack of meaningful presence in a State by a foreign enterprise or its agent) leads to discriminatory treatment of compliant taxpayers and ultimately to disregard of and contempt for the tax system. Likewise, the PE standard should be one for which there is a reliable consensus among governments on the method for attributing profits to the particular form of PE in question, and for which residence States are prepared to acknowledge that the other Contracting State should have primary taxing jurisdiction.

2.3 The specific focus of Action 7

36. Action 7 of the BEPS Action Plan calls for the development of proposals to prevent the “artificial avoidance” of PE status. The Discussion Draft notes the two problems the Action Plan identified in this respect. The first was that “the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor.” The Action Plan and Discussion Draft cite the use of “commissionaire arrangements” as the manifestation of this problem. The second was that “MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.”

37. As presented, the focus of Action 7 is squarely on “artificial” avoidance of PE status, and that focus should remain paramount for the Action 7 output. In particular, and as noted by both the Action Plan and the Discussion Draft, the Action Plan is “not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income”, and proposals that have that as their primary aim do not belong in the Discussion Draft or in the BEPS project.

38. The Discussion Draft also states that the Action 1 Report on Addressing the Tax Challenges of the Digital Economy (the Action 1 Report) identified two issues in the digital economy that need to be taken into account in the Action 7 work, namely ensuring that “core activities” cannot “inappropriately benefit” from the exception from PE status and that “artificial arrangements” relating to the sales of goods and services cannot be used to avoid PE status. The second issue does seem to focus on (unspecified) “artificial” arrangements used to avoid PE status. The Action 1 Report clarifies that this relates to situations “where, for instance, an online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients”. Given that the Action 1 Report concludes that it would not be appropriate to ring-fence the digital economy, one presumably has to assume that this concern relates not only to online providers but potentially to any business, so the focus for this purpose should be on whether a foreign enterprise uses a local sales force to negotiate and effectively conclude contracts, and the Discussion Draft options should be evaluated in light of whether they are well designed to address that concern.
39. The first issue, relating to the exceptions from PE status, is described in the Discussion Draft as arising from the belief that “certain activities that were previously considered to be preparatory or auxiliary may be increasingly significant components of businesses in the digital economy.” The Action 1 Report acknowledges that Action 7 was already addressing artificial avoidance of PE status through fragmenting of operations to benefit from the Article 5(4) exceptions. It states, however, that the Action 7 work should be “expanded” to “address situations in which these exceptions inappropriately apply to activities that have become core functions, whether this relates to BEPS (due to lack of both source and residence taxation) or not”. It recommends that the Action 7 work should consider whether “a reasonable, administrable rule” can be developed to identify circumstances under which activities covered by the Article 5(4) exception should be considered core activities and not eligible for the exception. It says that, for example, “work should consider whether and under what circumstances the maintenance of a local warehouse may constitute a core activity such that it should be outside the scope of the exceptions in Article 5.”

40. This description of the issue is rather striking, in that it shows an intention to redraw the boundaries between source and residence taxation in a particular area without regard to whether there are inherent artificial avoidance problems or BEPS concerns in that area. In other words, this suggests that Action 7 could be used to do exactly what the Discussion Draft said it was not intended to do, namely “change[e] the existing international standards on the allocation of taxing rights on cross-border income”. We question whether it is appropriate to do that under Action 7. We also question whether it is appropriate to base potential changes to Article 5(4) as a whole on a concern which has been peculiarly associated with digital economy businesses. Even if, however, one assumes that it is appropriate to consider such changes under Article 7, we believe it is critical to consider, as the Action 1 Report suggests, whether an option provides “a reasonable, administrable rule” for applying a new definition of PE.

2.4 The link with the attribution of profits rules

41. We have noted above the link between Article 5 and Article 7 and the reasons it is both appropriate and sensible to consider the profit attribution consequences of any particular new definition of PE. We therefore believe that in evaluating the appropriateness of a proposed change to the PE definition, one should ask: (i) have the profit attribution consequences of that particular change been considered?; (ii) are the profit attribution consequences sufficiently clear, and is there a sufficiently reliable consensus among governments as to those consequences, that introduction of the change will not lead to a substantial increase in disputes?; and (iii) is the potential profit to be attributed to the PE (in addition to any profit already being taxed by the PE State) material enough to justify the added compliance burden of the new form of PE for taxpayers and governments?
3. Options affecting Article 5(5) and 5(6)

3.1 Overview of concerns regarding the Article 5(5) options

42. Each of Options A through D proposes a change to the wording of Article 5(5) regarding so-called dependent agent PEs. The proposed new wording in each of them introduces unfamiliar and vague new concepts. They each appear to cover situations that go well beyond circumstances involving artificial avoidance of the existing PE definition. Depending on how they are interpreted, they could result in the creation of PEs in many situations involving buy-sell distributors or even pure marketing activities. They appear to represent a significant shift in the boundary between source and residence State taxation, and their vagueness presents substantial risk for the creation of disputes.

3.2 Option A changes to Article 5(5)

3.2.1 “Habitually engages with specific persons in a way that results in the conclusion of contracts”

43. The Option A proposal would change “habitually exercises an authority to conclude contracts” to “habitually engages with specific persons in a way that results in the conclusion of contracts”. The explanation says this refers to situations where the intermediary “habitually interacts with identifiable persons in a way that directly results in the conclusion of contracts”.

44. This change is obviously not necessary to address commissionnaire cases, as commissionnaires habitually conclude contracts with customers. Moreover, the existing Commentary regarding “habitually exercising an authority to conclude contracts” already covers situations where the intermediary “solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions” (paragraph 32.1), as well as cases where the intermediary “is authorized to negotiate all elements and details of a contract … even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation” (paragraph 33). It must therefore be assumed that the change is intended to sweep in some broader category of cases.

45. The scope of the intended coverage is, however, very unclear from the language. The proposal introduces several new concepts – “engages”, “specific persons”, “in a way that results in the conclusion” of contracts – no one of which clearly communicates a single meaning. For example, what does it mean to “engage” with persons? Does this require direct contact? Does it involve negotiation or discussion of the terms of a contract? Does the “engagement” even have to involve two-way communication? Similarly, what is meant by “specific” persons? Are these persons the intermediary has individually selected? Could they be “identifiable” by virtue of their membership in a group? Moreover, the meaning of engaging “in a way that results in the conclusion of contracts” is completely unclear. Is this a “but for” test? How direct does the connection have to be between the intermediary’s “engagement” and the conclusion of the contract?

46. As examples of the type of ambiguity the proposed language introduces, we wonder whether it could cover:
• Intermediaries who are authorized to present a standard contract for orders and who are allowed to make only specifically pre-approved modifications to the contract but who must refer all orders to the nonresident enterprise for approval?

• Intermediaries who solicit but do not receive orders and who have no authority to negotiate or conclude contracts?

• Intermediaries who meet with prospective clients (e.g. at their premises or at trade shows) to describe product or service offerings but who do not solicit or receive orders and who have no authority to negotiate or conclude contracts?

• Intermediaries who distribute marketing materials (including information about whom to contact for further information or to place orders) to targeted groups, but without soliciting or receiving orders or having any authority to negotiate or conclude contracts?

• Intermediaries who arrange for advertising within a country which results in orders being placed with a foreign enterprise, but who themselves do not solicit or receive orders or have any authority to negotiate or conclude contracts?

• Intermediaries who maintain servers that host the website of the foreign enterprise through which customers may place orders / conclude contracts with the foreign enterprise?

47. These ambiguities demonstrate that the proposed language is susceptible of interpretations that go very far beyond the existing standard of “habitually concluding contracts” (including the interpretation of that standard in the existing Commentary) and also go very far beyond the problem cases described in the Action 1 Report, namely situations involving the use of “a local sales force to negotiate and effectively conclude contracts”. The language is so vague that one cannot even determine whether the reference to the specific persons with whom the intermediary interacts includes only persons that enter into contracts relevant to the foreign enterprise. For example, is the concept broad enough to cover an intermediary’s interactions with a local advertiser or server operator, even if the intermediary has no direct interaction with customers who enter into contracts with the foreign enterprise as a result of the advertising or availability of the website?

3.2.1.1 Conclusion regarding “habitually engages” language

48. We believe the “habitually engaging” language put forward in Option A is much too vague to serve as the basis for a PE definition. We also believe it is susceptible of interpretations that go way beyond the problem cases described in the Discussion Draft and that it amounts to a wholesale rewriting of the PE standard. For both of these reasons, we recommend that this formulation be rejected.

3.2.2 Description of contracts covered

49. The Option A proposal would also include in Article 5(5) not only contracts concluded “in the name of” the foreign enterprise, but also contracts “for the transfer of the ownership of, or for the granting
of the right to use, property owned by that enterprise or that the enterprise has the right to use” or “for the provision of services by that enterprise”. The explanation in the Discussion Draft confirms that this is the portion of Option A which is intended to address the *commissionnaire* structure, since this would cover cases where the intermediary concludes contracts that are not themselves legally binding on the foreign enterprise (and to which the foreign enterprise is not even an actual party), but which have the indirect effect of, for example, transferring ownership of property owned by the foreign enterprise.

3.2.2.1 Lack of clarity regarding impact on distribution structures beyond *commissionnaires*

50. The question that then arises is whether the formulation Option A uses for describing the types of contracts that will generate PE status is well targeted to *commissionnaire* structures, or whether it sweeps in a much broader category of cases. Given that *commissionnaire* structures involving the sale of goods commonly result in a transfer of title directly from the foreign enterprise to the customer as a result of a direct legal obligation of the foreign enterprise to the *commissionnaire* (i.e., without passing through the *commissionnaire* and notwithstanding the lack of privity of contract between the foreign enterprise and the customer), one can understand how the language is designed to cover those structures. However, the proposed language does not appear to be limited in its effect to *commissionnaire* structures, and since the language is designed to cover contracts to which the foreign enterprise itself is not a party, one has to wonder how broadly the language might be interpreted.

51. For example, it is unclear to what extent the language could cover contracts entered into with customers by buy-sell distributors of the foreign enterprise’s products.

   - What if the foreign enterprise retains title to the goods until they are sold to customers by the distributor, who then takes “flash title”?

   - What if the foreign enterprise is not legally obligated to supply goods to the distributor upon the latter’s conclusion of contracts with customers but has entered into an arrangement with the distributor which makes it economically beneficial for the foreign enterprise to do so?

52. In either situation, one could imagine the language in Option A being read broadly enough to treat such contracts as contracts for the transfer of ownership of property owned by the enterprise. While it may be that the language is not intended to be interpreted that broadly (e.g., because in such cases the contracts with the customers are not technically contracts for the transfer of ownership of property owned by the foreign enterprise, or because the distributors are not formally acting “on behalf of” the foreign enterprise), one certainly cannot reliably arrive at that conclusion based on the language itself. As drafted, it is susceptible of interpretations that would have far-reaching effect beyond *commissionnaire* structures. This is an unacceptable result, as there needs to be a clear confirmation that foreign enterprises can sell into a country by using a local distributor without creating a PE, and a clear understanding of the circumstances in which that is possible. Without that clarity, there is liable to be tremendous disruption to normal commercial arrangements across the globe. The Discussion Draft itself cites as justification for the proposed changes the fact that “the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and
concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor”; where a local distributor is subject to tax in the market jurisdiction, there is no basis to find a PE as well.

3.2.2.2 Lack of clarity regarding impact on leasing and services transactions

53. It is likewise unclear what the effect of the Option A language is with respect to leasing or services transactions. For example, what if a host State service provider (e.g., in the utilities, insurance, telecommunications, transportation, cloud computing, etc. business) has an arrangement with a foreign enterprise allowing it to purchase services from the foreign enterprise (and compelling it to obtain the required services only from that enterprise) whenever necessary to fulfill services obligations to its customers where the local service provider has insufficient capacity itself to provide the services?

54. To the extent problems have been cited with respect to the effect of the current Model’s “in the name of” standard with respect to commissionnaire arrangements, those problems have been limited to situations involving the sale of goods. No clear justification exists for changing the “in the name of” standard for leasing or services transactions, since there have not been indications that the commissionnaire structure is used by foreign enterprises to avoid PE status in connection with such transactions. If the Option A language relating to leasing and services transaction is retained, it would be critical to provide guidance explaining when, if ever, the new language would have the effect of creating PEs outside the context of commissionnaire structures.

3.2.2.3 Conclusion regarding Option A’s description of contracts covered

55. Our basic view, however, is that the vagueness of the concept of contracts “for the transfer of the ownership of, or for the granting of the right to use, property owned by” the foreign enterprise or “for the provision of services by that enterprise” also militates against the use of this standard as a PE threshold.

3.3 Option B changes to Article 5(5)

3.3.1 Negotiating the material elements of contracts

56. The Option B proposal would add to the existing language about habitually “concluding” contracts a reference to situations where the intermediary habitually “negotiates the material elements of contracts”. The existing Commentary (paragraph 33) already covers situations where the intermediary “is authorised to negotiate all elements and details of a contract in a way binding on the enterprise”, even if the contract is signed by another person outside the host State. This Option B proposal appears to reflect an intent to prevent intermediaries who have negotiating authority from avoiding PE status for their foreign principal by avoiding having the authority to negotiate one or more elements of the contract.

57. This intent appears to align with the view expressed at paragraph 24 of the Commentary on Article 5 of the UN Model Treaty, which says: “The Committee’s view is that where paragraph 33 of the OECD Commentary above refers to ‘[a] person who is authorised to negotiate all elements and details of
a contract’, this should be taken to include a person who has negotiated all the essential elements of the contract, whether or not that person’s involvement in the negotiation also extends to other non-essential aspects.”

58. We are not aware of treaties that use the Option B proposed language regarding negotiating the material elements of a contract. If the Option B language were to be adopted, it would be necessary to clarify: (i) what are the material elements of a contract; and (ii) whether the language would apply only when the intermediary negotiates all the material elements of a contract or only some of the material elements (and if the latter, how many). For example, what if the intermediary can agree with a customer on the quantity of goods to be sold, but the determination of the price, delivery date, payment terms, etc. is to be made exclusively by the foreign enterprise’s home office? Would that be enough to view the intermediary as negotiating the “material elements” of the contract, such that a PE would exist under the Option B language?

59. Moreover, it would be critical to clarify what does not constitute negotiating the material elements of contracts. For example, in many situations, an intermediary does not possess any true negotiating authority in substance at all, but is merely authorized to present a standard format contract to potential customers or one with only a very limited range for variation, and both the substantive decision of whether to conclude contracts with specific customers and the actual execution of those contracts take place outside the intermediary’s jurisdiction. In such cases, the OECD should confirm clearly that the intermediary neither habitually concludes contracts nor habitually negotiates the material elements of contracts.

60. Equally importantly, it would be critical to clarify what the profit attribution consequences of finding a PE under the Option B language relating to the negotiation of material elements of a contract would be, particularly if that language could be triggered where the intermediary negotiates only some of the material elements. There would be a high risk of double taxation if more than one jurisdiction felt they were entitled to attribute the entire sales profit to their tax base on the grounds that someone acting in their jurisdiction on behalf of the principal was found to have negotiated material elements of the contract.

3.3.2 Description of the contracts covered

61. The second part of Option B’s change to Article 5(5) relates to the expanded category of contracts covered and is identical to Option A (i.e., contracts “for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use” or “for the provision of services by that enterprise”). It raises the same concerns outlined above and should be avoided on the same grounds.
3.4 Option C’s changes to Article 5(5)

3.4.1 “Habitually engages with specific persons in a way that results in the conclusion of contracts”

Of Option C’s two proposed changes to Article 5(5), the first (changing “habitually exercises an authority to conclude contracts” to “habitually engages with specific persons in a way that results in the conclusion of contracts”) is identical to Option A and presents the same problems. We believe that change should be rejected for the same reasons outlined above.

3.4.2 “Contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”

Option C’s second proposed change to Article 5(5) is to replace “contracts in the name of” the foreign enterprise to “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise.” The explanation in the Discussion Draft states: “This formulation refers to contracts that are on the account and risk of the foreign enterprise by virtue of the legal (not economic) relationship between the person and the intermediary (which would cover a relationship created, for example, by an agency contract, a commissionnaire contract, an employment contract, a partnership contract or even a trust deed through which a trustee would act on behalf of an enterprise).”

3.4.2.1 Lack of clarity regarding scope of contracts “on the account and risk of” the foreign enterprise

This language appears to relate to the contract between the foreign enterprise and the intermediary, and the manner in which it causes the intermediary’s contracts with clients with customers to be “on the account and risk of the enterprise”. As in the case of Option A, this language seems designed to sweep in situations where the intermediary is concluding contracts with customers which do not legally bind the foreign enterprise (and to which the foreign enterprise is not even a party).

We are not aware of treaties that use the Option C proposed language regarding contracts “on the account and risk” of the foreign enterprise. The language appears broad enough to extend well beyond commissionnaire structures and to cover a wide range of limited risk distributor arrangements, including common law disclosed and undisclosed principal situations which clearly do not give rise to PEs under the current Model and the use of which could hardly be said to constitute “artificial avoidance” of PE status.3

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3 We understand that this term may be used in certain European contract law (e.g., in the Netherlands, “voor rekening en risico van”), and that it has the meaning that the principal receives the benefits and bears the burdens arising from the intermediary’s contract with the third party. See D. Busch, Indirect Representation in European Contract Law, Kluwer, 2002, p. 229.
66. Arrangements between a foreign enterprise and its distributor can exhibit a wide range of approaches to allocating or sharing the risks involved in distribution, including risks related to damage, destruction, theft, or loss of the goods prior to passage of title to the customer; ownership and management of accounts receivable; market risks; foreign exchange movement risks, etc. In order to know whether the proposed language would cover a given arrangement, it would be necessary to know where on the spectrum the line is drawn, and how much of the risk potentially borne in distribution is allocated to the foreign enterprise under the contract it has with the intermediary. For example, a distributor arrangement may call for the distributor to take title to inventory well prior to its sale to customers, but may also require the foreign enterprise to buy back some (or all) of the unsold inventory at a certain point and for a certain price – would that influence whether the distributor’s customer contracts are “on the account and risk” of the foreign enterprise?

3.4.2.2 Conclusion regarding “on the account and risk of” language

67. Without a much clearer indication of what types of arrangements are intended to be covered by this proposed language, it would not be an appropriate standard to introduce for determining PE status.

3.5 Option D changes to Article 5(5)

68. Option D’s changes to Article 5(5) are identical to Option B’s inclusion of negotiating the material elements of contracts and Option C’s reference to contracts “on the account and risk of” the foreign enterprise, and they raise the same issues described above.

3.6 Conclusion regarding Options A-D changes to Article 5(5)

69. We find all of the proposed changes to Article 5(5) under Options A-D highly inappropriate as changes to the PE definition, because of both the tremendous ambiguity they introduce and the extent to which they appear to have much broader potential implications than the identified problem cases that sparked the BEPS Action Plan’s interest in changing Article 5(5). We believe they could result in a very substantial lowering of the PE threshold and could generate very costly and hard to resolve disputes due to their vagueness and broad sweep. Accordingly, we believe they could seriously interfere with the routine conduct of international trade.

70. If notwithstanding their serious flaws the OECD felt compelled to adopt one of these options, we believe that Option B may be marginally the least damaging, as it at least seems to focus on the familiar agent activity of negotiating contracts and its description of the contracts at issue seems arguably more tied to the contracts concluded by commissionnaires than the description found in Options C and D. Nevertheless, as indicated above, we believe Option B is fundamentally flawed due to its vagueness and potential over breadth.

3.7 Alternative approach to amending Article 5(5) – specific reference to commissionnaires

71. On the other hand, we believe that a better approach altogether, and one that would respond to the governmental concern about the use of commissionnaires while at the same time providing necessary
clarity for taxpayers and tax authorities, would be to draft an amendment to Article 5(5) which would specifically identify *commissionnaires*, by reference to the relevant statutory provision governing them, as creating PEs for their foreign principals. It is our understanding that the status of *commissionnaire*, in those civil law jurisdictions where the concept exists, is typically derived from a specific statutory provision, and Contracting States could easily refer to that provision in their treaties.

3.8 Option A-D changes to Article 5(6)

72. All of Options A-D would change Article 5(6)’s description of independent agents, in particular by introducing the sentence: “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 within the meaning of this paragraph with respect to these enterprises.”

73. Existing Commentary paragraph 38.6 has the following to say about the relevance of the number of persons on whose behalf an agent acts to whether that agent is independent: “Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative.”

74. Existing paragraph 38.6 also says: “Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.”

75. Thus, the proposed change would reverse the current standard by treating exclusivity as determinative in negating independence, and would go further by essentially treating a group of associated enterprises as a single principal for purposes of determining an agent’s independence without regard to whether they are “acting in concert” to control the acts of the agent on their behalf.

76. The only explanation given by the Discussion Draft for making this change is that it would address *commissionnaire* and similar strategies by “Preventing situations where a subsidiary that only acts as a *commissionnaire* for associated enterprises would escape the application of paragraph 5 even if it concluded contracts in the name of these enterprises.” The only apparent genesis for this concern was the sole comment submitted to the OECD in November 2013 in response to its request for input on PE avoidance strategies: that comment indicated that many MNE groups establish an entity in a source
jurisdiction to act as an agent for various members of the group in selling their products, where the entity is working under the control and direction of the respective principal entity’s management.4

77. A first point to note is that no change seems necessary to existing Article 5(6) to deal with the scenario described by the commentator, since that appears to describe a situation where dependence is likely to exist under the existing Commentary, both because the entity is subject to detailed control by the principal(s) and because the group members are acting in concert to establish the entity and control its activities. We are in any event not aware of any common practice among MNEs to try to avoid PE status for related party agents by relying on this kind of multiple related principal strategy.

78. A second point to note is that the explanation given in the Discussion Draft seems to assume that the proposed change would affect only those agents that are related to the principal(s), whereas the text of the proposed Article 5(6) is not limited in that way at all, but could affect any agent used by a principal anywhere in the world, even if totally unrelated to the principal. This could have serious implications for many multinational businesses that sell through unrelated agents in foreign jurisdictions. For example, some groups utilize thousands of unrelated parties around the world to act as their agents in distributing their products. These groups may have no exclusivity arrangements with the local agents and no practical way of knowing or tracking whether the agents are currently acting exclusively on behalf of the principal company and/or its affiliates. Moreover, that fact could change from year to year or more frequently.

79. For these reasons, we believe the proposed change to Article 5(6) is wholly unjustified and unwise. Moreover, we note that it appears to further narrow the independent agent definition by requiring that an agent must act on behalf of various persons “in a Contracting State” to be considered independent. The existing text in the Model would recognize an agent could be independent where it acts on behalf of multiple principals, even if those actions are conducted in various States (e.g., where it acts on behalf of Principal A in State X, Principal B in State Y, Principal C in State Z, etc.). The Discussion Draft cites no justification, and we can think of none, for conditioning an agent’s independence on whether it acts in a single jurisdiction on behalf of one or multiple principals.

4. **Specific activity exceptions under Article 5(4)**

4.1 **Overview of concerns regarding proposed options**

80. Having exceptions for preparatory and auxiliary activities is a sensible mechanism to avoid triggering compliance obligations and revenue disputes with respect to operations that are necessary to conduct business but do not typically reflect value drivers attracting material returns. Businesses across

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all sectors have relied on Article 5(4) exceptions for decades, and the availability of those exceptions will continue to be important to them.

4.2 Option E -- subject all of Article 5(4) to a preparatory or auxiliary condition

81. Subjecting paragraphs (a) – (d) of Article 5(4) to an overarching condition of being preparatory or auxiliary would lead to difficult debates about whether these types of routine business operations are “preparatory or auxiliary” in the taxpayer’s particular case. As noted by the Commentary on Article 5(4), “It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not.” (Commentary, paragraph 24).

82. Paragraphs (a) – (d) of Article 5(4) are already subject to the overall condition that carrying on a combination of the specified activities at a fixed place of business will be excepted from PE status only if the overall activity of that fixed place of business is of a preparatory or auxiliary character.

4.2.1 Meaning of “preparatory or auxiliary” too unclear to subject all activities to that test

83. If the OECD chose to maintain the availability of Article 5(4) exceptions but limit them to activities whose overall character is preparatory or auxiliary, it should provide further guidance on the concept that an activity is not preparatory or auxiliary if the activity “in itself forms an essential and significant part of the activity of the enterprise as a whole” (Commentary, paragraph 24). For example, is an activity like storage “essential” because it needs to be done to carry on a business, or “non-essential” because it can easily be, and often is, outsourced to a third party provider? Is an activity like delivery “significant” because it represents the entirety of an enterprise’s activity in a particular jurisdiction or because it attains certain volume levels, or “not significant” because it represents a small portion of the enterprise’s overall cost structure or can easily be, and often is, outsourced to a third party provider?

84. Similarly, existing paragraph 23 of the Commentary describes a fixed place of business used for preparatory or auxiliary activities as one which “may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question”. It says further: “Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.”

85. It’s not at all clear how useful the paragraph 23 guidance is in identifying preparatory or auxiliary activities in light of the modern transfer pricing and Authorised OECD Approach (AOA) principles,
which presume that all functions must be compensated at arm’s length. The intention of the Commentary language may have been to suggest that the activities were remote from the enterprise’s actual realization of profits based on its transactions with third parties, such that it was difficult to allocate a portion of those profits to the fixed place of business. Assuming that to be true, the Commentary’s description of “preparatory or auxiliary” activities could be modified to make that point clearer. Otherwise, subjecting all of the Article 5(4) activities to an overarching condition of being preparatory or auxiliary risks creating many more PEs than exist today, at least in the absence of clear guidance on what it means for activities to be “preparatory or auxiliary” which does not depend on the difficulty of attributing profit to those activities.

4.2.2 No justification given for subjecting all activities to “preparatory or auxiliary” condition

86. The Discussion Draft does not mention particular concerns about some of the activities listed in Article 5(4) (e.g., use of facilities or maintenance of a stock of goods for storage or display, maintenance of a stock of goods solely for the purpose of processing by another enterprise). The ability to conduct these activities without facing potential PE challenges should not be removed unless there is some identifiable concern about their current coverage in Article 5(4).

4.2.3 Subjecting all activities to “preparatory or auxiliary” condition would put great pressure on determining whether the activities are conducted at a fixed place of business of the foreign enterprise

87. Moreover, subjecting all the listed activities to an overriding “preparatory or auxiliary” condition puts a lot more pressure on the question of whether a place (including the premises of a third party, whether related or unrelated) constitutes a “fixed place of business” of the foreign enterprise. This was an area of considerable debate in WP1’s 2011-2012 work on interpreting existing Article 5 (e.g., when is a place “at the disposal” of the foreign enterprise, whose business is being conducted at a place, etc.), and that debate has not been fully resolved. It is very hard to evaluate the proposed changes to Article 5 without a clearer resolution of those issues.

88. Accordingly, we recommend against pursuing Option E because it would risk too much uncertainty about many routine business activities due to the fundamental ambiguity about what it means for an activity to be “preparatory or auxiliary”.

5 See, e.g., paragraph 17 of the 2010 Report on the Attribution of Profits to PEs, which says: “Under the second step of the authorised OECD approach the Guidelines are applied by analogy to the PE’s dealings with other parts of the enterprise to ensure that the performance of all of its functions in relation to these dealings is rewarded on an arm’s length basis.”
4.3 Option F – delete “delivery” from Article 5(4)(a) and (b)

89. The proposal in Option F would delete “delivery” from Article 5(4)(a) and (b), leaving references only to the use of facilities or the maintenance of a stock of goods belonging to the enterprise for “storage or display”. The Discussion Draft’s explanation for this proposed option is that: “It is difficult to justify the application of these exceptions where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online.” The Discussion Draft also refers to the fact that “delivery” has been deleted from the corresponding provisions of the UN Model.

4.3.1 Even UN Model includes serious caution about deleting “delivery”

90. The Discussion Draft also appropriately notes, too, however, that the Commentary on Article 5 of the UN Model contains a warning about deleting “delivery” from Article 5(4)(a) and (b), on the basis that countries might be led into attributing too much income to this activity if they do not pay close attention to the issue, “which could lead to prolonged litigation and inconsistent application of tax treaties”, and that it recommends that countries consider both points of view for the purpose of determining the practical results of either approach. It is interesting to note that, according to a study done in 1997, 75% of the treaties concluded by non-OECD countries included “delivery” in Article 5(4).6

4.3.2 Deleting “delivery” could eviscerate the exception for “storage”

91. It would be difficult to understand what would be left of the exception for “storage” once “delivery” is deleted, given that most goods being stored are destined for delivery. Indeed, given that the existing Commentary interprets use of facilities for delivery to include an oil company’s use of a pipeline to transport its own oil to its own refinery in another country, it seems that any storage which ends in delivery of the stored goods to another facility owned or operated by the foreign enterprise would be affected by the deletion of “delivery”.

4.3.3 No clear standard for determining whether delivery is “preparatory or auxiliary”

92. While it is understood that deletion of “delivery” from Article 5(4)(a) and (b) might still leave the possibility that use of facilities or maintenance of a stock of goods for delivery could be covered by the exception in Article 5(4)(e) for “other activities” of a preparatory or auxiliary nature, it is difficult to understand in what circumstances delivery might be considered preparatory or auxiliary (as opposed to, for example, an essential and significant part of the activities of the enterprise as a whole). Is the idea behind this proposal that taxpayers and tax authorities would have to analyze how essential it is to a taxpayer’s business model to use facilities or maintain a stock of goods in a particular country for

6 UN Model, Commentary on Article 5, paragraph 20.
purposes of delivery in order to determine whether that constitutes a PE? What factors would be taken into account in making that determination? What evidence would be relevant one way or the other? Is there a BEPS concern if the goods in question are delivered to customers in third countries?

93. The concern also exists that the affirmative deletion of “delivery” from Article 5(4)(a) and (b) would create a negative inference as to its potential characterization as “preparatory or auxiliary” under Article 5(4)(e). If the OECD adopts Option F, it should seriously consider stating affirmatively that no such negative inference should be drawn.

4.3.4 Deletion of exception for delivery likely to impact business sectors far beyond digital economy

94. While the inspiration to delete delivery appears to have sprung from unhappiness about certain online businesses, our discussions have revealed that the exception for the use of facilities or maintenance of a stock of goods for delivery is very widely relied upon across all sorts of business models having nothing to do with the digital economy as such. For example, a producer of consumer goods may use the services of an unrelated contract manufacturer (not a PE), purchase the inventory produced, and arrange to have it stored at the manufacturer’s premises until it can be shipped for delivery to an export destination. It would be highly disruptive to business models across the commercial spectrum to have to treat the locations where their goods are stored for delivery as PEs, or to have to analyze, according to very poorly articulated criteria, whether such storage for delivery is “core” to their business model.

4.3.5 Serious questions exist about how to attribute profit to a “delivery” PE and whether attributable profit would be enough to justify the change

95. In addition, the warning of the UN Committee of Experts that treating such locations as PEs could lead to excessive allocations of profits to those PEs should be taken to heart. The OECD should not even consider a change that would result in treating holding for delivery as a PE without accompanying that with a full analysis of how profit should be attributed to that location. It should be noted that many, if not most, locations where an enterprise holds goods for delivery are premises owned by a separate enterprise, whether related or unrelated, and that separate entity is compensated for providing the storage service at that location, so the profit attribution analysis would have to consider what, if any, profits are attributable to the enterprise’s PE at that location (i.e., in addition to those already taxed to the warehouse operator).

4.3.6 Deleting the delivery exception would put great pressure on determining whether the use of facilities or maintenance of a stock of goods for delivery is taking place at a fixed place of business of the foreign enterprise

96. As indicated above, the potential that a location of storage for delivery may be treated as a PE would also involve the question of whether the particular location is “at the disposal” of the foreign enterprise such that it could be considered a fixed place of business PE under Article 5(1) in the first place, if not excepted under Article 5(4). More guidance would be needed on that issue (taking into account that the issuance of guidance on the “at the disposal” standard has been suspended as a result of
the BEPS project), and that guidance would also have to address the potential treatment of Article 5(4)(b) and the circumstances in which the “maintenance of a stock of goods for delivery” could be considered a fixed place of business of a foreign enterprise.

97. We believe that the proposed deletion of “delivery” from Article 5(4)(a) and (b) is ill-conceived and likely to lead to controversies and compliance burdens that dwarf its potential revenue implications.

4.4 Option G – delete purchasing exception

4.4.1 Examples cited in support of Option G do not justify the change

98. Option G would amend Article 5(4)(d) by deleting the reference to “purchasing goods or merchandise” for the enterprise. The Discussion Draft indicates that the OECD Focus Group discussed the policy implications in light of 3 examples, two of which were described as raising BEPS concerns. We respectfully suggest that the two examples in question do not justify deletion of the purchasing exception from Article 5(4).

99. The first example assumes that a purchasing branch which purchases the output of several affiliated manufacturing plants on behalf of the group would be entitled to retain all of the group’s volume discount for those purchases, which would go untaxed if the host State had to apply the purchasing exception and the residence State’s domestic law did not tax the purchasing office’s profits. This example ignores the fact that the guidance being issued by WP6 indicates that volume discounts achieved by a centralized purchasing function are typically shared among those members of the affiliated group that will acquire the goods in question (see paragraph 1.103 of Action 8 Report of September 2014). In other words, the application of standard transfer pricing principles would not allow such a purchasing branch to be attributed a large pool of profits which might go untaxed anywhere. Accordingly, the apparent concern expressed in that example is illusory and does not justify a change to the purchasing exception in Article 5(4).

100. The second example involves a case where a company incorporated in a low-tax jurisdiction has a host State purchasing office where skilled buyers purchase local agricultural products for on-sale. This example ignores the fact that any BEPS concern here would be avoided if the host State followed the recommendations under Action 6 to refrain from entering into treaties with jurisdictions where the risk of double taxation is low. Here again, the example does not justify a change to the purchasing exception in Article 5(4).

4.4.2 Deletion of Article 7(5) cannot logically serve as justification for Option G

101. The Discussion Draft correctly notes that a recent update to the OECD Model Treaty deleted former Article 7(5), which had prohibited the attribution of any profits to a PE from purchasing activities. The effect of that change, however, was simply to put purchasing on a par with all the other excepted activities listed in Article 5(4)(a) – (d), namely that if the purchasing activity forms part of an otherwise
existing PE, profits may be attributed to that function. The deletion of Article 7(5) cannot logically serve as a justification to remove the purchasing exception from Article 5(4).

4.4.3 Deletion of the purchasing exception likely to impact business sectors far beyond digital economy
102. We understand that some focus may be placed on the purchasing exception because of unhappiness on the part of certain governments that some enterprises engaged in the digital economy may conduct purchasing through fixed locations in a country without becoming subject to tax there. We note, however, that this circumstance is by no means limited to enterprises engaged in the digital economy and may well apply more broadly to traditional businesses. For example, our members in certain industrial businesses have noted that they routinely have purchasing operations established in specific countries to purchase major components from third parties for equipment or structures they build for use or sale in their business, and they rely upon the purchasing exception to treat those locations as non-PEs. A reversal of that treatment, or a need to analyze under poorly articulated standards whether such operations are “preparatory or auxiliary” to their business, would be a major disruption for them.

4.4.4 Deletion of purchasing exception likely to harm the host State economically
103. It is also worth noting that the purchasing exception can play a role which is largely beneficial to the economy of the host State where the purchasing operations are taking place, since it helps to attract foreign buyers to make purchases from local sellers, thereby contributing to the local economy. This consideration, quite apart from the quantum of profits that might be attributed to a purchasing activity, is by itself an important one for countries to consider in deciding whether or not to include the purchasing exception in Article 5(4).

4.4.5 Conclusion regarding Option G
104. In summary, we do not agree that the purchasing exception should be deleted from Article 5(4). No credible justification has been given for why that should be done, and it would have a hugely disruptive effect to businesses across the commercial spectrum and could well operate to the economic detriment of source States where purchasing operations take place.

105. If the OECD does pursue the deletion of the purchasing exception, they should do so only in conjunction with clear guidance on when purchasing is a “core” business activity (as opposed to preparatory or auxiliary), when premises owned by a separate enterprise that may perform some purchasing functions for the foreign enterprise constitute a fixed place of business of the foreign enterprise, and how profits should be attributed to the resulting PE, particularly in cases where a local enterprise has already been compensated at arm’s length for carrying out purchasing activities on behalf of the foreign enterprise.

4.5 Option H – delete exception for purchasing and collecting information
106. Option H would delete the exception not only for purchasing but also for collecting information for the enterprise. We have already explained why we do not view the deletion of purchasing from
Article 5(4)(d) as justified. We have similar strong reservations about the proposal to delete the reference to collecting information. The justification given for this option is that some enterprises “attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises.”

4.5.1 No need to delete exception for collecting information to address the concern cited

107. The existing text of Article 5(4)(d) already specifies that the exception applies to “the maintenance of a fixed place of business solely for the purpose of … collecting information, for the enterprise” (emphasis added). In other words, there is no need to delete the exception to cover situations where the fixed place of business is used for the additional activity of “repackaging the information collected into reports” for other enterprises. Even though the existing Commentary (paragraph 22) indicates that an enterprise such as a news organization may use a fixed place of business in a host State to collect information which will be fed to a central location elsewhere for development into news products to be sold, that Commentary does not protect situations where the enterprise uses the host State location to go beyond collecting information and to process that information into reports, and experience shows that a court will be quite capable of drawing that distinction.7

108. If the delegates believe that the exception should not be available where the information collected is primarily destined for processing into reports for sale to other persons, whether that processing takes place at the situs of the information collection or elsewhere, that objective could be achieved by revising existing Article 5(4)(d) in a more targeted fashion, without going so far as to delete completely from the exception the collection of information for the enterprise itself. A complete deletion of collection of information for the enterprise itself would potentially affect any number of locations used by MNEs to collect information for their own use (e.g., marketing research and information about market opportunities; information about sources of supply; information about political, legal, or regulatory trends or developments; information about customer use of the enterprise’s products and services; etc.). In each such case, a deletion of the reference to collecting information for the enterprise from Article 5(4)(d) would lead to difficult questions about whether the location where the information is collected is a fixed place of business of the foreign enterprise, whether the information collection activity is a preparatory or auxiliary for the enterprise concerned, and how much profit, if any, should be attributed to the activity of collecting that information for the enterprise itself.

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7 See, e.g., “Russian Court Rules on PE Determination Under Treaty With U.S.”, Worldwide Tax Daily, January 3, 2011 (2011 WTD 1-1; treating the Moscow bureau of Bloomberg news agency as a PE where the Moscow office not only collected information but also used that information to prepare articles that were included in Bloomberg’s databases made available to clients for compensation).
109. For these reasons, we oppose the proposal to delete both purchasing and the collection of information for the enterprise from Article 5(4)(d).

4.6 Options I and J – anti-fragmentation rules

110. We understand that while paragraph 27.1 of the Commentary on Article 5 already contains a rule against an enterprise fragmenting complementary activities into separate locations in order to argue that each is excepted from PE status as preparatory or auxiliary, the Focus Group was concerned about an MNE group fragmenting complementary activities among group members in order to allow each to argue that its activities are merely preparatory or auxiliary.

4.6.1 Aggregation across entities would represent a reversal of a fundamental aspect of the PE standard

111. Basing a determination of whether a company has a PE in a Contracting State by reference to the attributes or activities of other members of the company’s group would introduce a major change to the OECD Model. As recently as 2005, language was added to the Commentary on Article 5 (paragraph 41.1) to emphasize that this was not the correct approach: “The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.” In other words, the 2005 Commentary language was aimed at discouraging aggregation of activities by MNE group members in determining whether any one group member had a PE. When the OECD first proposed this clarification in 2004, they stated that it was a “widely held interpretation” and a “basic aspect” of the PE concept.8

112. If the OECD is contemplating a change to such a fundamental aspect of the PE concept, it should consider doing so only in situations that are very clearly defined. That is not the case, however, for the Option I and J proposals.

4.6.2 The standard for triggering aggregation is very unclear, could result in PE status arising in surprising circumstances, and presents serious compliance challenges

113. Both Options I and J would apply only if “the business activities carried on by the two enterprises at the same place, or by the same enterprise or associated enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.” The only guidance given on what constitutes “complementary functions that are part of a cohesive business operation” is a reference

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114. That single example does not help to answer a myriad of questions that could come up in trying to apply the proposed Options. For example, what if a Country A resident, Company A, which otherwise has no presence or activity in Country B, maintains a stock of goods belonging to it at affiliated Company B’s manufacturing plant in Country B solely for the purpose of allowing those goods to be processed by Company B? Would Company A’s maintenance of the stock of goods and Company B’s processing of those goods be considered “complementary functions that are part of a cohesive business operation” such that Company A would be treated as having a PE at Company B’s plant? Would that mean that a foreign enterprise would essentially always have a PE at a related contract manufacturer’s location? Or what if a Country C resident, Company C, which otherwise has no presence or activity in Country D, maintains a stock of goods belonging to it for the purpose of storage at a location in Country D and sells those goods, through negotiations and contract conclusions occurring exclusively at its home office in Country C, to related and unrelated distributors operating in Country D and elsewhere? Would that mean that Company C would be treated as having a PE at the storage location? Would such a PE be deemed to encompass all the goods, whether sold to related or unrelated distributors, and whether destined for the Country D market or beyond? It is not even clear under the existing guidance whether the activities in a country have to involve a complete commercial cycle, or whether they can represent only part of a business operation.

115. As another example, suppose Company A resident in Country A purchases components for hardware products from third parties and provides those on consignment to an unrelated contract manufacturer in Country B for inclusion in the final product which is sold back to Company A. The components are held at the contract manufacturer’s location in Country B until needed for assembly. Manufacturing hardware has never been a core competency for Company A. An affiliate of Company A in Country B, Company B, provides quality control oversight at the contract manufacturer’s location on behalf of Company A. Would these circumstances cause Company A to be treated as having a PE in Country B under Option I, on the theory that its affiliate Country B has a fixed place of business there, the storage of Company A’s components in Country B and the quality control by Company B are complementary functions that are part of a cohesive business operation, such that the storage of Company A’s components in Country B could no longer be treated as covered by an Article 5(4) exception? It would seem quite unreasonable to treat this highly common situation as creating a PE for a company such as Company A, but the proposal appears to make that possible (or at least creates unwelcome uncertainty).

116. Moreover, Option J would introduce an alternative anti-fragmentation that could be triggered even if no member of the group had a PE in the host State under normal rules, so long as the “overall
activity resulting from the combination of activities” at two or more locations was not preparatory or auxiliary and the business activities constitute complementary functions that are part of a cohesive business operation. This Option presents even more serious compliance challenges to MNEs operating internationally than Option I, due to the fact that it could be triggered by a combination of non-PE presences in a Contracting State.

117. For example, what if Company A, resident in Country A, has an office in Country B through which it purchases raw materials which are subsequently used by affiliated Company C in Country C to manufacture components, which are used by affiliated Company D in Country D to manufacture finished products, which are sold to affiliated regional distributors in Countries E, F, and G, and affiliated distributor G in Country G maintains a stock of the finished products at a warehouse in Country B for delivery to customers in neighboring countries I, J, and K. Are Company A’s purchase of raw materials in Country B and Company G’s maintenance of a stock of the finished products at a warehouse in Country B in combination more than “preparatory or auxiliary”, and are they business activities that constitute “complementary functions that are part of a cohesive business operation”? Is there any limit on how many degrees of separation there can be between two affiliates’ activities in order for them to be liable to be aggregated? Does the “cohesive business operation” of which the two activities are a part have to take place exclusively or primarily in the host State before the activities are aggregated under this approach?

118. Examples such as these amply demonstrate the over-breadth of these Options and the compliance challenges they pose to MNE groups, who would have to have some means of monitoring all activities carried out by each member of the group in a given country in order to determine whether the aggregation would be triggered. The challenges are particularly egregious under Option J, where the group would have to monitor activities of all members in a country even though no single member’s activity by itself went beyond being preparatory or auxiliary.

4.6.3 Profit attribution also present serious issues

119. As indicated above, whenever a PE is treated as existing in situations involving activities that are clearly or borderline preparatory or auxiliary, it can be quite difficult, especially given the virtually nonexistent guidance in this area, to reliably determine how much profit should be attributed to such a PE. The aggregation aspect of Options I and J presents, however, even more acute problems.

120. Once a host State decides to aggregate activities of multiple group members, potentially including group members from more than one country, in order to treat each group member as if it had a PE in the host State, concerns could arise about how the host State would attribute profits to the respective companies’ PEs. What guarantee would the group (or the countries of residence of its affected members) have that the host State would limit its aggregate profit attributions to the PEs to 100 percent of the total profits from the “cohesive business operation” in question? If the OECD decides, contrary to our recommendation, to proceed with any form of multi-entity aggregation in deciding whether individual companies within a group have a PE in a particular country, it should provide clear guidance on this point.
and some mechanism for resolving the potential multi-country disputes that could arise if the host State over-attributes profits to the PEs it deems to exist.

5. **Options K and L – splitting up of contracts**

121. The Discussion Draft suggests two options to avoid the splitting up of contracts among related companies in order to avoid the time threshold in the Article 5(3) construction site PE threshold or the optional service PE 183-day time threshold.

122. Option K involves aggregating time periods during which related parties carry on activities at the same building project or on “the same or connected” services projects. The Discussion Draft correctly identifies as a problem that this could create a PE for an enterprise whose personnel are active in the country for only a very short period if a related party is operating at the site or on the same or a connected project for a period equaling or exceeding the relevant time threshold.

123. As in the case of Options I and J, the proposal to aggregate the activities of separate (albeit related) entities to determine whether a PE exists for any one of them represents a major reversal of prior PE policy and should be considered only if the policy justification for the change is very strong and the conditions for its application are very clear. The problem example identified in the Discussion Draft certainly highlights the over-breadth of the automatic aggregation triggered by Option K, and the compliance challenges it would impose on any group. The difficulties are all the greater because of the uncertainty that surrounds issues such as whether activities conducted in a country by two separate affiliates are conducted on “the same or connected” projects. The criteria for determining that question have generated substantial debate, even in the context of activities conducted by a single entity, let alone separate entities. For example, recent debates in the UN Committee of Experts have revealed significant international disagreement on whether the “connectedness” of projects should be determined from the perspective of the supplier or recipient of services. 9

124. We certainly do not favor adding a new and difficult to administer multi-entity aggregation rule to the PE definition to address what we believe to be a highly unusual factual situation. If, however, the OECD proceeds with a provision along the lines of Option K to target the splitting up of contracts, we recommend that it include at least two “safety valves” to limit somewhat the compliance burden it would impose and to prevent its application in non-abusive cases. The first safety valve should provide, as suggested in the Discussion Draft, that the aggregation rule should not operate to create a PE for any enterprise whose activities in the host State do not exceed a minimum threshold; the Discussion Draft’s reference to a threshold of at least 30 days in a 12-month period should be an absolute minimum for this

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9 See Note “Article 5: the meaning of ’the same or a connected project’” (E/C.18/2014/CRP.11), UN Committee of Experts, September 30, 2014.
purpose. In addition, however – and not as an alternative – the provision should include a second safety 
valve to ensure that the aggregation rule would not operate to create a PE if it is established that obtaining 
the benefit of the relevant treaty time threshold is not one of the principal purposes for carrying on these 
activities through different enterprises.

125. The Discussion Draft says the aggregation under Option K would take place only for purposes of 
triggering the time threshold, and not for purposes of attributing profits to either affiliate. While we 
welcome this clarification, we note that the opposite result seems to have come to pass in the development 
of the aggregation rule for subcontractors in paragraph 19 of the existing Commentary on Article 5. 
Thus, a rule which began as saying that a contractor had to aggregate its time and its subcontractor’s time 
spent working on a construction site for purposes of determining whether the construction site time 
threshold was met came to be interpreted by the OECD to mean that the activities of a subcontractor were 
allocated to the contractor for general purposes under Article 5. Treating activities which are 
aggregated with an enterprise’s own activities as if they were actually conducted by that enterprise would 
have obvious implications for profit attribution to that enterprise.

126. Under Option L, as an alternative to Option K, the splitting-up of contracts would be addressed 
through an example in the Commentary in which a power plant construction company, RCO, divides a 
projected 22-month project between 2 contracts, one concluded by RCO and one by its newly created 
subsidiary, SUBCO (both resident in State R). While, as indicated above, we certainly agree that the 
affiliated enterprise aggregation rule should not apply where the separate contracts did not have as one of 
their principal purposes remaining under the applicable treaty time threshold, we are concerned that 
making the aggregation possibility entirely subject to the subjective standard set forth in the principal 
purpose test would create too much uncertainty for taxpayers. While we appreciate that the example 
selected to illustrate Option L provides some hints on how the subjective standard might be applied to real 
facts, we doubt that any single example could provide enough guidance on the potentially far-reaching 
aggregation approach to leave taxpayers with adequate certainty.

127. Accordingly, if forced to choose, we would recommend the objective trigger of Option K rather 
than the subjective trigger of Option L, provided, however, that Option K is amended to incorporate the 
double safety valve provisions described above. Moreover, under either approach to aggregating the 
activities of related companies to find the existence of a PE, we believe consideration should be given to 
sanctioning “administratively convenient procedures” by the host State, pursuant to which the host State 
would effectively treat only one of the companies as having a PE (e.g., the one with the longer presence in 
the host State) and would tax that company on the full amount of the income from the two contracts

10 See “Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)”, OECD, 
October 19, 2012.
attributable to the activities carried out in the host State. This would be comparable to the approach sanctioned by the OECD’s PE Profit Attribution Report for handling the taxation of dependent agent PEs and dependent agent enterprises\(^\text{11}\) and would help to lessen the administrative burdens of being found to have a PE under the either Option K or Option L.

6. **Options M and N – Insurance**

128. The IAPT has no comments on Options M and N.

7. **Profit attribution to PEs**

129. Our initial comment on this topic, which we also highlighted in our introduction, is that the extent of potential profit attribution to a particular type of PE should be an important factor in determining whether that type of PE should be included in a treaty (even if it’s not a factor in determining whether a PE article in an existing treaty applies to a particular case). This is important to ensure that there is an appropriate balance between host State taxing rights and the administrative burdens imposed on businesses. It is therefore critical that Working Party 1 consult closely with Working Party 6 as it takes forward the work on Action 7, and that no decisions are made on amending the PE definition until there is a reliable and clear consensus on the specific way in which profits would be attributed to the newly defined PE and a careful reflection on whether the amount of profits likely to be attributed to the newly created PE justify the compliance burdens imposed on both taxpayers and tax authorities as a result of having to apply the new definition.

130. The Discussion Draft is defective in not including a serious discussion of the PE profit attribution implications of the potential PEs created under the various options presented, particularly those that involve little or nothing in the way of functions, assets, or risks of the foreign enterprise allocable to the host State beyond those already compensated as a result of the use of agents or other parties in that State. The Discussion Draft indicates that preliminary work has been done on what additional profits would be allocated to the PE State as a result of the potential Action 7 changes to the definition of PE, but then, in a rather breath-taking example of understatement, it says only that this preliminary work “has identified a few areas were additions/clarifications would be useful”.

131. We are struck by indicators throughout the Discussion Draft that suggest countries believe there is a “pot of gold” to be obtained in making many of the proposed changes to the PE definition discussed in the document. We think any serious analysis of how the Authorised OECD Approach (AOA) applies to the proposed new forms of PE would lead to exactly the opposite conclusion, especially on the assumption, confirmed by the Discussion Draft, that no “substantial changes” will be made to the existing

\(^{11}\) See paragraph 246 of Part I of the *2010 Report on the Attribution of Profits to Permanent Establishments*. 

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rules and guidance on the AOA. It is therefore very troubling to think that decisions about revising the PE definition might be made based on fundamental misunderstandings of the PE profit attribution implications. It is particularly troubling when the changes are liable to lead to as much administrative burden, disruption, and controversy as the proposals contained in the Discussion Draft are liable to do.

132. An example of this misunderstanding is the implicit assumption underlying Options G and H that elimination of the Article 5(4) exception for purchasing would allow a PE State to tax all (or even most) of the volume discount obtained by a centralized purchasing branch, when in fact a correct application of the AOA and standard transfer pricing principles would cause the profit attributable to that discount to be shared by the associated enterprises that would actually be obtaining the purchased property through the centralized purchasing branch, and would leave the purchasing branch with only a fee for its services.

133. Another example relates to the apparent insistence on treating commissionnaires as PEs. Commissionnaires, which in most cases are entities resident and already taxable in the market jurisdiction, bear no inventory and generally no credit risk and have no need for any significant working capital. Their arm’s length remuneration, generally in the form of a commission, can typically be fairly easily determined by reference to available benchmarks. Paragraph 43 of the Discussion Draft says BEPS concerns arise because a commissionnaire has nexus but “is allocated limited profits because of low risk, whilst another member of the MNE group is shielded from tax by the technical operation of the PE rules and is allocated a large share of the relevant group income (e.g. by virtue of assuming or being allocated business risk, of holding valuable assets, etc.)”. This alleged concern does not explain why these results are inappropriate if the substance aligns with the risk allocation, an issue to which the AOA devoted much attention, particularly with its focus on where the significant people functions take place that are relevant to the assumption or management of risk and to the economic ownership of assets.

134. What has become evident in practice, however, is that some governments that are asserting that commissionnaires create PEs for their foreign principals under existing treaty definitions have had a tendency to attribute to the alleged PE a much larger amount of profits than is justified under the AOA. For example, they have a tendency to try to attribute to the PE all the income from intangibles owned by the foreign enterprise, without taking into account the fact that the significant people functions relevant to the economic ownership of those intangibles may be carried out outside their jurisdiction.

135. We perceive a substantial risk that a failure on the part of the OECD to analyze seriously the specific profit attribution implications of each of the various options for amending the PE definition will inevitably lead to unrealistic expectations on the part of a number of governments as to the revenue to be potentially derived from those changes. That will in turn lead to ill-considered decisions about whether to make those changes and ultimately to a long period of costly disputes.
ANNEX 2

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON ACTION ITEM 7 OF THE JULY 19, 2013 BEPS ACTION PLAN

OCTOBER 16, 2013
ACTION 7 - Prevent the artificial avoidance of PE status

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

Action 7 of the Action Plan states that the OECD Model Convention definition of PE will be changed to “prevent the artificial avoidance” of PE status, including through the use of commissionaire arrangements and the specific activity exemptions. Although the meaning of “artificial avoidance” is not explained, the background discussion accompanying Action 7 expresses specific concern regarding the manner in which current Article 5 guidance on dependent agency PEs applies to commissionaire arrangements and suggests that the use of a commissionaire arrangement instead of a distributor arrangement constitutes an “abuse” in at least some circumstances, because it permits the “shifting of profits” from the jurisdiction. The discussion also expresses general concern regarding the “artificial fragmentation” of activities among entities to qualify for the preparatory or auxiliary exceptions from PE status for specified activities, again without indicating what is considered to constitute “artificial fragmentation”.

Action 7 thus differs from the general approach of the Action Plan in that it signals specific conclusions in advance of the technical work slated for the next two years. PE concerns were not noted in the February 2013 BEPS Report, so their introduction in the Action Plan also came as a surprise. Although no specific proposals have been put forward on the PE elements of the BEPS project, the IAPT would like to take this opportunity to offer some general perspectives on PE issues.

There is an Urgent Need for Clearer and More Consistent PE Guidance

As noted in the IAPT’s comments of 8 April 2013, a primary challenge that businesses face in implementing existing treaty standards is how to achieve certainty regarding the application of certain poorly defined standards to common commercial arrangements and transactions. A prime example of this is the interpretation of the Article 5 PE threshold, which is generating an ever-increasing volume of assessments by and cross-border controversies with both OECD and non-OECD members.

Although the OECD has revised its PE guidance five times in little more than a decade and has done substantial work in the past several years on current interpretative issues, it unfortunately has tended to fall short in responding to the repeated requests of business in recent years to confirm the application of Article 5 to increasingly common situations or in discouraging countries from pursuing heavily questionable interpretations of existing text. We understand that work on the current WP1 project on Article 5 interpretive issues has now been suspended pending work on the BEPS project. Given the
apparent inability of the OECD to lead the way to a consensus on the treatment of even common business scenarios such as multi-jurisdictional contract approval processes or the use of purchase orders or statements of work under a master agreement framework, business is often faced with unattractive options for dealing with these challenges, including engaging in costly analysis to try to achieve greater certainty, devoting increasingly significant resources to dispute resolution, or simply refraining from certain cross-border activities, the conduct of which tax treaties are designed to foster.

Existing uncertainties have already been exacerbated because of the revisions to the PE standard that have been tabled in connection with the BEPS project. For example, at least one OECD member tax administration has indicated that it plans to terminate its bilateral APA agreements on commissionaire structures, citing the BEPS project as the ground, and some are already issuing substantial assessments premised on the changes to the PE definition that have only just been tabled for discussion in that project. Others are continuing to maintain positions that are inconsistent with the application of the current treaty provisions by most major taxing jurisdictions and their interpretation by the OECD Commentary and by the weight of recent supreme court decisions, and are declining to engage constructively in MAP discussions of affected cases. These trends have created levels of uncertainty and controversy that are becoming untenable from a business perspective.

- **The BEPS Project Is Not Well-Suited to Addressing PE Threshold Issues**

The absence of PE issues from the February BEPS Report was not surprising. As Action 7 acknowledges, it contemplates changes to the PE definition in both the OECD Model Convention and the texts of existing bilateral treaties. These are not anti-base erosion or anti-profit shifting measures, at least in the sense in which those terms are otherwise understood. Rather than addressing base erosion or profit shifting concerns under current law, the changes announced by Action 7 would instead create new rules that shift the respective tax bases of residence jurisdictions and would-be PE host jurisdictions.

While it is clearly the prerogative of tax policymakers to revisit the current PE threshold if desired, this undertaking is of a different nature that does not fit well within the parameters of BEPS project. Indeed, the IAPT respectfully submits that the opportunistic use of the BEPS project to address non-BEPS concerns through direct changes to the current balance of taxing jurisdiction could set an unfortunate and dangerous precedent for jurisdictions inclined to press overreaching claims to taxing jurisdiction. We would recommend that such changes be considered very carefully and that the concepts of “artificial avoidance” and “artificial fragmentation” be construed with restraint.

- **Such Significant Changes to the Current PE Threshold Would Also Require the Development of New Consensus Guidance on the Attribution of Profits**

As the Action Plan recognizes, the changes contemplated by Action 7 would also raise related profit attribution issues that would need to be addressed. The IAPT agrees and respectfully requests that, to avoid creating new uncertainty and controversy, no significant change should be made to the current standards for what constitutes a PE without the publication of accompanying new consensus guidance on how profits are to be attributed to that new form of PE.
Unfortunately, as the Secretariat has acknowledged, the track record on prior attempts to develop such consensus on Article 7 issues has been long and difficult. This was presumably due both to the complexity of the issues and to the difficulty in achieving international consensus. In our experience, even the extensive guidance on profit attribution issued by the OECD in 2010 has met with limited acceptance among tax jurisdictions in practice. Given the challenges involved, it would, therefore, seem essential for work on profit attribution issues to proceed immediately as well and to be very closely coordinated with the discussions regarding the PE threshold.

- **Implementation of Changes**

Given the nature of the contemplated changes, both current law and basic concepts of fairness and due process should require that any change made to treat commissionnaires (or other arrangements) as creating PEs, or to introduce other substantive changes to the dependent agency provisions, the preparatory or auxiliary exceptions, or other aspects of the PE threshold both:

(i) be made in the text of the applicable treaty, and

(ii) be made expressly applicable only for taxable periods beginning after the entry into force of the relevant treaty.

Given the contrary actions taken in some jurisdictions already, it would be very helpful for the OECD to make both of these points clear at this juncture so that the Action Plan does not create additional controversy in the interim.
Comments to the OECD Discussion Draft on BEPS Action 7
“Preventing the Artificial Avoidance of PE Status”

The International Chamber of Commerce (ICC) welcomes the opportunity to provide comments on the Discussion Draft regarding BEPS Action 7 ‘Preventing the Artificial Avoidance of PE Status’. While ICC acknowledges that there are clear BEPS related concerns in this area, an expansion of the definition of a PE poses very high risks of conflicting claims of taxing jurisdiction and double taxation.

There is a concern that a project intended to tackle BEPS is resulting in a wider reconsideration of the allocation of taxing rights between source and residence countries. This will result in an increased risk of double taxation in non-abusive circumstances unless there is a very clear consensus as to the precise detail of how the new approach will be applied, including objective (rather than subjective) criteria and “bright lines” tests, supported by clarifying examples. Proposals currently laid out in the Discussion Draft are subjective in nature and lacking the necessary objective criteria and “bright lines”.

ICC agrees with the comments provided by BIAC regarding the importance of further considering the attribution of profits to PEs. The practical application of the Authorized OECD Approach for the attribution of profits to Dependent Agent PEs for industrial businesses is already extremely challenging, with authorities often resorting to arbitrary formulary apportionment methods. Such existing difficulties highlight the importance of addressing attribution issues. The Discussion Draft dismisses, as insubstantial, the issues relating to attributing profits to these new PEs.

To the extent that a PE is ‘virtual’ or essentially ‘virtual’ because functions, assets and risks of that PE are minimal, no significant profits should be attributed to that PE. Countries may, however, attempt to use such ‘marginal PEs’ to attribute significant profits based on the value of the market or some other attribution theory. Broad PE rules, combined with a lack of attention to profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed. This will inevitably result in double taxation.

The Discussion Draft seeks to address artificial avoidance of PE status through the use of commissionaire arrangements and similar strategies. Commissionaire arrangements, and other arrangements involving dependent agents, are quite frequently employed in non-abusive cases. A proposed restrictive version of the independent agent exemption is included in all of the four alternatives discussed. To assert that an agent may never be of independent status where the agent works exclusively, or almost exclusively, for associated enterprises, even in commercially justifiable situations goes substantially beyond the scope of the BEPS project. Lowering the dependent agent threshold below the ‘concluding contracts’ test is likely to widen the scope of the rule considerably, and introduce greater subjectivity into the determination of whether a PE exists in any particular case. ICC strongly believes that this will not only impact commissionaire arrangements, but also a wide range of arrangements used for making direct sales or providing sales support, i.e. limited risk distributor and other principal structures. Furthermore, appropriate weight should be given to the nature of the activities and the functions being performed, outside the territory in which the PE is argued to exist. In such instances, where significant substance and activities do take place outside the territory, ‘bright line’, objective tests or gateways could perhaps be used to exclude the existence of a PE. ICC suggests that there is a strong case for applying the existing rules where there is no intended abuse and where arrangements, often of long standing nature, represent an efficient way of conducting business.

All of the options considered in the Discussion Draft are likely to have unintended consequences. ICC is particularly concerned that investment and cross border trade may be discouraged, for example, if an enterprise were to close a representative office because of the risk of PE characterization, or the application of ‘force of attraction’ principles. Some of the proposals risk piercing the corporate veil in relation to the aggregation of what may be functionally unrelated business activities.
It is key that activities which are genuinely of a preparatory or auxiliary nature should be excluded from the definition of a PE. This is why in there is support for the inclusion of the final words, as indicated in paragraph 15: “provided that such activity, or in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character”. But it has to be noted, that with this amendment the clarity of the former exclusion will be replaced by a ‘test’ which is open to subjectivity. There is concern that this test, in the absence of the detailed provisions, could be approached by tax authorities in an excessively subjective way, giving rise to a proliferation of PEs the overall test should not displace the specific tests.1

ICC does not support the deletion of the word “delivery” from subparagraphs a) and b) of paragraph 4 because the mere “delivery” activity, in isolation, of a non-resident enterprise should not be regarded as a sufficiently substantial link with a country for a PE to exist.

ICC does not support the deletion of subparagraph d) of paragraph 4 of Article 5 dealing with purchasing goods and collecting information. ICC believes that the maintenance of a fixed place of business solely for the purchasing of goods or collection of information is not by itself sufficient to trigger the existence of a PE. However, if the concerned enterprise exports goods to a jurisdiction other than the residence country the source country might more appropriately attribute profits to that fixed place of business, which would most likely result in double taxation.

As regards the collection of information, ICC believes that a functional analysis would be required to determine whether this activity is a core function of the enterprise, or of a preparatory or auxiliary nature. If information is provided gratuitously to an enterprise, it may not be practical to tax the profit of a PE as valuation and attribution would be extremely difficult and in any case the profit attributed to the PE would be very modest as more profit would be attributable to functions carried on elsewhere. This is even more so if the information is provided remotely by third parties.

Various options are presented in the Discussion Draft to address the artificial splitting of contracts. The principal purpose test has the advantage of ensuring that in cases where contracts are separate for wholly commercial purposes the enterprise is not inappropriately deprived of the benefit of the “preparatory or auxiliary” test. The Treaty should allow for cases where there are genuinely separate contracts either for particular commercial reasons, because of the way in which the particular business has developed, or for administrative, regulatory or other such reasons.

ICC does not support the addition of a new paragraph 4.1 to Article 5 mentioned in paragraph 31 of the Discussion Draft. Such a proposal would fail to recognize that associated enterprises may perform preparatory or auxiliary activities. Such a new paragraph could result in the automatic creation of a PE for the non-resident enterprise concerned, even if there is no actual business activity of that enterprise in the source country.

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1 This is not the view of the US Council for International Business (USCIB). USCIB feels that the specific exclusions should be preserved without this qualification in order to avoid a proliferation of PEs in cases where existing law and practice has provided a clear outcome.
Marlies de Ruiter, Head, Tax Treaties,
Transfer Pricing and Financial Transactions Division,
OECD/CTPA

We refer to the Proposed Discussion Draft “Preventing the Artificial Avoidance of PE Status” dated 31 October, 2014 (the “Discussion Draft”), which includes the preliminary results of the work carried on with respect to Action 7 of the BEPS Action Plan, concerning issues related to the artificial avoidance of PE status. The Discussion Draft includes proposals for changes to the definition of permanent establishment (“PE”) found in the OECD Model Tax Convention. We are submitting this paper in response to the request by the Committee on Fiscal Affairs for comments on the Discussion Draft.

These comments represent the views of the International Tax Group, an organization that since 1970 has dedicated itself to advancing the study of international tax law and the publication of co-authored tax articles in respect thereof.1

Our comments below follow the outline of subjects in the Discussion Draft.

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1 The International Tax Group is comprised of the following members: Stéphane Austry (France), Philip Baker QC (UK), Peter Blessing (USA), Robert Danon (Switzerland), Shefali Goradia (India), Koichi Inoue (Japan), John Avery Jones (UK), Jürgen Lüdicke (Germany), Guglielmo Maisto (Italy), Toshio Miyatake (Japan), Angelo Nikolakakis (Canada), Kees van Raad (the Netherlands), Richard Vann (Australia), and Bertil Wiman (Sweden).
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A. Artificial Avoidance of PE Status Through Commissionnaire Arrangements and Similar Strategies

1. Perceived Problems

A great deal of attention has been paid to the use of related commissionnaires by a foreign enterprise to sell goods in local markets permitting the enterprise to avoid a PE nexus yet derive the profit other than a relatively small selling commission, which may be based as a cost-plus transfer pricing methodology or may be sales based. Court cases of France, 2 Norway 3 and Italy 4 have confirmed that this represents a valid interpretation of the PE definition under existing treaties. They indicate that the use of the commissionnaire structure is not generally an “artificial” avoidance of a PE, although it may at least in certain cases be considered an avoidance.

The concept of commissionnaire is found in civil law countries with the background of more than six centuries’ historical development, but is foreign to common law countries.

The OECD Committee of Fiscal Affairs has been tackling for some time the question of whether a commissionnaire gives rise to a PE. While most of the attention has been on the commissionnaire relationship, the Focus Group is addressing the matter on a broader basis. The Discussion Draft contemplates enlarging the scope of Paragraph 5 of the PE definition in Article 5 (referred to herein as “agency PE”) to include arrangements other than the commissionnaire structure. 5

The Discussion Draft articulates the basic policy objective of Paragraphs 5 and 6 of Article 5 as follows (“Statement of Policy”): “As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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.” (Emphasis added.) We understand that there is substantial agreement among the relevant OECD member States and participating G-20 States in respect of this articulation. 6

In commenting, beyond some observations on scope, we do not undertake to question this description of policy, but rather accept it as a given and evaluate drafting alternatives as best we can through this lens. We confess to some misgivings in this exercise, however, considering that

3 Supreme Court of Norway, Dell Products (NUF) v. Tax East, 2 December 2011, 14 ITLR 371
4 Supreme Court of Cassation, Boston Scientific International BV v. Italian Revenue Agency, 9 March 2012, 14 ITLR 1060
5 However, it does not appear that the Discussion Draft targets so-called low risk distributors, as noted below.
6 We, however, note the release of legislative proposal regarding a “diverted profits tax” by the UK Government, which would impose taxation on certain arrangements that involve UK activity but avoid a PE. The UK approach creates a domestic law concept of “avoided PE,” which has the practical effect of enlarging the scope of the agency PE concept.
there is little direction either in the Statement of Policy or in the wording of the alternative, proposed rewordings to guide the drafting process. We believe that the crafting of a properly scoped and targeted revision has to be based on the fact patterns that cause concern and are intended to be covered and that, until those are concretely identified, drafting the revised language is premature.

We also provide in this paper a rather elementary matrix that is intended to illustrate how selected fact patterns would fare under various alternative revisions of Paragraph 5. A couple of these seem intended to be covered, a few seem to be not intended to be covered and a few leave us without a clear view. We do not find reliable guidance in the use of the word “artificial”, as the clear example of a targeted arrangement is the commissionnaire structure, which is a creature of statute and has long existed under the laws of a number of countries, as noted above. We infer from that fact that, to some undefined extent, economic realities are intended to be reflected in the revisions.

Under such circumstances, we are unable to express a preference for a particular proposal or confidently suggest drafting revisions.

2. Summary of Options in Proposed Discussion Draft to Revise Paragraph 5

The Discussion Draft notes that the Focus Group on the Artificial Avoidance of PE Status has discussed various alternative formulations of Paragraphs 5 (and 6) of Article 5 of the OECD Model Tax Convention that would reflect the above referenced policy concerns and would attempt to disallow certain perceived avoidance strategies that are observed currently. Four of these formulations are set forth in the Discussion Draft as alternative “Options” that the Focus Group is currently considering. We comment briefly on those below.

Each of the four Options targets two concepts of the Paragraph 5 formulation that are perceived by the Focus Group to overly limit the scope of the PE definition. The proposals would retain contracts as the focal point but would (i) eliminate the requirement that the contracts be in the name of (legally binding on) the enterprise (the “Name” standard) and (ii) eliminate the requirement that the contracts be concluded in the source Contracting State (the “Conclusion of Contracts” standard) (as well as the need for any authority to conclude contracts). The four Options reflect the four permutations represented by the two alternative formulations presented in the Discussion Draft to replace, respectively, the two requirements proposed to be eliminated.

Each of the Options would result in significant changes in the operation of Paragraph 5. The locally-concluded, and binding-on-enterprise, contract conditions have operated for decades as

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7 See part 4.f, infra.
8 See, e.g., part 4.a.ii, infra, for a discussion of some uncertain cases.
9 The League of Nations did not have contracting as the central part of the agency PE and had the concept of PE by reason of a person holding a stock of goods for delivery on behalf of an enterprise (“delivery agent PE”). The delivery agent PE was in the original OEEC draft but was dropped before the draft was concluded. The UN Model still has this variant, which also is found in a significant number of treaties (28% of treaties concluded between 1997 and 2013). Wim Wijnen and Jan de Goede, IBFD, “The UN Model in Practice 1997-2013,” (2014) Bulletin for International Taxation p.124).
the threshold for the agency PE. Nevertheless, if one proceeds from the Statement of Policy as representing a consensus view by the relevant Governments, then the Focus Group’s conclusion that the current wording of Paragraph 5, and in particular the requirement that a person in the source State conclude contracts binding on the enterprise, is inadequate to achieve such policy objectives necessarily follows.

We believe that it should be made clear that any changes to the text of the Model are intended to have no effect on the interpretation of treaties concluded using the current language of Article 5. We consider that such a statement is important as the courts of some countries treat changes in the Model as clarifying, rather than changing the meaning; indeed changes to the Model are sometimes explained in the Commentaries as clarifying, such as the change to Article 3(2) in 1995. When changes are indeed intended to change the meaning, then the Commentaries should make that clear, as did the Commentary on the change deleting equipment leasing from the definition of royalties in 1992.

a. **Option A**

Option A would revise Paragraph 5 in particular to include not only contracts made in the name of an enterprise, but also contracts for the provision of property or services by the enterprise even if they are not made in its name (the “Name or Subject Matter” standard). It also would replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts” (the “Activities Resulting in Contract” standard). The proposed revised provision would read as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts

   a) in the name of the enterprise, or
   b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
   c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless [the activities would be exempt under paragraph 4.]

b. **Option B**

Option B would revise Paragraph 5 in particular to include contracts for the provision of property or services by an enterprise even if they are not made in its name. It further would replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts” (“Material Negotiations” standard). The proposed revised provision would read as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise
and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, that are

\[ a) \text{ in the name of the enterprise, or} \]
\[ b) \text{ for the transfer of the ownership of, or for the granting of the right to use,} \]
\[ \text{property owned by that enterprise or that the enterprise has the right to use, or} \]
\[ c) \text{ for the provision of services by that enterprise,} \]

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless [the activities would be exempt under paragraph 4.]

Essentially, Option B would include the Name or Subject Matter standard of Option A but would depart from Option A by substituting a Material Negotiations standard for the Activities Resulting in Contract standard.

c. **Option C**

With respect to Paragraph 5, Option C would replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise” (“Account and Risk” standard). It also would replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts.” The proposed revised provision would read as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless [the activities would be exempt under paragraph 4.]

Essentially, Option C would combine an Accounts and Risks standard, for the degree to which the contracts must commit the enterprise, with the Activities Resulting in Contract standard of Option A, for the triggering activities.

d. **Option D**

In respect of Paragraph 5, Option D would replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise,” and replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts.” The proposed revised provision would read as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of
contracts, which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless [the activities would be exempt under paragraph 4.]

Essentially, Option D combines the Accounts and Risk standard of Option C, for the degree to which the contract must commit the enterprise, with the Material Negotiation standard of Option B, for the triggering activities.

3. Preliminary Comments

a. Limited Scope of Action 7 Undertaking

Each of the four Options would retain the requirement of a nexus based on contracts for an agency PE. The focus on contracts in the Options mirrors the Statement of Policy set forth in the Discussion Draft and quoted above.

Acknowledging that the scope of Action 7 as embodied in the Statement of Policy in the Discussion Draft is intended to be framed in terms of the conclusion of contracts, it also is evident from the Statement of Policy that, within that scope, an initiative at least somewhat more ambitious than simply treating commissionaires as PEs is contemplated. Further, if this were the only issue, there could simply be a rule deeming a commissionnaire to be a PE, which is not even an option proposed for consideration.

A further issue arises from the economic indivisibility from a practical standpoint of the business activities of typical multinational enterprises, which undercuts the rationale for viewing group members as separate enterprises. Nevertheless, the OECD position as reflected in the Commentaries has been that activities of associated enterprises are not taken into account for determining PE status, although those activities themselves may meet the agency PE standards. In view of the Statement of Policy (that taxable nexus generally should result if “the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise”) as well as the wording of certain of the Options, the activities of associated enterprises could become much more relevant to the PE status of a foreign enterprise.

b. Elements of Agency PE

In determining the agency PE formulation, it is useful to review briefly the factual and conceptual criteria that are used in the Options (in some cases as alternatives), for their relevance in making the policy determinations as to where to consider drawing lines when examining particular fact patterns.

10 Commentaries, Art. 5, par. 41.1 (added in 2005 following the decision by the Italian Supreme Court (Corte Suprema di Cassazione) in the Philip Morris case, Supreme Court Decision No. 7862 of 25 May 2002). Some other options in the Discussion Draft include provisions for reversing this approach in quite specific circumstances (Options I, J and K).
In adopting a formulation, an important consideration should be the likelihood that at least the large majority of States are likely to accord the same general meaning to the words, and that the application be as uniformly applicable to enterprises across industry lines as reasonably possible.11

i. Contracts as reference point

Each of the Options, as noted, ties back to contracts. Accordingly, we assume herein that the alternative of not making reference to contracts, as in the case of the proposed UK diverted profits tax, is not under consideration.

ii. Conclusion or negotiation of material elements of contracts in the source State

Proceeding from the contract requirement, two of the Options also would require that the action in the source State actually involve “touching” contracts (either negotiating the material elements of them or concluding them), and thus are more familiar terrain. Two would look to other, unspecified activities.

iii. Acting on behalf of

Consistently with existing Paragraph 5, each of Options A through D describes the person in the source State as acting “on behalf of” the enterprise. The key words in each case are: “is acting…on behalf of an enterprise and, in doing so…..” Normal rules of construction of legal language would suggest that these words be given meaning and not viewed as mere surplus verbiage.

This raises the question under what circumstances a person can be considered to be acting “on behalf of” (“pour le compte” de in the French version) an enterprise while at the same time acting in its own business for profit and in that sense for its own account. On the one hand, a common law commission agent and a civil law commissionnaire generally may be thought of as acting on behalf of another person even though in doing so it generally would be operating a separate enterprise as well. Further, the proposed change to Paragraph 612 necessarily implies that a person can be acting in its own business but nevertheless be within the scope of Paragraph 5. On the other hand, in a buy-sell arrangement (e.g., a distributor, whether or not low risk), the purchasing entity generally is not considered to be acting “on behalf of” the seller and that would not seem different where the relationship is exclusive and the parties are related. The question is whether any limits on that distinction are being suggested for purposes of Action 7. A great deal turns on this question, and so clarification of the meaning of “on behalf of” is essential, given that contracting by the agent in a way which legally binds the principal will no longer be necessary under Options A-D.

iv. Legal relationship

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11 Special rules have been found desirable for certain industries, such as extractive industries, construction and insurance.

12 Discussed below at part 6.
Closely related to the concept of “on behalf of” is the new formulation of a “legal relationship”. Two of the Options—the Options that include the Account and Risk Standard—would expressly include a legal relationship requirement, which require that the “account and risk” status arise by reason of the legal relationship, but not necessarily that the representative have the ability to contractually bind the foreign enterprise. We wonder whether such a legal relationship is intended to include, e.g., an arrangement, express or implied, to purchase and distribute goods to a particular market. Based on the fact that the Discussion Draft makes no reference to Paragraph 7 of Article 5, it appears that the control relationship between associated enterprises would not be considered such a legal relationship.

v. On the Account and Risk

Also closely linked to the concept of “on behalf of” is the new formulation of “on the account and risk.” The term “on the account of” is for us one without clear precedent in tax law parlance (in English at least (compare “pour le compte de” in the French version of the Model as the equivalent of “on behalf of” or “for the account of”) but involves a very similar and perhaps synonymous concept as “on behalf of.” We discuss this term further below in connection with Option C.

The concept of risk is at least a term familiar in many tax law contexts (transfer pricing, special rules for limited recourse loans, etc.), though it is often accompanied by some objective criteria for determining whether and to what extent a person is at risk. In the current context, the question is to what extent the enterprise needs to bear risk to satisfy the test, especially given that many transactions involve various kinds of risk which may be distributed among the parties by type or in other ways. For example, if a person in the source State bears independent risk in connection with the representation, the question is to what extent that fact cuts against an “on behalf of” and “risk” requirement, and vice versa. This may be illustrated by a commissionnaire or other agent that acts in a del credere capacity.13

vi. Habitually Acts

Consistently with existing Paragraph 5, each of the Options includes the traditional requirement that the action be habitual.

vii. Engages with Specified Persons in a Way that Results in the Conclusion of Contracts

This is a novel phrase that is used in two of the Options as an alternative to concluding or negotiating the material elements of contracts. We discuss this language below in connection with Option A.

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13 An agent del credere refers to an agent that, in consideration of an additional premium or commission, engages, when he sells goods on credit, to indemnify his principal with respect to the solvency of the purchaser, and to pay the debt itself if it is not punctually discharged by the buyer when it becomes due. In France, such an agent is referred to as ducroire, in Germany as Delkredere (the relevant clause is referred to as Delkredereprovision) and in Italy as star del credere.
c. Observations Regarding Collateral Consequences

We note here very briefly a few collateral concerns associated with a lower PE threshold.

One concern is that a widened PE definition, combined with new standards that are ambiguous or subjective and thus require exercise of judgment, increases the chances that local tax authorities may be inclined to assert inappropriate positions, which could take years to resolve.

A second concern is the risk of double taxation given the introduction of new terms, as to which tax officials and courts in various States may take differing views.

Third, a lower PE threshold means additional instances in which traveling employees of an affected enterprise may be subject to tax in the source State without regard to any day limit, by reason of clause (c) of Paragraph 2 of Article 15. It is important for the OECD to recognize that the PE test has several quite different applications in the Model and is relevant not only to Article 7.

Fourth, we believe there may be ramifications for the application of the VAT, which could create an unnecessary burden to foreign enterprises conducting business in the source State. In the EU VAT Directives, the meaning of "fixed establishment" (which in the French version is the same expression as used for a PE ("établissements stable")) is not the same as the definition of a PE. However, it would be unfortunate if the broadening of the PE definition for income taxes might suggest a broader meaning of "fixed establishment" for VAT purposes.

A fifth concern is avoiding income tax compliance burdens that are not justified by the targeted arrangements. We believe that compliance issues can be managed by de minimis exceptions and permitting delegated filing by local company on behalf of other group members, and so would view this issue separately from whether the substantive components of a revised allocation of jurisdiction for business profits can be agreed. We discuss this briefly below.

d. Modular Relationship of Proposals

As noted above, each of Options A through D retain the concept that a nexus based on contracts is needed, and represent the four permutations of the selected alternative formulations for the two requirements in the existing contract formulation proposed to be replaced.

Each of Options A through D would eliminate the requirement that the relevant contracts be binding on ("in the name of") the enterprise. Two would replace the Name standard with the Name or Subject Matter standard and two would replace the Name standard with the Account and Risk standard. The Name or Subject Matter standard in effect would eliminate the requirement that the contract be legally binding on ("in the name of") the enterprise and instead include also contracts for, e.g., the “transfer of ownership of property” or “provision of services” by the enterprise even if they are not legally binding on it (in its name). The alternative Account and Risk standard in effect would eliminate the requirement that the contracts be legally binding on...
on the enterprise and replace it by an economic nexus standard (contracts that are “on the account and risk of the enterprise”) but only if the contracts with that nexus result from “the legal relationship between that person and the enterprise.” Selecting either of these alternative formulations would appear to capture the commissionnaire relationship.

Second, each of the four Options would change the action in respect of a contract that must occur in the source Contracting State in order to result in an agency PE. Two would replace the “Conclusion of Contracts” standard with the broad Activities Resulting in a Contract standard and two with the narrower Material Negotiation standard. The Activities Resulting in Contract formulation would replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts.” The alternative Material Negotiation standard would replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts.” These alternative formulations (to the extent they go beyond the mere conclusion of contracts) do not appear to be required to address concerns with the commissionnaire structure, as that apparently would be addressed adequately by the first set of alternative proposed reformulations discussed above and involves actual conclusion of a contract in the source State. These proposed changes appear designed to target arrangements of other sorts, such as activity of one kind or another (the Discussion Draft is unclear on exactly what kind), short of concluding a contract, by an employee or other representative of the foreign enterprise in a source State.

4. Comments on Specific Options

We discuss each Option in turn, and illustrate the Options using a matrix for certain paradigmatic cases.

a. Option A

i. Replacement of Name Standard by Name or Subject Matter Standard

As noted, the Name or Subject Matter formulation in Option A in effect would eliminate the requirement that the contract be legally binding on (“in the name of”) the enterprise and instead include also contracts for, e.g., the “transfer of ownership of property” or “provision of services” by the enterprise even if they are not legally binding on it.

We understand the purpose of this alternative is to link the contract economically to the enterprise and yet not require that it be legally binding on the enterprise. Thus, a causal condition (“results”) is included. The meaning of that term, however, is very unclear, as there are various degrees of causal proximity. Further, we question whether a PE should result even if the property is not exported to or sold within the source State or the services are not provided in the source State.

On the other hand, words are added that may be over-limiting in terms of the intended purpose. For example, the Discussion Draft notes in connection with the Paragraph 4 exceptions that procurement activities may be part of the core business of an enterprise. Procurement activities may involve services (i.e., in the case of certain group procurement companies), the purchase of property for purposes of sale (to associated enterprises or to others), or the purchase of materials used by the enterprise in the production of products. Neither “the transfer of ownership of
property” owned by the enterprise nor “the provision of services” by the enterprise (the formulations under Option A) would include the acquisition of property for export for the enterprise’s use in its production activities in a different State, or the acquisition of property for export and for sale by the enterprise in a different State or on the high seas. In turn, these possibilities raise the question whether the language is intended to deal with contracts with unrelated entities only or is intended to include contracts with associated enterprises. Depending on the policy determination made with respect to the Paragraph 4 exception, conformity of the language with the agency PE language may be needed.

Similarly, in certain States, the term “services” might not cover every activity which is not a supply of goods. For example, it might not encompass the core activities of lending or insurance enterprises. In this regard, the drafting should make clear that provision of services is intended to cover everything that is not an acquisition or supply of goods, if that is the intended meaning.

ii. Replacement of Conclusion of Contracts Standard by Activities Resulting in Contract Standard

The Activities Resulting in Contract formulation in Option A would replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts.”

We first note that, as compared with the alternative Material Negotiation standard discussed below, the Activities Resulting in Contract standard would cover much more ground. We caution that such an approach, if adopted, be based on a thoughtful consideration of relevant policies. We express no views on that point.

As a matter of how the proposed language might operate, we are concerned about the breadth and imprecision of the words “engages with specific persons in a way that results in the conclusion of contracts” (for the provision of goods or services by an enterprise). The proposed phrasing is intended to not require actual entry into a contract binding on an enterprise of the other Contracting State. An action leading to a binding contract under which the foreign enterprise transfers ownership of property or provides services is intended to suffice. But what is intended by the term “engages with specified persons”, which seems to have no limits? Further, the wording (“in a way that results in”) does not appear to require that such action itself cause the result but implies that a contributory effect is sufficient. There is no defined point that is identified as sufficiently tied to the referenced result, nor do we think one could be defined, other than by reference to negotiations, as discussed below. In many cases, if not the typical case, there would be a variety of activities that could be said to be a contributing factor or even to have that result, at least in the sense of being an element in the chain.

As an example, consider a person in a Contracting State interacting on behalf of an enterprise of the other Contracting State with a potential customer concerning information about the attributes of the product or service, or date of anticipated delivery, required by the customer in order to make a purchase decision, or such a person providing instructions on how to place an order. And what about a marketing agent? Are these cases intended to be covered?

Another example is a party that brokers a transaction on behalf of a foreign enterprise with a third party (brings the parties together but does not play a material role in negotiations). Such a
person (courtier in French, Makler in German, mediatore in Italian) would seem to fit within the language of the Activities Resulting in Contract standard.

Consider the example of a low risk distributor (“LRD”) in a Contracting State that solicits an order for the sale and delivery of goods and to fill that order immediately orders and receives delivery of the goods from a related enterprise in the other Contracting State. Our reading of the Discussion Draft suggests that it is not intended to include “buy-sell” arrangements, such as sales through low risk distributors. Without expressing a judgment on that, we note that the new wording of this alternative may be broad enough to bring such arrangements within its scope, as there is a direct casual effect (back-to-back) in this example and the words do not specify any particular transferee of the goods owned. On the other hand, Option A (as each Option) retains the current language requiring, as part of the definition of an agency PE, that the local entity “on behalf of” the foreign enterprise, which traditionally has been viewed as not being the case as long as there is some modest economic benefit derived by the local entity. Even if there were an intention to cover this situation, the degree of causal connection becomes less clear to the extent the distributor not only bears customer credit risk but also maintains a stock of inventory for its own account and so bears inventory risk.

We understand that in certain cases the local activity may be excluded as preparatory or auxiliary. In many other cases, however it would be part of the regular, core activity of the enterprise. In any event, we are concerned about adopting perhaps unnecessarily vague, agency PE language that then results in overreliance on the imprecise phrase “preparatory or auxiliary.” At the same time, we recognize that broadening the PE definition in any manner perforce places some additional weight on the preparatory and auxiliary exceptions and we believe that additional clarification of that phrase in the Model or the Commentaries would be very helpful.15

b. Option B

i. Replacement of Name Standard by Name or Subject Matter Standard

Regarding the Name or Subject Matter standard in Option B and the objective of linking the contract economically to the enterprise short of requiring that it be binding, see comments at 4.a.i above.

ii. Replacement of Conclusion of Contracts Standard with Material Negotiation Standard

The Material Negotiation standard in Option B would replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts.” We understand this to be a different standard than that in the Model and Commentaries currently, which refers to the authority to “negotiate all elements and details of a contract in a way binding on the enterprise.”16 As we understand the proposed test, the contractual provisions need not have been formally drafted. Further, there may be elements that have not been discussed but are not

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15 We note, however, that the courts are not required to follow the Commentaries, though they generally may take them into account.

16 Commentaries, Art. 5, para 33. See also para 32.1.
“material” in the eyes of the parties engaged in the negotiation and are left to the lawyers to work out. In addition, the contract need not necessarily be binding (though under both civil law and common law it may well be), and in those cases the result would be the same even without the addition of the negotiation clause.

On the other hand, we read “the” material elements as requiring negotiation of all material elements, which might not have been intended. It is not clear whether each of the material elements must be fully negotiated or only negotiated in part. Presumably, however, it is intended that the activities of multiple individuals present in the source State and acting on behalf of the enterprise would be aggregated, but this could be clarified.

We believe that, with clarifications, the Material Negotiation formulation can be a workable standard as a surrogate for the Conclusion of Contracts standard. It would be objective, understandable and administrable and could be applied relatively uniformly. The question of which elements in a particular contract are “material”, which may vary for contracts of different types, subject matter, duration, amounts and governing law, could benefit from illustrations in the Commentaries. That the contract may be negotiated but not concluded should not be a problem with the standard, as the negotiation process is the relevant triggering activity using this standard, and no profits would be attributable other than in respect of concluded contracts.

We also note that the Material Negotiation standard may not fully capture what may be intended. Consider standardized contracts, as to which negotiation is not necessary. For example, in the case of insurance, the fact that much business (at least in certain areas) is transacted using standardized contracts, without the need for local negotiation or signing, has been considered to justify a taxable nexus under various treaties. Where the representative does not qualify under Paragraph 6, it may be considered appropriate that a similar principle should apply in other areas. We read the existing Commentaries as supporting the position that standardized contracts may be considered “concluded” in a Contracting State under certain circumstances:

For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transaction.

The intended scope of this “example” is unclear. Use of the Commentaries to state what may be intended rules is suboptimal generally, and in this context a few points might be noted. First,

17 This could be the case if no meaningful review and approval of an additional person or group or body of persons (e.g., a board of directors) is required for the contract to become binding.
18 Expenses of unsuccessful negotiations should be attributed to a PE resulting from the Material Negotiation standard.
19 We have considered whether explaining the important terms of a standardized contract may be sufficient to meet the negotiation standard.
20 Wijnen and de Goude, supra, at pp.124-125 note that 30% of treaties in the 1997-2013 period had an insurance provision, with most in the United Nations Model form, which excludes independent agents. The issue has been litigated successfully by the taxpayers under a treaty (Canada-US) that did not have such a provision. Knights of Columbus v. Her Majesty the Queen, 2008 TCC 307; American Income Life Insurance Co. v. Her Majesty the Queen, 2008 TCC 306.
21 Commentaries, Art. 5, para 32.1. The example relates to text addressing what is “in the name” of an enterprise.
courts are not bound by the Commentaries. Second, the example in the Commentaries is not clear in all respects, including the significance of the warehouse in that example. Third, the introduction of “negotiation” as a concept in the treaty text may complicate the analysis for a court, even if the court looks to the Commentaries for guidance. As an alternative, for example, the term “negotiates” might be expanded by “or, in the case of [standardized contracts], represents an enterprise in dealings with client or customers that results in the conclusion of contracts with them.” This would be applying what in effect is the Activities Resulting in Contract standard to standardized contracts while not to other contracts. A special rule for standardized contracts, if considered appropriate, would require clarification in the Commentaries, as some contracts may require relatively little negotiation and yet may be asserted to not be standardized.22

c. Option C

i. Replacement of Name Standard by Account and Risk Standard

The Account and Risk formulation in effect would eliminate the requirement that the contracts be legally binding on the enterprise and replace it by an economic nexus standard (contracts that are “on the account and risk of the enterprise”) but only if the contracts with that nexus result from “the legal relationship between that person and the enterprise.”

We have reservations regarding the proposed requirement that contracts be “on the account and risk of the enterprise.” First, it is not clear what the words “on the account…of” are intended to mean. Is there a distinction intended from the phrase “for the account of” (or the equivalent “pour le compte de” used in the French version of the model for “on the behalf of”)?

For example, “on the account” might be construed as only for the legal account of an enterprise. If that is not what is intended, then, as an alternative, consideration might be given to the wording of “for the economic account” of an enterprise, and “whether by virtue of a legal relationship or otherwise,” with some explanation in the Commentaries indicating that the economic account generally means that the residual rewards of the arrangement inure to the benefit of the enterprise.

Further, we question whether the separate predicate “at the risk of” is necessary, if a contract is for the economic account (in the above sense) of an enterprise. We note that risk may take many forms and degrees and that any or all of the risks may be easily shifted or split among affiliated enterprises. We also noted above the del credere concept in the context of a commissionaire arrangement, under which a commissionaire may bear the risks, including collection risks, associated with its customers in exchange for additional commission. It is not clear whether the presence of customer credit risk should by itself suffice to insulate a commissionaire (or other sales representative) arrangement from PE status, or is considered only a factor to be weighed.

22 Also, would it follow from such an approach for standardized contracts that if a representative office, or an affiliate’s office, in a Contracting State advises customers to use a website to purchase from the enterprise of the other Contracting State, that also should be covered, as in effect presenting the customers a standardized contract?
The term “legal relationship”\(^{23}\) may and presumably is intended to include implied contracts. For example, the Italian Philip Morris case illustrates this in the case of civil law.\(^{24}\) However, we have difficulty seeing the benefit of expressly requiring that contracts result from a “legal relationship” with an enterprise if, for example, they must be for the “economic account” of the enterprise. The reason is that a contract “for the account” of a person must possess such an implied, if not express, legal relationship, but it is possible that the express term “legal relationship” may be construed narrowly in some countries and broadly in others. For example, we wonder whether a contract negotiated by an employee of an affiliate of an enterprise would be considered to result from a legal relationship with the enterprise.\(^{25}\) We caution against the inclusion of predicates for the application of an agency PE that are not essential elements.

**ii. Replacement of Conclusion of Contracts Standard with Activities Resulting in Contract Standard**

See comments at 4.a.ii above (under “Option A”) for our concerns regarding the formulation “engages with specific persons in a way that results in the conclusion of contracts.”

**d. Option D**

**i. Replacement of Name Standard by Account and Risk Standard**

See comments at 4.c.i above (under “Option C”) regarding our comments on the Account and Risk standard.

**ii. Replacement of Conclusion of Contracts Standard with Material Negotiation Standard**

See comments at 4.b.ii above (under “Option B”) for our comments regarding the Material Negotiations standard.

**e. Exception for SMEs and Eased Compliance Requirements**

**i. Inclusion of Turnover Threshold**

If the intention of Action 7 is to expand the scope of the agency PE in a way that is not clearly defined and articulated, we believe that it would be appropriate to include an exception for small and medium-sized enterprises and/or a provision for a minimum amount of turnover in a source State (annually or averaged over, for example, three years) below which an enterprise would not be deemed to have a PE.\(^{26}\) The primary catalytic force behind the Action 7 initiative as best we can tell is the ease with which large-scale enterprises that operate substantially or even primarily

\(^{23}\) Discussed *supra* at part 3.b.iv.

\(^{24}\) Supreme Court Decision No. 7862 of 25 May 2002).

\(^{25}\) In the Philip Morris case, activities of individuals employed by an Italian associated enterprise of the German taxpayer in connection with the negotiation of a license agreement to produce and supply tobacco product were found to result in a PE.

\(^{26}\) Compare the exceptions for SMEs and for businesses with a turnover less than £10m in the UK diverted profits tax proposal discussed *infra* at part 5, and in the 2014 OECD suggestion of monetary limits in Paragraph 10.1 of the Commentary on Article 17 in relation to entertainers and sportspersons.
on a global basis in overseas markets are able to derive large cross-border revenues without a source State taxable nexus, despite strong indirect or even direct presence in the source State. If that is in fact the concern, then allowing enterprises that have only a toehold in a market the benefits of access without the complications that PE status might bring would make sense to us. Although distinctions of this sort are not theoretically pure, the purpose of treaties to encourage just this sort of trade where tax rules might otherwise be perceived as a barrier, provide ample justification and a valid distinction from the global player.

A turnover threshold generally should be based on the group’s aggregate turnover rather than the turnover of an individual member. That could be affected by a splitting provision similar to that for time limits in Option K or by reliance on the principal purpose test as suggested in Option L. If, however, an affected member is in a completely different business than other group members, then it may be appropriate to measure only the turnover of that different business.

ii. Administrative Allowance of Surrogate Filing and Tax Payment

PE status involves certain compliance burdens, in particular, filing obligations and dealing with local tax authorities in respect of tax audits. It may be appropriate that that burden, which is of greatest concern to SMEs, be dealt with in a way that it need not be considered an impediment to the distribution of tax revenues that otherwise would be accepted from a policy standpoint. To that end, permitting (with credit support by the group member relieved of the obligation, if necessary) a group member that already has taxable nexus in the source State to fulfill filing and tax payment obligations seems sensible.

f. Testing Options Against Specific Situations

i. Matrix

Below we list certain paradigmatic situations based on reasonably concrete and identifiable factors in order to test the results under current law, Options A-D, and, for counterpoint, the UK diverted profits tax proposal described briefly below. In each case other than the first, the assumption is that the person is either dependent or is acting exclusively or nearly exclusively for the enterprise.
Matrix of Options A-D and Paradigms: PE—Yes, No, or Maybe?

<table>
<thead>
<tr>
<th>Paradigm:</th>
<th>Option</th>
<th>Current</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>DPT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Non-Exclusive Commissionnaire*</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>2. Exclusive Commissionnaire</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>3. Synthetic Commissionnaire</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>4. Commissionnaire/agent del credere</td>
<td>No</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>Yes</td>
</tr>
<tr>
<td>5. LRD</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>M***</td>
</tr>
<tr>
<td>6. Broker</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>M***</td>
</tr>
<tr>
<td>7. Promotional/marketing agent</td>
<td>No</td>
<td>M</td>
<td>No**</td>
<td>M</td>
<td>No**</td>
<td>M***</td>
<td></td>
</tr>
</tbody>
</table>

* Assuming independent.

**Assuming not involved in negotiation of material elements.

***Depending on, e.g., the tax avoidance and mismatch conditions.

ii. Observations on LRDs

As noted, it appears that the Discussion Draft likely does not intend that a typical LRD relationship be treated as a PE, though that is not entirely clear. There is no discussion of such a relationship in the Discussion Draft. Given that such a significant application is not discussed, we suspect that is not intended.

While we express no view, some note that it may be considered relevant that the economic distinctions between a commissionnaire del credere and a typical LRD may not be significant, especially where title is acquired and immediately retransferred, or where there otherwise is little chance that a back to back sale does not occur. Similarly, some of the proposed changes to Paragraph 4 could result in treatment of consigned goods for delivery as a PE (though that would have no relevance for the distribution of services). If commissionnaires are covered and LRDs are not, a common behavioral response would be to convert to LRDs.

Depending on what is intended as a matter of policy, consideration should be given to the functional elements that a controlled distributor might have to possess in order to give rise to an agency PE. We caution, however, that any changes in this area must be considered in terms of risks of double taxation and what may be done to prevent it.
5. UK Diverted Profits Tax

Because of its relevance in timing and subject matter to Action 7, we touch briefly on draft UK legislation to be included in Finance Bill 2015, which will establish a new tax regime imposing the “diverted profits tax” (“DPT”).

The DPT charge will arise if either of two rules applies, only the first of which—addressing arrangements of a non-UK resident company (“foreign company”) which avoid a UK PE—is on point here. In general, the taxable diverted profits arising in an accounting period to the foreign company are “an amount equal to the profits which it is just and reasonable to assume would have been the chargeable profits of the foreign company for that period, attributable…to the avoided PE, had the avoided PE been a [PE] in the [UK] through which the foreign company carried on the relevant trade.” The tax will be at a rate of 25 per cent (higher than the normal corporation tax rate of 20%) of “taxable diverted profits” specified in a charging notice (or supplementary charging notice) by an HMRC officer in respect of an annual accounting period, plus interest thereon.

The avoided PE rule has overtones of the Activities Resulting in Contract standard as it might be broadly construed in the context of Option A, and the reservations expressed above in that regard also would be relevant here. It differs, however, in decoupling the PE test from contracts. It further differs very substantially from a functional agency PE construct in imposing a number of limitations and exceptions that apparently are intended to focus the DPT on large multinational companies that have engaged in a certain type of tax planning in respect of the UK market. Thus, it considers whether the foreign enterprise’s activity is “designed” to avoid a PE, and whether either the tax avoidance condition or the mismatch condition are met, and exempts SMEs. The DPT legislation has the unmistakable flavor of an anti-abuse measure, and that is reinforced by various other attributes including a rate structure designed to change behavior rather than collect revenue, standards based on whether conditions can be reasonably

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27 This rule applies in relation to a foreign company if (a) “a person (‘the avoided PE’), whether or not UK resident, is carrying on activity in the [UK] in connection with supplies of goods or services made by the foreign company to customers in the [UK],” (b) “it is reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company is not carrying on a trade in the [UK] through a [PE] in the [UK] by reason of the avoided PE’s activity (whether or not it is also designed to secure any commercial or other objective); (c) it is also reasonable to assume that (i) the “mismatch condition” is met, (ii) the “tax avoidance condition is met,” or (iii) both those conditions are met; and (d) certain exceptions for SMEs or low turnover are not met.

28 The DPT legislation is inconsistent with at least the spirit of existing income tax treaties, whether or not under certain treaties it technically is a treaty breach.

29 Leaving aside the limiting rules, the base test of the avoided PE rule is whether “a person…is carrying on activity in the [UK] in connection with supplies of goods or services made by the foreign company to customers in the [UK].” This has similarities to Option A of the Discussion Draft, which in pertinent part would provide a deemed PE “where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts…for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or…for the provision of services by that enterprise.”

30 A reference to contracts may have been considered overlimiting or perhaps manipulable, or simply quaint in today’s economy.
assumed to be met and the unusual procedural rules. Thus, it differs very substantially from the intended deliverable of Action 7.

A significant difference between the base test of the avoided PE rule and Option A may be the “on behalf of” requirement in Option A, which introduces a legal relationship condition that in certain countries may meaningfully limit the scope of the provision. For example, a company acting pursuant to a contractual relationship, even if that contractual relationship is exclusive, can be viewed as acting on its own behalf rather than on behalf of the foreign enterprise in performing under the contract if the contract involves the transfer of ownership of property or rights for retransfer by the company. As noted above, we believe that it is critical that there be clarification as to whether a distinction is intended. Casting a wider PE net that is restrained by an SME exception and/or principal purpose test could be made to work from a technical standpoint, if that is the direction chosen, but even more in this case than otherwise, a determined effort would be required to minimize instances of double taxation. On the other hand, the principal purpose test (already adopted under Action 6) may be considered adequate to deal with avoidance of PEs through commissionaire and similar arrangements; if so, that could be spelled out in the Commentary for that test (compare Splitting of Contracts below).

6. Proposal in Discussion Draft to Revise Paragraph 6

The Discussion Draft proposes to restate Paragraph 6 as follows:

6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of that business. 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 within the meaning of this paragraph with respect to these enterprises.

As regards the first sentence, the proposed revision would change the current wording in several respects for clarity and, substantively, to eliminate the reference to a “commission agent.” (and presumably “commissionaire” in the French version of the Model). More significantly, whereas existing Paragraph 6 makes no reference to the number of persons for whom an independent agent acts, the Discussion Draft would add a second sentence, which reverses the interpretation stated in the Commentaries that an otherwise independent agent may be respected notwithstanding that it acts exclusively on behalf of a single person. The new language parallels language that was in Paragraph 7 of Article 5 of the 1980 UN Model Treaty, which drew the provision from treaties that India (initially) and certain other developing countries had negotiated.

31 Commentaries, Art. 5, para 38.1, 38.6, 41.
from those that would have been made between independent enterprises, and thus currently is more generous than would be the proposed Paragraph 6.

As a policy matter, the Committee on Fiscal Affairs apparently has concluded, tentatively at least, that allowing for the possibility that an enterprise may qualify under Paragraph 6 even though acting exclusively or almost exclusively for a single party (or that party and its affiliates) is not appropriate. It seems likely that the targets motivating the proposed change are instances in which the independent agent actually is an associated enterprise of the principal, either by ownership, by common control or by some other mechanism effectively ensuring subservience. Current Paragraph 6 allows an enterprise to gain access to a market using an associated enterprise, which if qualified under paragraph 6, would allow the local agent to actually enter into contracts on behalf of the principal.\(^{33}\)

The terms “various persons” and “almost exclusively” leave room for interpretation. We would read “various persons” (or “several persons,” which we would prefer as a matter of English language) to mean at least three persons. We would read “almost exclusively” to mean a very high threshold--over 90% by turnover, perhaps more.\(^{34}\) We suggest that consideration be given to providing more guidance in the Commentaries regarding this provision, either along these lines or alternatively avoiding objective tests.

B. Artificial Avoidance of PE Status Through the Specific Activities Exemptions

1. Overall “Preparatory or Auxiliary” Limitation

a. Perceived Problem

The Discussion Draft notes that some delegates participating in a Working Group dealing with Article 5 expressed the view that subparagraphs \(a\) to \(d\) should be subject to the extra condition that the activities referred therein be of a preparatory or auxiliary nature, and view this as consistent with the original purpose of the paragraph. In addition, the Focus Group considers it is important to address situations where these subparagraphs give rise to BEPS concerns.

b. Option E

Option E would subject each of the Paragraph 4 categories to a requirement that the activity be “preparatory or auxiliary.” We have some reservations in this regard. As one example, we are not clear as to what would it mean to condition a facility for the delivery of goods on being preparatory or auxiliary.\(^{35}\) Given the core nature of the activities, it would not seem preparatory. Perhaps the intention is that only situations in which the activity is minor in quantum, and so auxiliary, should be covered.

\(^{33}\) We note that some have questioned whether the Article 5 distinction between dependent and independent agents should be maintained.

\(^{34}\) The scant material that attempts to quantify the UN test is consistent with 90% by turnover. Vann, \textit{supra}, pp. 77-78.

\(^{35}\) While delivery is proposed to be eliminated, the example remains valid, as it illustrates that revision of the categories is preferable to creating an uncertain overriding test.
The proposed change may be considered inconsistent with the policy objectives of the provisions. As originally articulated, these were tied to a desire to “encourage international trade” (in particular exports) “or in certain cases for convenience of administration.”

At a minimum, the change would create uncertainty as it would subject what currently are fairly objective rules to a very imprecise test.

2. **Eliminate “Delivery”**

   a. **Perceived Problem**

   The Discussion Draft notes that there are concerns based on the reference to “delivery” in subparagraphs (a) and (b) of Paragraph 4, which currently provide exceptions for:

   - **a)** the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
   - **b)** the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery.

   The concern is that an enterprise may maintain “a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online” without having a taxable nexus.

   b. **Option F**

   Option F would delete the word “delivery” from subparagraphs (a) and (b).

   The historical evolution of subparagraph (a) of Paragraph 4 was that the word “delivery” was added later than the other terms:

   - The use of mere storage facilities (FC/WP1(56)1 (17 September 1956)).
   - The use of facilities merely for the storage or display of goods or merchandise (FC/WP1(57)2 (29 August 1957)).
   - The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise (FC/WP1(57)3 (12 November 1957)).

   On the other hand, the historical evolution was the reverse in subparagraph (b) of Paragraph 4, in that the word “delivery” came first and the other items were added:

   - The maintenance of a stock of merchandise, whether in a warehouse or not, merely for convenience of delivery (FC/WP1(56)1 (17 September 1956)).

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• The maintenance of a stock of goods or merchandise, merely for the purpose of display or delivery (FC/WP1(57)2 (29 August 1957)).

• The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery FC/WP1(57)3 (12 November 1957).

We believe we understand the premise of Option F, namely, that allowing the holding of inventory for delivery to customers as an exemption from PE status and hence from taxable activity status is inconsistent with the principle that core activities should be permitted to be taxed.

The way the provisions evolved, however, suggests that it was thought that storage, display and delivery logically had to go together. The mere deletion of delivery may not be as clear as desirable. If the intention is that inventory to be delivered in the normal course by whatever means (including an independent party or the post) is not to be exempt, then that would need to be clarified. If the intention is simply that the foreign enterprise itself may not deliver inventory maintained by it but that a different party may do so, that should be specified (though in such case we have reservations as to what is intended to be achieved by the change, as delivery would require a separate contracting party and nothing more).

One approach that would be clearer would be to follow the lead of those treaties that have added the word “occasional” before “delivery.” Such wording has been interpreted to consider an arrangement involving regular delivery to customers, whether by the foreign enterprise itself or not, to cause PE status.

We note that the example set forth in the Discussion Draft describes “a very large warehouse in which a significant number of employees work.” We wonder whether there is intended to be some distinction drawn based on the size of the warehouse and activity conducted therein. Would a very small warehouse be considered a PE? Does it matter if such a small warehouse is owned or, is rented for, e.g., six months? If not otherwise a PE, would a small warehouse be viewed differently if repackaging occurs there?

3. Eliminate “Purchasing” Offices/“Collection of Information” as Specific Categories

   a. Perceived Problem

Subparagraph (d) of Paragraph 4 sets forth the following exception to the definition of a PE:

   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise.

The Discussion Draft notes that the original predicate for the exception for purchasing offices—that no value was to be attributed to the function of purchasing—has been recognized to lack merit, and that recognition culminated in the deletion of Paragraph 5 of Article 7 in 2010.
The Discussion Draft notes also that concerns have been expressed concerning the collecting of information for an enterprise as covering the collection of information that is commercially exploited by being provided to other enterprises, or otherwise.

b. Options G and H

Option G would delete the exception for a fixed place of business used solely for purchasing goods. Option H would delete both that exception and the exception for collecting information for the enterprise. We believe we understand the concerns underlying Option G as well as Option H, as regards specific exceptions for purchasing offices or for the collection of information which provide or at least imply special status for those activities. Procurement activities can be profit centers. Collecting information is a core business function of many businesses today. A policy determination might be made that, rather than have special categories under Paragraph 4 for those potentially core activities, activities of this kind that are preparatory or auxiliary can be expected to qualify or not under that standard. However, at least as much here as in other cases addressed, a focus on avoiding double taxation is very important.

4. Fragmentation of Activities

a. Perceived Problem

For purposes of determining whether an enterprise is engaged in preparatory or auxiliary activity, associated enterprises have been able to structure their activities as a whole so that any single enterprise’s activities remain within the scope of the exception.

b. Option I and J

Option I would add a provision to Paragraph 4 to the effect that it is inapplicable to a fixed place of business that is used or maintained by an enterprise if the same enterprise or an associated enterprise carries on business activities through a PE at the same place or at another place in the same Contracting State and the business activities carried on constitute complementary functions that are part of a cohesive business operation. Option J is similar except that would not require that one or another enterprise have a PE under the ordinary rules before it operated.

Each Option is a potentially workable approach to the fragmentation of activities issue, and consistent with the contemporary recognition that for various purposes the activities of associated enterprises should be viewed together to reflect the commercial reality of modern corporate groups and to avoid abuse. Option J may better reflect the concerns expressed; it may be considered odd that there must be at least one PE before activities can be aggregated, as this would reward extreme fragmentation over less extreme fragmentation.

C. Splitting-up of Contracts

The Discussion Draft notes the concerns that have arisen in connection with the splitting of contracts in order that an enterprise might stay under time thresholds in Article 5, such as those for construction or installation site PEs and those for service PEs.

The Focus Group notes that BEPS concerns related to the splitting-up of contracts could be addressed either by an objective rule that would take account of any activities performed by
associated enterprises (wherever resident) at the same or a connected site (Option K) or by a
general anti-abuse rule looking to the enterprise’s “principal purposes” (Option L). In order to
deal with, e.g., the situation where days of presence of a local associated enterprise might cause
any presence of the foreign enterprise to be taxable, it may be appropriate to create an exception
for a one-time presence that is under, e.g., 30 days, provided the taxpayer can show that avoiding
a PE under Article 5 was not one of the principal purposes for splitting the contract between
associated enterprises.

We agree that Options K (with the additional language) is reasonable to address the problem
identified and find it preferable to Option L, both because of the unified nature of multinational
enterprise groups generally and because of the difficulty of administering a broad purpose test.
We recognize that situations often exist where contracts are not split up for tax planning
purposes, but believe that, to the extent the contracts are in fact related to a single project,
aggregating the contracts without regard to purpose of separation is more consistent with the
purpose of Article 5.

D. Option M: Insurance

The Discussion Draft notes the dual issues in an insurance context of whether a foreign
enterprise is able to engage in substantial local business activity without creating a PE but also
the issue of removing the profit through risk transfer agreements. Transfer pricing principles
must play a role but the Discussion Draft notes:

In the case of transfer of risk to an independent party that can be done through bona fide
insurance or re-insurance, the most significant BEPS concern seems to be related to the
possibility that an insurance enterprise could actively sell insurance or re-insurance in a
country through the use of exclusive agents without having a PE in that State.

Option M would endorse the following provision, adopted from the UN Model Treaty and
included in approximately 30% of existing treaties, as noted above.

Notwithstanding the preceding provisions of this Article, an insurance enterprise of a
Contracting State shall, except in regard to re-insurance, be deemed to have a permanent
establishment in the other Contracting State if it collects premiums in the territory of that
other State or insures risks situated therein through a person other than an agent of an
independent status to whom paragraph 6 applies.

We believe we understand the reasons why a special provision addressing insurance nexus may
be considered appropriate, at least where intensive, on-the-ground dealings with potential
customers in respect of sales of insurance policies is involved and where pricing and terms of
insured risks are relatively standardized. An insurance enterprise can easily achieve direct access
to local markets without crossing the threshold of traditionally accepted PE criteria.

Combined with the proposed change to Paragraph 6, the provision would result in PE status if
based on the local activities of either employees or dedicated (exclusive) agents even if not
employees. In neither case would they be required to contract on behalf of the enterprise. Thus,
taxable nexus would result based on economic presence as opposed to actual entry into binding
contracts. If the Paragraph 5 standard were to be changed to address standardized contracts, a special provision for insurance companies may not be needed.

E. Profit Attribution and Interaction with Transfer Pricing

We entirely agree that changes to the PE definition should be considered in conjunction with the effect under Articles 7 and 9. What the proper approach is to attribute profits to an agency PE is a critical area of concern and should be advanced in tandem with further developments on the threshold issue of whether a PE arises. We further believe that the rules determining the appropriate share of profit under Article 9 should be consistent with those under Article 7.

If the profits properly attributable to an agency PE are no different than the remuneration that an independent agent would be entitled to, then the relevance of whether or not a PE arises in the first place would be diminished, although it would still give rise to collateral consequences under the sourcing rules such as those in Article 11 and with reference to the taxation of employees in accordance with Article 15. If the profits properly attributable to an agency PE are expected to be different than the remuneration that an independent agent would be entitled to, then it is important that this be understood before any attempt is made to reach a real consensus on what should or should not give rise to a PE in the first place.

We are not confident that only minor issues are involved in respect of attribution, but that will depend on the work in progress in relation to Actions 8-10 and the extent to which that work will apply to the attribution of profits to PEs.

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We appreciate the opportunity to share these comments with you.
9th January 2015

Marlies de Ruiter
Head,
Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD/CTPA,
Paris

For e-mail transmission to: taxtreaties@oecd.org

Dear Ms de Ruiter,

Discussion Draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Introduction

Thank you for inviting comments on the Discussion Draft, *BEPS Action 7, Preventing the Artificial Avoidance of PE Status*, issued on 31st October 2014. The insurance industry has actively participated in the OECD consultations to date on BEPS and has a special interest in the discussions relating to both Action 7 and Action 9 (Transfer Pricing of Risk and Capital). The IUA supports the aim of Action 7 as set out in the Action Plan, viz. to "[d]evelop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions".

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2013 was some £24bn.

The IUA has submitted to the OECD a background paper on the importance of reinsurance and affiliate reinsurance to the insurance industry model. Our comments on the Draft on Action 7 should be read bearing in mind the basic model for the insurance industry as set out in that paper, a copy of which was sent to you on 24th November. The paper is not intended to form part of our response to the Discussion Draft, but a further copy is being sent separately for ease of reference.

Branches of an insurance company can carry on full scope underwriting activities and claims management, or they may be restricted to certain functions such as sales and marketing. Reinsurance, whether external or affiliate reinsurance, can cover the whole of the business underwritten by an insurance company or specific branches. Such branches are treated as PEs for tax purposes. In addition, insurers can currently do business cross border in many situations, either under the EU Freedom of Services principle or on another basis, which allows insurance activity without the need to establish a local presence or to acquire a local licence (variously known as permitted unlicensed, non-admitted or surplus lines basis). Under current OECD guidance, that manner of writing business does not create a PE.
There is a long-established practice of third party agents providing services to regulated insurers or providing services to potential clients of the insurers, remunerated by reference to services provided. However, such third party agents, in addition to being part of their own separate value chains, are distinguishable from insurance groups because they have an entirely different business model: they do not assume insurance risk (they are not “risk carriers”) and are regulated differently from insurers and in their own right.

Additionally, it should be noted that premium taxes are payable in many countries on the gross premiums for risks insured which are located in the jurisdiction. While premium taxes are not a focus for BEPS, when they are considered together with the tax paid by the agents on the fees they earn, it can be seen that a material amount of tax is levied in respect of risks insured in a country where an insurer is not currently considered to have a PE.

We have summarised our responses to the discussion draft below and included comments on the draft paragraphs in an Appendix.

Summary of points

1. Insurance is a highly regulated activity and much of the organisational structure of insurance groups is driven by what is required by regulators (for example, how much capital is required in which jurisdictions, how much risk is retained in a particular jurisdiction) and what will allow the most efficient use of capital within those regulatory constraints (for example, having one risk carrier hold the shares in another risk carrier, operating through branches, the use of reinsurance with external and internal parties).

   In practice, all significant organisational structuring and restructuring requires pre-approval from the relevant regulator which will involve explaining the business rationale. This point is recognised in paragraph 86 of the Discussion Draft on BEPS Actions 8, 9 and 10 issued on 19th December 2014: “Except in certain regulated sectors, MNE groups have freedom to control their structures, including shareholding, capitalisation, and legal form...”

   Furthermore, the use of an insurance agent to provide services to potential clients in a territory where the insurer does not have an establishment is clearly distinguishable from a commissionaire arrangement in that the insurance agent has no authority to bind the insurance company and takes on no risk as a result of its activity in the local territory.

   We are concerned that the proposals to address the flaws in the current system by broadening the definition of what is considered a PE (Options A to D) could inadvertently result in the recognition for tax purposes of additional PEs of an insurance group created by third party agents which are not in fact part of that group’s value chain.

2. Insurance is a highly regulated industry and in most cases, the definition of a PE for tax purposes is closely aligned to the definition of a PE for regulatory purposes. Where a PE which is not intended by the business arises for tax purposes (perhaps as a result of unauthorised conduct by a member of staff), there may often be regulatory consequences from carrying on an unauthorised insurance activity. The prospect of regulatory sanction aligned with tax guidelines is often a key factor in ensuring and monitoring compliance for both regulatory and tax purposes. If there is a bifurcation of the definitions of PE and regulatory branch, that would create complexity which would be difficult to manage for business purposes. The IUA considers it important that the concept of what constitutes a PE for tax purposes continues to be aligned with what is approved by the regulator as
appropriate activity for an insurance company. Option B would result in the least divergence between the tax and regulatory definitions of branch and, for that reason, the IUA considers that Option B is the preferred option of the four put forward.

3. The core of any insurance business is the acceptance of risk. Before entering any market, an insurer will undertake a certain amount of preparatory investigation of market conditions. If it writes a risk in a country, it will need to monitor those conditions. While auxiliary to the main business of the insurer and preparatory to the decision to underwrite, such data is important in that in its absence, an insurer will be less likely to be in a position to offer cover. The removal of the exemption for data collection could therefore have an impact on insurance business models. Accordingly, the IUA suggests that the exemption for data collection be retained (Proposal H) and made more targeted rather than removed.

4. Insurance should not be singled out as a separate activity with a separate provision in the PE article (Option M). It is an economic activity like all others, so the IUA prefers Option N. Following the profit attribution principles of Part IV of the OECD’s 2010 Report on the attribution of profits to permanent establishments would arguably result in little or no profit being attributed to an Option M deemed PE and that would result in administrative complexity.

Our comments reflect our concern that the definition of a PE should be workable and well-targeted against abuse whilst providing clarity and certainty in normal business situations where there is no abuse.

Yours sincerely

W. J. Lowe
Director of Government Affairs
Appendix – detailed analysis of points in the discussion draft

Option A: “where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts …”

This wording is very broad and will potentially create PEs in many countries where the insurance entity has no physical presence and merely carries out preparatory activities in the state if ultimately an insurance contract is entered into.

That would lead to a significant administrative burden, as there could be a significant increase in the number of jurisdictions in which the insurance entity is required to file returns. Any profits attributable to such a PE would be a small part of the underwriting value chain and so would not result in a significant increase in tax revenue in the host country. In order to avoid double taxation, the home country would be required to give credit relief for the tax paid in the host state. The home country may be reluctant to do that if, on the basis of the principles of Part IV of the OECD’s 2010 Report on the attribution of profits to permanent establishments, it believes that the KERT is carried out solely in the home country and that that would create double taxation and increase the tax burden of the insurance entity beyond what is equitable.

Groups tend to issue guidelines to their staff as to what activities are permissible in locations where they have not set up a formal branch in order to reduce the risk of a PE being inadvertently created for tax purposes. Sales and marketing activities are regarded as auxiliary and preparatory activities and are therefore activities which can often be carried out in a country where the insurance entity has no presence. However, in many cases, all of the pricing and the negotiation is carried out outside the host state.

If the scope of what could constitute a PE becomes very broad, that could result in groups restricting their staff from carrying on any activity which might ultimately result in a contract being included outside of the home country and that could restrict the availability of insurance in some countries.

Additionally, that could lead to undue restriction of the ability of staff within a global insurance group to travel to the group’s offices round the world for non-underwriting related activities (for example, for internal training purposes rather than to interact directly with brokers and clients), out of concern for inadvertently creating a PE.

The IUA considers that that would have the effect of hampering economic activity.

Option B: “where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts …”

Currently, the regulatory rules that determine when it is necessary to set up a presence in the host state and/or obtain a licence are broadly in line with the tax definition of a PE. Any move away from the current wording of Article 5 will see a bifurcation of these definitions and create situations where there is no presence from a regulatory perspective, but there is a PE for tax purposes. That creates complexity and is difficult to manage from a business perspective.
The wording of option B would lead to a bifurcation, but is more consistent with the principles set out in Part IV of the OECD’s 2010 Report on the attribution of profits to permanent establishments, where the most value is attributed to activities that form part of the underwriting activity. It may, however, increase the likelihood of split KERTS and more disputes between tax authorities with differing views on what activities produce the most value.

The reference to negotiating and concluding does provide some parameters for activity which would allow multi-national groups to issue guidelines to their staff on what is permissible to manage their PE exposures in overseas jurisdictions and provide certainty of tax treatment, but would go further than guidelines issued by compliance teams in order to manage the regulatory risk. The word “negotiates” is broad and the reference to “elements” adds uncertainty. The proposal is aimed at situations where all the terms of a contract are agreed in a country but contracts are formally signed or “rubber-stamped” elsewhere. We suggest the replacement of “elements” by “terms” and a reference to negotiating all the terms of a contract to the point where they cannot be materially amended prior to conclusion.

Of the four options A to D, this is the IUA’s preferred option.

Options C and D: addition of: “[contracts which,] by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise” to Option A and B wording.

This wording is intended to deal with commissionaire structures, but there is a concern that that could be interpreted more widely and potentially applied to fronting arrangements or other arrangements involving a number of different (and independent) insurers and reinsurers as well as internal reinsurance, on the basis that a tax authority could argue that the underlying insured risk is partly “on the account and risk of” the reinsurer. On that basis, the IUA does not support Options C or D, as their impact is much wider than the intended targets and would have a considerable adverse impact on the reinsurance industry.

Proposal to strengthen the requirement of “independence” within each of Options A to D: Paragraph 5 shall not apply where the person acting in a Contracting State carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of that business. 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…”

This proposed change could have the effect of bringing more third party agents of insurers within the definition of PE, particularly where they are in start-up situations and have not built up a portfolio of insurers for which they act. Perhaps this could be dealt with in the commentary, to remove such agents from such a definition.

There is also a concern that this could be interpreted as bringing third party fronting partner insurers within the definition of a PE. Fronting partners are third party insurers typically used where an insurer is writing a global contract and does not have a licence to write in one or more of the territories in which the multi-national client requires cover. In that situation, a fronting partner writes the local insurance cover and then reinsures it with the insurer. The IUA does not support the amendment to the definition of a dependent agent. Instead, each case should be reviewed based on the facts and circumstances.
H. **Delete the exceptions in subparagraph d)**

[Delete subparagraph d) of paragraph 4 of Article 5:]

*d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise.*

The discussion draft highlights a concern that some enterprises attempt to disguise what is in reality the collection of information for other enterprises by repacking the information collected into reports prepared for those enterprises and therefore proposes the deletion of the exemption for collecting information, alongside the proposals for the deletion of the exemption for purchasing goods or merchandise.

Insurance groups use data to research markets in which they may provide cover and to monitor conditions in those markets where they are on risk. They also use data to assess, price and reserve for risk. Data gathering in a specific location where there is no PE is important to allow an insurance group to understand the local market to decide whether to enter that market or to write risks in that market on a Freedom of Services or similar basis.

The IUA suggests that this exemption for data collection is retained. Within a value chain, the collection of data (in contrast to its analysis) should have relatively lower value, and so the taxable receipts from re-characterising such activity as a PE should not give rise to significant taxable profits in the host country but would create an administrative burden.

**Option M - a specific measure for certain insurance activities**

The discussion document does not make a clear case for distinguishing insurance activities from reinsurance, or from other financial services, or from other activities in general.

As a financial service, insurance may be distinguished in some respects from non-financial services. However, we do not consider that there is any inherent distinction between insurance and other financial services. The OECD’s *2010 Report on the attribution of profits to permanent establishment* acknowledges [paragraph 16 of the introduction] that, in the financial enterprise sector, “the same significant people functions will generally be relevant both to the assumption of risk and to the economic ownership of those assets” and the authorised OECD approach uses the “key entrepreneurial risk-taking function” (“KERT function”) terminology in describing the functions relevant to the attribution of both risks and assets, but not for other sectors”. The OECD *2010 Report* discusses the attribution of profits where a PE exists, whereas the Discussion Draft considers the circumstances where a PE may exist in the first place. The point we wish to emphasise here, however, is that there is nothing specific to insurance activities which would justify its being treated separately from other [financial] sectors and the Discussion Draft does not put forward a case for it to be so.
In the current digital economy, it is theoretically possible for an insurer, as a provider of a financial service, to write risks in any location. It is local licensing, regulatory and legal restrictions which determine which activities are permitted in a specific location. The Draft expresses concern [paragraph 35] that insurers “do large-scale business in a State without being taxed in that State on their profits arising from such business”. However, the laws and regulations of many jurisdictions allow insurance groups to provide insurance cover without a corporate presence or branch (for example the Freedom of Services basis in the EU and the provision of permitted unlicensed cover).

If this provision were adopted to recognise the presence of a PE, but the attribution of profit continues to be based on Part IV of the OECD’s 2010 Report, arguably the profit attributed could be insignificant or non-existent (as the KERT would be most likely to be in the host state). Alternatively, where states diverge from the principles of Part IV of the OECD’s 2010 Report, that will result in double taxation and a greater number of disputes.

If the provision were adopted and the profits of the deemed PE were by reference to a deemed profit based on a percentage of premiums collected, that would create another basis of taxation incompatible with the principles of Part IV and result in double taxation.

The IUA considers that the inclusion of measures specifically aimed at insurance is unhelpful and unjustifiable and should be removed.
Dear Ms de Ruiter

RE: OECD DISCUSSION DRAFT ON BEPS ACTION 7

The Investment Association\(^1\) welcomes the opportunity to comment on the BEPS Action 7 consultation.

We recognise the need to update the treaty definition of permanent establishment (PE) both to reflect better how businesses operate today and to prevent the artificial avoidance of PE status. We also support the broader objectives of the BEPS Action Plan.

Of the various aspects of the PE definition that could give rise to BEPS concerns and which are covered in the discussion draft, those designed to address the artificial avoidance of PE status through commissionaire arrangements and similar strategies are of most relevance to investment managers.

**Artificial avoidance of PE status through commissionaire arrangements and similar strategies**

We agree with the underlying policy objective that where the activities that an intermediary exercises in a country 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 unless the intermediary is performing these activities in the course of an independent business. Four alternative proposals have been suggested to achieve this.

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\(^1\) The Investment Association (formerly the Investment Management Association) represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around $5.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.
Options A, B, C and D all address the concern of artificial avoidance of PE status through commissionaire arrangements and similar strategies, but also lower the PE threshold generally in a way that applies to many other business arrangements.

Options A and C both replace “conclude contracts” in Art.5(5) with “engages with specific persons in a way that results in the conclusion of contracts”. The wording is so broad that the threshold at which a PE is created is effectively unascertainable and, on our reading, could result in the creation of PEs unnecessarily. Minor activities of an intermediary could give rise to a PE but with no commensurate increase in tax payable in the local jurisdiction on the basis that the PE is bearing minimal risk and so is allocated limited profits. We believe this would lower the PE threshold too far and would result in an unnecessary increase to the administrative burden for businesses.

Options B and D both replace “conclude contracts” with “concludes contracts, or negotiates the material elements of contracts”. This results in a lowering of the threshold but not to the same extent as would be achieved by options A and C. However, it would still seem to address the concern of artificial avoidance of PE status through commissionaire arrangements and similar strategies. Most importantly we believe that the threshold for businesses creating a PE by “negotiating material elements of contracts” is ascertainable and controllable.

We would suggest that ‘terms’ replaces ‘elements’ as being more normally used in the context of contracts.

The difference between options B and D is that option B covers contracts in the name of the enterprise etc whilst option D deals with contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise. Of the two, option B seems clearer to interpret, whilst achieving the policy objective.

**Examples in investment management businesses**

Investment managers frequently work in a cross-border environment. This is the case where either the investment manager manages the assets of funds or other clients that are resident in other jurisdictions, or because the funds it manages are distributed to investors in other jurisdictions. It is common, therefore, for investment managers to have either branches or subsidiaries in other jurisdictions (although it is not a critical feature of investment management businesses).

Funds typically outsource all services, ranging from custody, fund administration, fund distribution and sales, transfer agency, and investment management. In most cases, the fund manager will be responsible for arranging the outsourcing of all of these services, and sometimes these services are provided from overseas.

Where overseas activities of a fund manager are significant and, for example, result in the conclusion of contracts, then they constitute permanent establishment. However there are also likely to be interactions with specific persons that are relatively minor, such as meetings to discuss a service level agreement with a transfer agent in a particular jurisdiction, or a distributor simply pointing an investor towards the group’s funds and leaving the investor to invest directly on standard terms.

In between these, there might be a range of other activities that are likely to be caught by the new wording but with a level of uncertainty, such as agreement of side letters, negotiation of separate accounts or discretionary fund management arrangements.
The key concern is the ability to ascertain the threshold of when a PE is created, given the many varied types of interaction that occur on a daily basis in an investment management business. Businesses should be able to control which types of meetings/interactions give rise to a taxable presence in any jurisdiction. We believe option B is the option that provides greatest certainty to investment managers.

**Strengthening the requirement of independence**

All of options A to D strengthen the requirement of independence in Art.5(6) in that third parties will no longer be treated as independent agents where acting ‘exclusively or almost exclusively on behalf of one enterprise or associated enterprises’.

This seems to go further than the stated policy objective that “where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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”.

The requirements of an enterprise or of associated enterprises may be such that a third party has little need of any other business, yet in this case the third party will no longer be treated as independent.

In fact, many small investment managers act only for a single fund. In practice such small investment managers will have a relationship with the investors in the single fund, which will be numerous, and may regard these investors as its ‘real’ clients on a day-to-day basis – even though the contractual and commercial relationship is with the fund alone. In the UK and other countries, domestic law provisions exist to ensure that an investment manager in these circumstances will not be treated as a dependent agent and a permanent establishment of the fund it manages. We agree with the analysis and comments put forward by the Alternative Investment Management Association (AIMA) in its response to this consultation paper.

Thank you again for the opportunity to comment on the discussion draft. We hope to continue to be able to contribute to the consultation and I am available at your convenience to discuss anything in this letter at jmorley-smith@investmentuk.org or on +44 (0)20 7831 0898.

Yours sincerely

Jorge Morley-Smith
Director, Head of Tax

cc. Mike Williams HM Treasury
Irish Tax Institute

Response to OECD Discussion Draft:
Artificial Avoidance of PE Status

January 2015
About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland’s AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.
Introduction

Action 7 of the OECD’s Base Erosion and Profit Shifting (BEPS) project is entitled “Preventing the Artificial Avoidance of PE Status”.

While the Discussion Draft contains a number of options for changes to the definition of Permanent Establishment (“PE”), all the proposals, if implemented, would result in a dilution of the existing PE threshold which will arguably result in an increase in inter-fiscal disputes and potentially an uncertain change in the balance between source and residence-based taxation.

A. Impact of the options proposed – four key repercussions for businesses and countries

1. Significant and disproportionate business cost and risk

The changes proposed to the PE definition would almost certainly result in additional PEs being created for corporate tax purposes which would significantly increase the administrative and compliance burden for businesses. This cost would be amplified by increased levels of risk for businesses operating internationally:

- Risk - arising from uncertainty over the changed definitions and whether a corporate tax PE actually exists under the new rules. There is very little guidance in the proposals as to how new terminology in any amended PE definition would be interpreted and countries are likely to adopt a wide range of differing interpretations thus increasing the level of uncertainty and the risk of double taxation.
- Risk - resulting from increased uncertainty and compliance cost for indirect taxes as a result of an evolving direct tax regime.
- Risk - of interest and penalties for non-compliance if a PE is ultimately found to exist under the new rules, which had not been recognised by the company. This is particularly important as tax compliance penalties are on the increase worldwide.

Despite this level of cost and risk that will be borne by businesses, many of the additional PEs created may be attributed little (if any) profit, based on the substance of the activity carried out through them. The result would then be little, if any, extra tax revenue for the source country and, in some cases, any new tax liability generated may simply replace the existing tax being paid by a related party in the same country.

Increasing the number of PEs would also have other knock-on implications for businesses and tax administrations. Other compliance obligations will arise for business, such as the completion and filing of additional Country by Country Reporting templates and potential need to revisit transfer pricing analyses. The resources of tax administrations may also become tied up in additional audits, enquiries and MAP/Competent Authority claims for administrative PEs that have little attributable profit.

2. Less efficient Business and Global Trade Models could end up being adopted by multi-national companies

The lowering of the PE threshold could also result in businesses adopting alternative and potentially less efficient business models, simply to minimise the additional administrative costs of creating multiple PEs worldwide. For example, businesses could take the costly decision of outsourcing activities currently carried out more efficiently in-house, to avoid the punitive administrative costs of creating a PE.

Wideley worded definitions would result in significant uncertainty which could negatively impact international trade flows. In small open economies such as Ireland, a significant proportion of
busineses, including SMEs, are heavily reliant on exports and trade in foreign jurisdictions. Therefore, the unintended effect of increased risk surrounding PEs and the increased compliance burdens could prove a barrier to the continued growth and expansion of businesses and restrict the ability of such businesses to trade internationally.

Increasing barriers to entering new markets (by making the PE threshold lower and more uncertain) could also impact negatively on those markets. A business may be less likely to enter a new market if minimal activity in the country can create a PE and result in significant compliance obligations.

3. **Greater uncertainty and disputes for both businesses and tax authorities**

As noted above, there is significant potential for uncertainty if the proposed changes are adopted as currently worded. There is little guidance in the Discussion Draft on interpretation for any of the proposed options and detailed examples and guidance are essential before any changes are decided upon. In fact, the lack of guidance currently makes it is difficult to provide detailed comments on the exact impact of the changes on existing business models. There is also uncertainty around implementation of the changes.

This increased uncertainty will create more disputes between (and more MAP challenges by) tax authorities. This will undoubtedly put further pressure on the resources of tax authorities which are already struggling to deal with the huge increase in MAP cases in recent years. This uncertainty could cause significant damage to international trade.

4. **The current proposals go far beyond targeting artificial avoidance**

The Irish Tax Institute fully endorses the OECD’s overall objective of preventing the artificial avoidance of PE status. However, the proposed options appear much wider than this stated aim. The Discussion Draft clearly states that the OECD’s work on this action is not directly aimed at changing the existing international standards on the allocation of taxing rights on cross border income. However, with its lowering of the PE threshold and narrowing of available exemptions, it is inevitable that the changes proposed in the Discussion Draft would create a clear shift towards increased taxing rights for source countries generally.

There appears to be a tacit implication from the wide wording of the options, that simply operating in a lower tax country is in itself a “BEPS” motivated activity, rather than a legitimate commercial choice. It would be preferable if any changes to the PE definition were targeted at situations which have the hallmarks of “BEPS” actions – such as situations where there is double non-taxation or clear artificial avoidance of PE status.

B. **Detailed Comments on Commissionaire Arrangements (Options A to D)**

The intention of the proposed options appears to go beyond simply targeting Commissionaire structures which more typically arise in civil law jurisdictions - the measures could potentially impact a wide range of businesses with global sales operations. The overall approach of lowering the dependent agent test from the current “concluding contracts” test would widen the scope of the rule and introduce greater uncertainty and subjectivity as to whether a PE exists in many cases.

Of the four options A-D, Option B would appear be less problematic than options A, C or D. However detailed guidance and clarification would be necessary to fully examine the potential impact of this option. In particular, it is important that any guidance issued addresses the following issues:

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1 The most recent OECD statistics show the rising number of outstanding MAP cases in most OECD countries - [http://www.oecd.org/ctp/dispute/mapstatistics2012.htm](http://www.oecd.org/ctp/dispute/mapstatistics2012.htm)
Detailed guidance and examples are needed to demonstrate the meaning of the phrase “negotiates the material elements of contracts”.

It should be clarified that a local entity must have power to bind the company in order for a PE to be created.

It should be clarified that the use of the wording is not intended to create a PE in situations which can commonly occur in business to business transactions where preliminary or interim discussions of terms of a contract occur in a State which do not reflect the final agreement of terms.

Guidance should also make clear that a PE would not be created in a situation where local staff are given strict negotiation parameters and do not have authority to derogate from these parameters.

It is inevitable that a consequence of the proposals to strengthen the independent agent test (in the proposed paragraph 6 in options A to D) will be that more agents, both related and unrelated, are treated as dependent agents, and therefore as PEs of their principals, leading to a material shift in taxing rights from residence to source states.

While the number of principals an agent represents may be relevant in determining the dependent or independent status of that agent, it should not be the determinative of the status. Similarly, the wording of the proposed paragraph 6 could result in a related party agent and unrelated party agent being treated differently as to whether a PE is created for the principal even though identical activities may be carried on by the agent. This appears to be at odds with respecting arm’s length related party transactions, and appears to disregard separate legal corporation status.

C. Detailed Comments on Specific Activity Exemptions (Options E-J)

Options E to J in the Discussion Draft propose changes to the Specific Activity exemptions in Article 5(4) of the OECD Model Treaty.

Option E - preparatory and auxiliary exemption

Option E proposes to restrict all of the exemptions to activities which are “preparatory and auxiliary”. The phrase is currently used in a number of the exemptions and the experience of our members is that it can be interpreted differently across countries and can create significant uncertainty. Extending the requirement to all of the exemptions will likely increase this uncertainty and result in an increase in the number of PE challenges made by tax authorities.

We suggest that the concerns above might be addressed by adopting a variation to General Option E which would be to have a presumption inserted into the lead in statement in paragraph 4 of Article 5 that the specific activities in subparagraphs (a) to (d) in article 5(4) could continue to be eligible for exemption unless those activities are core to the business activities of the enterprise - perhaps using wording such as ‘form a significant and essential part of the enterprise as a whole.

To supplement this, detailed guidance on the meaning of ‘core’ activities and the meaning of ‘preparatory and auxiliary’ would be needed.

The Discussion Draft proposes Options F, G and H be implemented if Option E is ultimately not adopted.

Option F – delivery exemption

Option F proposes that the exemption for ‘delivery’ is removed. This is likely to create a significant number of permanent establishments where warehouses are located in larger consumer markets. It could lead to the outsourcing of delivery functions to avoid incurring the prohibitive administration costs of a PE, even where delivery is currently carried out more efficiently by other group entities. It could also lead to warehouses being established in less commercially efficient locations (e.g. by
locating a warehouse on a border to serve multiple countries, thus ensuring that only one PE is created, rather than locating separate warehouses in more efficient locations in each country).

As noted above, there may be relatively little profit actually attributable to the delivery function carried out by these ‘delivery’ permanent establishments, resulting in little tax being generated but significant administrative and compliance costs incurred by the business.

Options G and H – purchasing and collecting information exemptions

Options G and H propose deleting the exemptions for purchasing and for the collecting of information.

It is not apparent what the rationale is for removing these exemptions as part of the BEPS process - these activities would not seem to create BEPS concerns. Again, these options could result in significant administrative PEs with very little profit attributable to them. Many businesses with global procurement models would be significantly affected and may ultimately need to adopt less efficient business models to avoid the administrative consequences of creating multiple PEs.

Option I - fragmentation

We have reservations about the proposals to extend the anti-fragmentation rules as provided for under Option I. Deeming the services of an affiliate entity as creating a PE may disproportionately penalise enterprises for using affiliates to provide appropriate services. Furthermore, the potential uncertainty and subjectivity surrounding the proposed terms “complimentary functions” and “cohesive business operations” may lead tax authorities to seek to ignore the separate legal personality of substantive legal entities.

D. Splitting up of contracts

Careful consideration of the proposals in Option K are needed as, in the absence of further qualification or amendment, a range of different activities within a single MNC group could be aggregated where there is arguably no abuse of the sort that is envisaged. To prevent this, we would suggest the activities referred to in paragraph (b) be linked so as to refer to the actual activities to be undertaken in paragraph (a).

E. Insurance

Option M proposes a specific change which would deem a PE to exist in respect of certain insurance activities. There is no explanation given in the Discussion Draft as to why the insurance industry has been identified as requiring specific treatment. As paragraph 39 of the Commentary to Article 5 notes, the creation of a PE by virtue of premium collection or locally sited risks would be contrary to the factual and legal situations in many countries, and therefore it will not be appropriate in many circumstances. We believe that this comment continues to be valid. There is a risk that implementing this proposal would impose a disproportionate compliance burden on insurers by creating a significant number of tax PEs where there would be no regulatory PE and with no or minimal profit being attributed to the tax PE.

Except in cases where an insurance or reinsurance company has a physical presence in the country, we recommend that the guidance should make it clear that a taxable presence should only arise in the country if the insurance company would be carrying on a KERT (key entrepreneurial risk taking) function in that country (as defined in the 2010 Report on the Attributions of Profits to Permanent Establishments). Alternatively the tax approach to PE could be aligned with the regulatory approach to establishment for insurance/reinsurance, so that in the absence of a company having a regulatory establishment in a country it would not have a taxable presence, but that if it had a regulatory presence in the country the normal tax rules would apply to determine its taxable status.
F. **Profit Attribution**

There is limited analysis in the Discussion Draft on the key question of profit attribution to the new PEs that could result from the proposed changes. The Discussion Draft appears to make the assumption that moving towards an increasing number of PEs will result in an increased tax take. However, this may not be the case in practice.

If the PE threshold is lowered as proposed in the Discussion Draft it is increasingly important that consistent approach is adopted as to how profits should be attributed to these new PEs.

It is very important to preserve the principles on profit attribution established in the OECD’s ‘Report on the Attribution of Profits to Permanent Establishment’ of 2010. An enhancement in the legal standing of this report (similar to the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in many countries), would ensure that a formulary apportionment approach is not adopted by any country seeking to attribute profits to a PE. Our concern here is that, in the absence of clarification, the practical effect will be increased PE attacks by Revenue authorities on the assumption that the PE changes must lead to greater profits attributable to a PE.
January 9, 2015

VIA E-MAIL

Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comment letter on the OECD Public Discussion Draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. de Ruiter,

This letter is in response to the request for comments on the OECD Public Discussion Draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status, issued October 31, 2014. I’m writing to share the views as representative of, and on behalf of the Information Technology Industry Council (“ITI”),1 the Semiconductor Industry Association (“SIA”),2 the Silicon Valley

1 ITI is an advocacy and policy organization for the world’s leading innovation companies. ITI navigates the relationships between policymakers, companies, and non-governmental organizations, providing creative solutions that advance the development and use of technology around the world. See Appendix A for a list of ITI’s members.

2 SIA represents U.S. companies involved in research, design, and manufacture of semiconductors. Semiconductors are a foundation of the information technology sector and essential to modern communications, entertainment, national defense, health care, transportation, and other aspects of the world’s economy. SIA works to encourage policies and regulations that fuel innovation, propel business, and drive international maintain a thriving semiconductor industry in the United States. See Appendix B for a list of SIA’s members.
Tax Directors Group (“SVTDG”), the Software Finance and Tax Executives Council (SoFTEC), and TechNet.

Respectfully submitted,

Rod Donnelly
Partner

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SVTDG represents U.S. high technology companies with significant presence in Silicon Valley dependent on R&D and worldwide sales to remain competitive. SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace. See Appendix C for a list of SVTDG’s members.

SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance, and accounting. SoFTEC represents the leading developers of software and is the voice of the U.S. software industry on tax issues. See Appendix D for a list of SoFTEC’s members.

TechNet is the U.S. bipartisan network of CEOs and senior executives promoting the growth of the technology industry by advocating a targeted policy agenda at the federal and state level. TechNet’s diverse membership of over 60 companies includes every part of the technology industry. See Appendix E for a list of TechNet’s members.
I. Introduction and summary

We thank the Focus Group on the Artificial Avoidance of PE Status (“Focus Group”) for preparing the Public Discussion Draft—BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS (“Action 7 PDD”) and for asking interested parties to give written comments. The Action 7 PDD is, we appreciate, an interim step—describing strategies identified, and options considered, by the Focus Group—and doesn’t represent the consensus views of the CFA or its subsidiary bodies. As an interested party, we accept the CFA’s invitation to comment on the options considered in the Action 7 PDD. We restrict our comments to three of the five topics addressed in the Action 7 PDD—artificial avoidance of PE status through commissionaire arrangements and similar strategies, artificial avoidance of PE status through the specific activity exemptions, and profit attribution to PEs and interaction with action points on transfer pricing.

The work done by the Focus Group is a mandated piece of the overall BEPS Action Plan. In considering whether and, if so, how to change rights of a “source” Contracting State to tax income earned by an enterprise of another Contracting State it’s appropriate to look at all aspects of what constitutes a nexus sufficient to warrant allocation of income taxing rights to the source State. Options for change to Article 5 should be entertained, however, only if they don’t have as an effect unreasonably changing existing international standards on allocation of tax rights on cross-border income, if they’re sufficiently precise to enable both tax administrations and taxpayers to know in most situations with some degree of certainty whether nexus exists, if they’re not overly expansive by creating nexus either in common commercial non-

1 Section A of the Action 7 PDD.
2 Section B of the Action 7 PDD.
3 Section E of the Action 7 PDD.
commissionaire situations (such as those involving buy-sell or limited-risk distributors) or in situations in which an intermediary isn’t substantially involved negotiating the contracts, if they condition nexus only on business activities conducted in that State, and if they’re not motivated by broader BEPS concerns better addressed by other measures. Moreover as a practical matter options for change to Article 5 should be entertained only if new PEs covered by such options are likely to be attributed a non-de minimis amount of profits under Article 7, measured by comparison with the burden and expense of compliance imposed on taxpayers and of verification imposed on tax authorities.4

The options for Article 5 changes described in the Action 7 PDD—at least for the two topics we comment on5—fail one or more of these requirements. These options must accordingly be rejected. Below we describe these fundamental flaws of options for changes to Article 5, ¶¶ 4, 5, and 6. If in spite of these flaws the Focus Group decides to proceed with some form of the options, we point out the least flawed options and suggest changes that could be made to certain options to mitigate some harmful effects.

A. **Summary of comments on options addressing commissionaire arrangements and similar strategies**

OPTIONS A–D deem a dependent agent PE by mixing and matching two requirements for the level of involvement an intermediary must have in the contracting process with two requirements for the substance of the contracts. The requirements for the level of intermediary involvement and the requirements for the substance of the contracts are too imprecise. The *Action 7 PDD* explains that the first requirement common to OPTIONS A & C (that an

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4 Of course, once a PE threshold is set, it would apply both to loss and gain years of a PE.

5 Proposed changes to dependent agent PE provisions in Article 5, ¶¶ 5 & 6, and proposed changes to PE exemptions in Article 5, ¶ 4.
intermediary “habitually engages with specific persons in a way that results in the conclusion of [certain] contracts”) means that “[t]he determination of whether the intermediary’s interaction with specific persons results in the conclusion of a contract would require a direct causal connection between that interaction and the conclusion of the contract.” The inquiry of whether such a “direct causal connection” exists would be new to tax law, has been difficult to resolve in other areas of the law where it’s applied, and the inherent imprecision would lead to disputes not easily resolved, thereby discouraging cross-border commerce. The first requirement common to OPTIONS B & D can be met if an intermediary “habitually . . . negotiates the material elements of [certain] contracts,” but it’s unclear how one determines what the “material elements” of a given contract are, and also unclear what level of intermediary participation in negotiation is required. The second requirement common to OPTIONS A & B is that the contracts are “for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting] or that the enterprise has the right to use, or for the provision of services by that enterprise.” It’s unclear whether this language—intended to address commissionnaire arrangements—might be interpreted so broadly as to capture intermediaries acting as buy-sell distributors for foreign enterprises. The second requirement common to OPTIONS C & D is that the contracts “are on the account and risk of the enterprise,” because of (by virtue of) “the legal relationship between [the intermediary] and the enterprise.” The requirement that the contracts be “on the account and risk of the enterprise” introduces in tax treaties a new concept with no commonly understood definition, thus raising the specter of a tax authority interpreting the phrase to apply to situations, going beyond commissionnaire arrangements, such as buy-sell or limited-risk distributorships.
The imprecision in OPTIONS A–D would create uncertainty, dampen cross-border commerce, lead to protracted tax audit disputes and Competent Authority proceedings, and decrease the likelihood of Contracting States agreeing on the existence of a dependent agency PE. Uncertainty could also lead to tax authorities selectively targeting businesses.

These requirements are too expansive. Regarding the requirements for the level of involvement of a putative agent in the contracting process, depending on how broadly the phrases “in a way that results in” or “negotiates the material elements of” are interpreted, OPTIONS A–D could deem dependent agent PEs in situations involving mere sales-support affiliates. Regarding the requirements for the substance of the contracts, depending on how broadly the phrases “for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting]” or “on the account and risk of the enterprise” are interpreted, OPTIONS A–D could reach beyond commissionaire arrangements and deem dependent-agent PEs in situations involving limited risk distributors that take ownership from a foreign enterprise of products being distributed. Neither of these common commercial arrangements, we believe, should give rise to a dependent agent PE.

OPTIONS A–D would, we believe, change existing standards on the allocation of taxing rights on cross-border income, although the Action 7 PDD asserts these standards weren’t directly targeted. The Action 7 PDD justifies changing the current definition of PE to address low- or non-taxed cross-border income, but the existence (or not) of a PE should in principle depend only on the degree of nexus a foreign enterprise has in a Contract State, not on the foreign enterprise’s tax rate.
Commissionnaire arrangements can be more narrowly targeted with more limited changes to Article 5, ¶ 5. We suggest some general language for this purpose, and also a treaty-by-treaty approach that would reference relevant language in the applicable commercial law to identify commissionnaire arrangements.

Each of OPTIONS A–D proposes the same change to Article 5, ¶ 6, giving an unqualified exception to the existence of an independent agent if a person “acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises.” We recommend that this change be withdrawn and the existing concept from the Commentary—that the extent of a person’s exclusivity is only a factor to be considered in determining independent agency status—should be retained. The proposed bright-line unavailability of independent agency can unduly harm businesses that lack visibility about the client bases of agents (or their assignees), and in any case presumes a level of coordination among associated enterprises not always found.

B. Summary of comments on options addressing specific activity exemptions

We recommend that no changes be made to the PE exemptions in Article 5, ¶ 4. The nominal goal of Action 7 is to develop changes to the definition of PE to prevent the “artificial avoidance” of PE status, and Action 7 calls out specifically “the use of . . . the specific activity exemptions.” None of the PE exemptions either modified (OPTION E) or deleted (OPTIONS F–H) from ¶ 4 are per se artificial, yet the Action 7 PDD bases justification for the proposed ¶ 4 changes on the alleged ground that various aspects of ¶ 4 may potentially give rise to the artificial avoidance of the PE threshold. We point out, in the discussion below, flaws with the proffered justifications for the OPTIONS.
The thrust of OPTIONS E–H is to remove some or all of the bright-line rules for PE exemptions in ¶ 4 and replace them with facts-and-circumstances determinations of whether the relevant activities are preparatory or auxiliary. But there’s almost no helpful guidance in the Commentary on when activities might be considered preparatory or auxiliary, and the resulting uncertainty is likely to dampen cross-border investment by businesses. OPTIONS F–H are for this reason marginally preferable to OPTION E in that only some of the specific activity exemptions would be affected in the former (assuming continuing possible qualification for the PE exemption through ¶ 4e)). Without further helpful guidance on determining whether activities are “preparatory or auxiliary,” uncertainty in making such determinations could—as in the case of imprecision & expansiveness in OPTIONS A–D—lead to tax authorities casting a very broad PE net, or selectively targeting businesses.

Importantly, the Action 7 PDD doesn’t consider whether profits likely attributable to PEs created by the proposed ¶ 4 changes might be relatively small, and outweighed by administrative costs and burdens associated with such PEs.

C. Summary of comments on profit or loss attribution to PEs and interaction with action points on transfer pricing

According to the Action 7 PDD, no substantial changes would be need to be made to existing rules on the attribution of profits or losses to a PE (under the Authorised OECD Approach (“AOA”)) if the proposals included in the Action 7 PDD were adopted. Nothing in the AOA signals a need for modifying guidance on determining profits or losses attributable to a PE if the underlying PE threshold is changed, and we recommend that the scope of the AOA—which is relatively untested—not be broadened as part of Action 7.
The AOA would, we believe, determine that relatively little profit (or even loss) would be typically attributable to many of the “new” PEs deemed to exist if proposals in the Action 7 PDD were adopted. In such cases the profits attributable might well be outweighed by increased administrative costs and burdens associated with such PEs, resulting in a dampening of cross-border commerce, contrary to a central purpose of tax treaties. Accordingly, we recommend the PE Focus Group reject changes to the PE threshold that would in typical commercial settings have low profits (or even losses) attributable to “new” PEs deemed.

We ask that proposed changes to Article 5, ¶ 5 lowering the PE threshold be accompanied by a discussion of how the AOA would apply in typical commercial situations. In particular, we ask the Focus Group to provide guidance on when—in representative “new” PEs created by the proposals—significant people functions exist that would warrant attribution of assets and/or risks and thereby attribution of profits or losses to the dependent agent PEs in excess of an appropriate arm’s length payment to the relevant (associated) dependent agent enterprise. We recommend that the PE Focus Group reverse the signaled presumption in the Action 7 PDD that “new” PEs deemed to exist if the proposals were adopted would necessarily have profits attributable to them. It would, we believe, be more appropriate to clarify that—in the context of activities performed in typical commissionaire arrangements—no presumption should arise that any profits or losses attributable to such a PE are other than routine. Finally, we recommend the Focus Group clarify—consistent with guidance in the AOA—that no presumption should arise that personnel whose activities give rise to a dependent agent PE necessarily perform and control functions, or control risks, related to the development, enhancement, maintenance, protection, or exploitation of any intangibles involved in PE transactions.
II. Specific concerns

A. Options addressing commissioneer arrangements and similar strategies

1. Flaws with OPTIONS A–D as they affect Article 5, ¶ 5

   a. OPTIONS A–D are too imprecise

      i. Language common to OPTIONS A & C

         OPTIONS A & C deem a dependent-agent PE if an intermediary “habitually engages
         with specific persons in a way that results in the conclusion of [certain] contracts.” The
         requirement that an intermediary’s actions “result[] in the conclusion of contracts” would—
         presumably with the hope of lowering the dependent-agent PE threshold—introduce in tax
         treaties a concept entirely untested in tax settings. The Action 7 PDD translates this requirement
         by stating that “[t]he determination of whether the intermediary’s interaction with specific
         persons results in the conclusion of a contract would require a direct causal connection between
         that interaction and the conclusion of the contract.” ⁶ This explanation isn’t especially helpful in
         a tax setting. The requirement that there be “a direct causal connection” between an action and a
         result is commonplace in tort law, where it’s sometimes rephrased as requiring the action be a
         “proximate cause” of an injury (tort). In tort law this apparently simple inquiry has led to much
         case law from which it’s difficult to draw general principles. To our knowledge this inquiry has
         never been applied to contracts in a tax setting, nor is it clear that it practicably could be applied.
         For any given contract many different combinations of an intermediary’s actions might be found
         to be directly causally linked to the conclusion of the contract, so could potentially be held to
         “result[] in the conclusion of contracts.” Barring further clarification, a risk exists, for example,
         that tax authorities could assert that negotiation of any single provision of a contract—whatever
         the materiality—results in the conclusion of the contract in the sense that “but for” negotiation of

⁶ Emphasis added.
the provision the eventual contract wouldn’t have been concluded. In this vein another possibility is a tax authority asserting remote “upstream” activities—e.g., marketing personnel arranging online advertising that could be demonstrated to attract (contract-concluding) customers—result in the conclusion of contracts. Thus, the proposed language in Options A and C regarding habitually engaging with specific persons in a way that results in the conclusion of contracts is imprecise enough to be open to interpretations that affect many more situations than those cited as justifying a change to Article 5(5) (i.e., commissionaire structures and situations involving the use of a local sales force “to negotiate and effectively conclude sales with prospective large clients”7). It is also very unclear how profit should be attributed to such a murky defined activity.

ii. Language common to OPTIONS B & D

OPTIONS B & D deem a dependent-agent PE if an intermediary “habitually concludes [certain] contracts, or negotiates the material elements of [such] contracts.” The first alternative requirement—that the relevant person “habitually concludes [certain] contracts”—is similar to a requirement in the current definition of a dependent-agent PE.8 The plain meaning of this alternative requirement is relatively straightforward, and we think guidance could be given in the Commentary to flesh out the common understanding of this phrase. The second alternative requirement—that an intermediary “negotiates the material elements of [such] contracts”—is, however, unclear for two reasons for which the Action 7 PDD gives no explanation. First, and most obviously, it’s unclear what the “material elements” of a contract are. Who determines what they are—the taxpayer, or the tax authorities of each Contracting State? One would expect,

8 That is, the requirement that the relevant person “has, and habitually exercises . . . an authority to conclude [certain] contracts . . . .”
e.g., contracts for the sale of goods would have as material elements price and quantity, and that
delivery terms would be non-material, but between these hopefully un-contentious conclusions
lies a no man’s land. Do the “material elements” depend on the facts and circumstances of the
contract, so that an intermediary in a Contracting State negotiating the same elements of two
different contracts may be deemed a PE in one instance but not the other? Could it even be that
materiality isn’t only contract specific, but also customer specific, so that a PE springs into
existence because a handful of customers find, e.g., warranty provisions to be material? For a
bilateral tax treaty, will the Competent Authorities readily agree what the “material elements” of
a contract are? Further, the plain meaning of the phrase “negotiates the material elements of
[such] contracts” is that all material elements must be negotiated, but the PE Focus Group would
have to clarify this to prevent mis-application by a tax authority.

Second, the phrase “negotiates the material elements” is unclear. To what extent must an
intermediary participate in negotiations to be treated as having negotiated? An intermediary that
doesn’t either solely or almost solely negotiate each of the material elements—whatever they
might be—shouldn’t be held to have negotiated such elements. This is because OPTIONS A–D
focus on situations in which intermediary activities “effectively result in the conclusion of
contracts,” signaling an emphasis on what in substance is being done. The phrase “negotiates
the material elements” would thus have been better written “substantially negotiates the material
elements.” Without signaling clearly that a high degree of intermediary participation is needed
there’s a risk of multiple claims of taxing jurisdiction—with associated complex “profits
attributable to” problems and risk of double taxation—in situations in which negotiations of the
same contract are done by different persons in multiple jurisdictions.

9 Action 7 PDD, ¶ 4.
Contract negotiation often involves both an initial stage during which a potential customer gets comfortable enough with approximate “element” ranges to invest further resources in negotiation, then a subsequent stage during which convergence is negotiated on each element. An intermediary simply negotiating within precise ranges dictated by a foreign enterprise isn’t in effect participating in the initial stage, and shouldn’t be held to have substantially negotiated such elements.

The current definition of a dependent-agent PE suffers from neither of these shortcomings.10 Thus, the proposed language in Options B and C regarding “habitually negotiating” the “material elements” of a contract introduces ambiguities that would make it very difficult to identify with precision when a PE exists or how much profit to attribute to the PE.

iii. Language common to OPTIONS A & B

A PE arises under OPTIONS A & B only if the referenced contracts are “for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting] or that the enterprise has the right to use, or for the provision of services by that enterprise”. This language certainly makes sense under the existing dependent-agent PE standard, where a PE exists only if the contract concluded by the agent legally binds the principal to the customer in a sales, leasing, or services transaction.

On the assumption, however, that this language is intended to cover a broader category of cases, if only in order to apply to commissionnaire structures where the contract concluded by the intermediary with the customer does not bind the principal (and does not even have the

10 See, e.g., Commentary on Article 5, ¶ 33.
principal as a party), one has to ask how broad the new category would be and whether it could
sweep in routine commercial distribution arrangements that do not involve *commissionnaires*.
For example, could it apply to an intermediary acting as a buy-sell distributor of goods for a
foreign enterprise? It shouldn’t. The BEPS Action Plan prefaced Action 7 with an expression of
discontent with taxpayers moving to *commissionnaire* arrangements from situations in which a
“local subsidiary traditionally acted as a distributor,”11 so local affiliate buy-sell distributors
should not be targeted by Action 7 proposed changes to the definition of PE in Article 5. Would
the fact that such a distributor, unlike a *commissionnaire*, typically takes title to the goods, even
if only on a flash title basis, before passing title to the customer in a sales transaction mean that
sales contracts by such intermediaries would not be considered contracts “for the transfer of the
ownership of . . . property owned by the enterprise”? If the proposed language is not intended to
sweep in distribution arrangements where the intermediary takes title to the goods being sold,
that should be made very clear by the OECD. If on the other hand the proposed language is
intended to be broad enough to sweep in such distribution arrangements, the OECD should
explain whether that would be the case across the board or only in some situations, and where the
dividing line would fall. The potential scope of the proposed language is also very unclear in the
context of leasing and services transaction, where there is not even the possibility of relying on a
standard such as direct passage of title to know when a foreign enterprise might be treated as
having a PE by virtue of a contract between an intermediary and a customer to which the
enterprise itself is not a party.

iv. **Language common to OPTIONS C & D**

A PE arises under OPTIONS C & D only if the referenced contracts “are on the account and risk of the enterprise,” because of (by virtue of) “the legal relationship between [the intermediary] and the enterprise.” The requirement that the contracts be “on the account and risk of the enterprise” introduces in tax treaties a new concept. The *Action 7 PDD* doesn’t explain what this phrase means. The phrase sometimes finds use in the context of a transfer of an interest in property to or from a person—e.g., “trading in stocks . . . for the account and risk of the taxpayer”\(^{12}\)—that seems akin to a tax sale or purchase—i.e., transfer of the benefits and burdens of ownership. No commonly understood definition of the phrase exists, however. In particular it’s unclear precisely how the phrase would apply in civil law jurisdictions to find a dependent-agent PE in the case of a *commissionnaire* arrangement—a primary target of the proposed change to ¶ 5—where an agent acting on behalf of an undisclosed principal generally doesn’t bind the principal, unless the phrase is intended to cover cases where the intermediary does not bind the principal. But this raises the question of how broadly the phrase is intended to apply beyond the current dependent-agent PE standard of binding the principal. The lack of clarity raises a risk of a tax authority considering the phrase elastic enough to apply to situations, going beyond *commissionnaire* arrangements, in which an intermediary gets tax ownership of property, such as buy-sell or limited-risk distributorships, thereby affecting much more cross-border commerce. Such an effect would go beyond leveling the playing field between common law undisclosed principal and civil law *commissionnaire* cases and would move the goalposts of the source-residence State taxing allocation for both common law and civil law jurisdictions. Moreover, even if an agreed-upon definition of the phrase existed, it’s unclear how it would

\(^{12}\) U.S. Treasury Regulation § 1.864-2(c)(2)(i)(c).
apply, for example, to services or leasing transactions, where passage of title to property is not at issue.

v. Consequences of imprecision in the definition of a dependent-agent PE

The consequences of imprecision in the conditions triggering the deeming of a dependent-agent PE are serious. Businesses need certainty on the tax consequences of their operations and investments in any country. Uncertainty about whether intended operations in a jurisdiction will give rise to a PE can only dampen cross-border commerce. Businesses can face criminal and civil (e.g., VAT) penalties for failing to carry tax compliance burdens associated with a PE. Businesses that fail to accurately assess PE risks for tax provisioning purposes risk accounting regulatory violations and shareholder litigation.

Imprecise dependent-agent PE triggering conditions will surely also result in unnecessary time spent on audits by tax administrations and taxpayers. The effect of such imprecision will, in Competent Authority proceedings, decrease chances of Contracting States agreeing an enterprise of one State has a PE in the other State, thereby increasing chances of juridical double taxation, contrary to the avowed main purpose of the OECD MTC.  

13 A prerequisite for application of Article 7, ¶ 3—whose purpose is to avoid double taxation on profits attributable to a PE—is agreement a PE exists.
14 OECD MTC, Introduction, ¶ 3.
b. **OPTIONS A–D are too expansive**

Each of OPTIONS A–D has a first requirement triggered by a certain level of involvement in the contracting process by a putative dependent agent,\(^{15}\) and a second requirement triggered by the substance of the contract itself.\(^{16}\)

Regarding the first requirement, BEPS Action 7—*Prevent the Artificial Avoidance of PE Status*—describes its justification, in part, as situations in which sales contracts are “negotiated and concluded” by the sales force of a local subsidiary without the profits from the sales being taxable to the same extent as they would be if the sales were made as a distributor. Depending how broadly the phrases “in a way that results in” or “negotiates the material elements of” are interpreted, OPTIONS A–D could deem dependent-agent PEs in common commercial situations involving mere sales-support affiliates.

Regarding the second requirement, BEPS Action 7 further explains that “[i]n many cases” the above-described situation has led enterprises to replace buy-sell subsidiaries with “commissionaire arrangements.” Regarding the second requirement, depending on how broadly the phrases “for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting] or that the enterprise has the right to use, or for the provision of services by that enterprise” or “on the account and risk of the enterprise” are interpreted, OPTIONS A–D could reach beyond *commissionnaire* arrangements and deem dependent-agent PEs in common commercial situations involving limited risk.

\(^{15}\) OPTIONS A & C require the putative agent to habitually engage “with specific persons in a way that results in the conclusion of [certain] contracts.” OPTIONS B & D require the putative agent to “conclude[] contracts, or negotiate[] the material elements of contracts.”

\(^{16}\) OPTIONS A & B refer to contracts in the name of the enterprise, for the transfer of ownership rights in property held by the enterprise, or for services performed by the enterprise. OPTIONS C & D refer to contracts that “are on the account and risk of the enterprise.”
distributors that take ownership from a foreign enterprise of, for example, products being distributed.

These common cross-border commercial arrangements are potentially put at deemed PE risk under OPTIONS A–D, but weren’t targeted in the BEPS Action Plan, nor should they be considered “artificial,” nor should they give rise to deemed dependent-agent PEs.

c. OPTIONS A–D upset existing international standards on the allocation of taxing rights for no rational policy reason

The Action 7 PDD “actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.” While the Action 7 PDD proposals mightn’t be “directly aimed” at upsetting such international standards—which have existed for over 50 years— they’ve nonetheless scored a direct hit on them. Businesses have during this half-century expanded global operations, tailoring operations country-by-country using a blend of associated and unrelated enterprises, in good faith reliance on bilateral treaty networks imposing relatively precise nexus requirements as a condition for “source” country taxation of profits. In proposing to change the PE threshold in a way that’s imprecise and expansive, the Action 7 PDD would in a fell swoop require dismantling much of such structuring, forcing businesses to expend significant resources to restructure without knowing precisely what nexus level triggers source-country taxation rights, and with no adequate policy rationale for why the PE-net has been so broadened.

17 Article 5, ¶ 4 of the 1963 OECD MTC provided that “[a] person acting in a Contracting State on behalf of an enterprise of the other Contracting State—other than an agent of an independent status to whom paragraph 5 applies—shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercise in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.”
The *Action 7 PDD* explains that the BEPS Report and the Action Plan assert that the current definition of PE must be changed to address situations in which “cross-border income [that] would otherwise go untaxed or would be taxed at very low rates.”18 In so tipping its hand, the *Action 7 PDD* thus proposes lowering the PE threshold because in some cases cross-border income is subject to low- or non-taxation. The existence or non-existence of a PE should in principle depend only the degree of *nexus* a foreign enterprise has in a Contracting State. It shouldn’t depend on the tax rate of the foreign enterprise.

Lowering the PE threshold potentially affects all cross border income, whatever tax rate it’s subject to. In proposing to lower the PE threshold, the *Action 7 PDD* thereby asserts, for income taxation purposes, the primacy of a “source” State over that of a residence State even in situations in which profits received by a foreign enterprise are subject to high tax—i.e., a situation not triggering concern in the BEPS Report.

Lowering the PE threshold because in some cases cross-border income is subject to low- or non-taxation is in any case a crude way for dealing with situations far better treated with more specific approaches. A CFC regime, for example, can be precisely tuned to the tax rate imposed on income received.19 Continuing efforts could be made to deter Contracting States from enacting harmful tax practices, encouraging them to condition implementation of preferential tax regimes based on substantial activities.20 A jurisdiction could simply choose not to sign a bilateral tax treaty with another jurisdiction in a situation where there’s little risk of double

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18 *Action 7 PDD*, ¶ 3. *See also* ¶ 26, Examples 1 & 2, discussed below, which argue for non-applicability of PE exemptions in Article 5, ¶ 4 because of low- or non-tax ed cross-border income.

19 *See, e.g.*, §§ 4201, 4202, & 4211 of H.R. 1, 113th Cong., 2d Sess. (*Tax Reform Act of 2014*).

taxation or could build into the treaty the right to amend the bargain if the treaty partner’s domestic law changes to remove or substantially reduce the risk of double taxation.

d. Commissionnaire arrangements can in any case be targeted by a simple change to Article 5, ¶ 5

As an alternative to OPTIONS A-D, the language of Article 5, ¶ 5 could be changed to target commissionnaire arrangements. The Action 7 PDD defines such an arrangement loosely as “one through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products.” The OECD’s concern with commissionnaire arrangements largely stems from the fact that in civil law jurisdictions, in a situation of indirect representation, an agent acts in its own name and contractually binds itself, but not the principal (enterprise), to a third party that therefore can’t enforce the contract against the principal. In this situation the agent doesn’t conclude a contract in the name of the principal—the agent concludes a contract but the principal primarily performs under the contract. Various wordings could deal with this situation. One example would be: “habitually concludes sales contracts with customers resulting in direct transfer of ownership of property from the enterprise to such customers.” This language clearly wouldn’t deem a dependent agent PE to arise in situations involving limited risk distributors (who contract for themselves and own property transferred to customers) or sales-support affiliates (who neither conclude contracts), but would deem a commissionnaire arrangement to be a dependent-agent PE. As a more targeted alternative, the OECD could also recommend that Contract States negotiating Article 5 reference

21 Action 7 PDD, ¶ 6.
22 Avery Jones and Ward, Agents as Permanent Establishments under the OECD Model Tax Convention, European Taxation 33 European Taxation No. 5, 154, 156–157 (1993).
23 Perhaps this was the intention of the Action 7 PDD in OPTIONS C & D by referring to “contracts . . . which . . . are on the account and risk of the enterprise,” but that’s unclear because no explanation of the choice of language was given.
relevant provisions in the applicable commercial law, in order to identify *commissionnaire* arrangements which are intended to create PEs.

2. **Flaws with OPTIONS A–D as they affect Article 5, ¶ 6, and how they could be corrected**

   Each of OPTIONS A–D proposes the same change to Article 5, ¶ 6, replacing the existing sentence of this paragraph with two sentences. The first sentence provides for the non-application of ¶ 5 for an “independent agent” acting in the ordinary course of business. This is similar to the existing exception to ¶ 5 for an “agent of independent status . . . acting in the ordinary course of [its] business.” The second sentence introduces a new concept, giving a specified exception to the existence of an independent agent:

   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 within the meaning of this paragraph with respect to these enterprises.

Paragraph 38.6 of the current OECD Commentary on Article 5 explains that “[a]ll the facts and circumstances must be taken into account to determine whether the agent’s activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge,” and that the number of principals represented by an agent is one factor to be considered in determining independent status.

A non-resident enterprise may have no knowledge of the extent to which an agent of the enterprise acts on behalf of other enterprises. The agent may simply refuse to provide information relevant in making this determination. Even if it’s provided, the consequences of misinformation could be grave for a principal. It’s not uncommon for agents to assign or sub-contract all or parts of contracts to associated [agent] enterprises, and the principal may have no
visibility into this. In this case a non-resident enterprise principal may unknowingly end up in contractual privity with an assignee that works exclusively or almost exclusively for it. Moreover, the exclusivity of an agent’s actions can change with time, so the determination would have to be continuously updated across possibly (for some businesses) many agents. Some business members of the trade association signatories to this letter have distribution channels encompassing many thousands of unrelated enterprises, each of which may further contract with associated or unassociated enterprises. The impracticability of this bright-line exception to independent status is obvious. The second sentence to the change to Article 5, ¶ 6 proposed by OPTIONS A–D should accordingly be stricken, and the existing concept—that the extent of exclusivity is but a factor to be considered in determining independent status—should be retained.

The deemed non-independent agency of a person acting “exclusively or almost exclusively” on behalf of associated enterprises presupposes a level of coordination among associated enterprises on a par with that found within a single enterprise. In effect OPTIONS A–D assume constructive knowledge of all agents used by members of an multinational enterprise group, and ignore the fact that associated enterprises can often exercise autonomy over regional functions, including third-party service providers. This can be punitive, and again it supports using exclusivity or near-exclusivity as not being dispositive but rather as being a factor to be considered in determining independent status.
B. Options addressing specific activity exemptions

1. OPTIONS E–H

   a. No changes to Article 5, ¶ 4 are warranted—in general

   No changes to the PE exemptions in Article 5, ¶ 4 are warranted. The Action 7 PDD proposes three measures each of which lowers the PE threshold: (1) proposed changes to ¶ 5 to deem dependent-agent PEs in many situations; (2) proposed changes to the exemptions in ¶ 4 making them harder to qualify for; and (3) proposed changes to ¶ 6 making it harder to qualify as an agent of independent status. Proposed changes to the exemptions in ¶ 4 lower the threshold for finding both dependent-agent PEs in ¶ 5 and fixed-place-of-business PEs in ¶ 1. The BEPS Action Plan prefaced its statement of Action 7 by explaining that “MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.”

   None of the ¶ 4 exemption activities either modified (OPTION E) or deleted (OPTIONS F–H) from ¶ 4 are per se artificial. The Action 7 PDD doesn’t assert that, nor could it rationally do so given that the activities are common facets of most cross-border commerce, unless the Action 7 PDD assumes most cross-border commerce somehow involves artificial activities. The Action 7 PDD apparently adopted the recommendation of the Action 1: 2014 Deliverable—Addressing the Tax Challenges of the Digital Economy, which recommended that work done on Action 7 consider “whether certain activities . . . previously considered to be preparatory or

24 Emphasis added.
auxiliary may be increasingly significant components of businesses in the digital economy.”

But the *Action 7 PDD* also apparently bases justification of proposed ¶ 4 changes on the grounds that “various aspects of Art. 5(4) . . . may potentially give rise to the artificial avoidance of the PE threshold.”

Under this rationale, for example, reliance by an enterprise on the ¶ 4 exemption for use of facilities solely for the purposes of delivery of its goods constitutes the artificial avoidance of the PE threshold unless such use is preparatory or auxiliary. The *Action 7 PDD* bootstraps itself into its conclusion without ever explaining why such non-preparatory or auxiliary use is “artificial avoidance.” Why is the non-existence of a PE under current rules the “artificial avoidance” of a PE under those rules? Businesses that have for 50-plus years built cross-border commerce networks in good faith reliance on the existing ¶ 4 exemptions deserve an explanation why such reliance represents “artificial avoidance” of the PE threshold. No sensible explanation can be given. The *Action 7 PDD* may tacitly base proposed changes to ¶ 4 on the results of its having considered—at the request of the Action 1: 2014 Deliverable—the increasing significance, within the digital economy, of activities previously thought to be preparatory or auxiliary. The nominal justifications given for ¶ 4 changes proposed in OPTIONS E–H, addressed below, don’t acknowledge this consideration, however. Moreover the proffered justifications are questionable.

OPTIONS E–H remove some or all of the bright line rules for PE exemptions in ¶ 4 and replace them with facts-and-circumstances determinations of whether the relevant activities are preparatory or auxiliary, with scant guidance on how this determination is made.

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26 *Action 7 PDD*, ¶ 13.

27 “It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of
E–H thus compound existing uncertainty around the determination of what’s preparatory or auxiliary. This uncertainty is unhelpful, and is likely to dampen cross-border investment decisions by businesses.

Another important consideration not addressed in OPTIONS E–H is whether the profits likely attributable to PEs created by the proposed changes are outweighed by the administrative costs and burdens associated with such PEs, including costs of country-by-country determinations of what activities are or aren’t preparatory or auxiliary. This consideration was intended to inform the determination of what might qualify under the preparatory-or-auxiliary exemption in ¶ 4e\(^{28}\) but it seems forgotten in the *Action 7 PDD*.

b. OPTION E

The *Action 7 PDD* justifies OPTION E on the grounds of addressing “situations where these [¶¶ 4a–4d] give rise to BEPS concerns.” But, again, *Action 7 PDD* gives no explanation of what those BEPS concerns are—do they (again) involve the “artificial avoidance” of the PE threshold?\(^{29}\)

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\(^{28}\) “It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.” Commentary on Article 5, ¶ 23.

\(^{29}\) The *Action 7 PDD* mentions—but nominally chooses not to base its OPTION E recommendation on—“the views of some delegates who . . . considered . . . the original purpose of [¶ 4 was] to cover only preparatory or auxiliary activities.” These delegates are mistaken. There’s no indication of such a purpose in the Commentary on Article 5 of the 1963 Draft Double Taxation Convention on Income and Capital. Rather, such Commentary explains (paragraph 10) that the specific-activity exemptions are “forms of business activity which should not be treated as constituting permanent establishments even though the activity is carried on in a fixed place of business . . . .” (Emphasis added).
OPTION E would, if implemented, introduce subjectivity into the current bright-line specific activity exemptions in ¶¶ 4a–d. An enterprise conducting any of these specified activities in a Contracting State would qualify for the exemption only if it could convince that State’s tax administration (or its courts) the activities are preparatory or auxiliary. To this end, guidance in the Commentary isn’t especially helpful in reaching conclusions about whether, in a given context, any of the specific activities in ¶¶ 4a–d is preparatory or auxiliary, and the Commentary acknowledges the difficulty of the task in general. The Action 7 PDD includes no discussion of how to determine whether any of the specific activities potentially affected by OPTION E “in itself forms an essential and significant part of the activity of the enterprise as a whole”, thereby failing to fulfill the mandate of the Action 1: 2014 Deliverable to determine “whether a reasonable, administrable rule . . . can be developed” to identify “the circumstances under which such activities may be considered core activities.” Compounding the difficulty is the further determination that must be made concerning whether the locations at which such activities are conducted are fixed places of business of the foreign enterprise—i.e., typically, whether such locations are “at the disposal” of such enterprise. The OECD acknowledged concerns about the lack of clarity of this phrase, and prior to the BEPS project issued a public discussion draft with proposals addressing this issue.

30 “It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not.” Commentary on Article 5, ¶ 24. This argument would apply with appropriate changes under OPTIONS F–H, addressed below.

31 Commentary on Article 5, ¶ 24.


33 Commentary on Article 5, ¶¶ 4 & 4.1.

34 Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (12 October 2011), ¶¶ 10–16.
This exercise of resolving the “preparatory or auxiliary” and “fixed place of business” question would have to be repeated in possibly many other countries. Global objective certainty would have been replaced by country-by-country subjective uncertainty, with no guarantee that an outcome in one country applies in any other. Businesses, tax administrations, Competent Authorities, and courts will have to expend significant resources making these subjective determinations. Harmful results of uncertainties in the precision of proposed changes to ¶ 5 (described above) would also flow if OPTION E were chosen.

c. OPTIONS F–H

OPTIONS F–H are proffered if OPTION E isn’t adopted. It may have been the intention of the Focus Group that explicit removal of specific activities in ¶¶ 4a, b), & d) would still allow an enterprise to qualify for an exemption for any such activity under the general exemption in ¶ 4e), but the Action 7 PDD doesn’t say so in so many words, even though the proposed drafting appears to favor that conclusion. To preclude inference of a contrary intention—i.e., a negative inference that explicit removal of an activity meant the general exemption in ¶ 4e) wouldn’t apply—either OPTIONS F–H could be accompanied by Commentary language signaling possible application of ¶ 4e) to exempt a deleted activity, or each of OPTIONS F–H could be modified to make this clear in ¶ 4 itself.36

Assuming continuing possible qualification for PE exemption through application of ¶ 4e), OPTIONS F–H are marginally preferable to OPTION E in that only some of the specific

35 Because the ¶ 4 exemptions are relevant both to fixed-place-of-business and dependent-agent PEs, the enterprise would face uncertainty in any Contracting State in which it hires an associated or even an unrelated enterprise to perform any of the specified activities.

36 Each of the relevant activities would be qualified rather than deleted—e.g., OPTION F could be changed to read recommend ¶ 4a) to read “the use of facilities solely for the purpose of storage, display or (if of a preparatory or auxiliary character) delivery of goods or merchandise belonging to the enterprise.”
activities in ¶¶ 4a–d) would be affected. An enterprise would have to plead application of the general exemption ¶ 4e) to affected specific activities, but unaffected specific activities—e.g., use of facilities solely for the purpose of storage of goods or merchandise belonging to the enterprise—would continue to constitute per se PE exemptions. The burdens on taxpayers, tax administrations, Competent Authorities, and courts—while significant—would be less under OPTIONS F–H than under OPTION E.

Each of OPTIONS F–H nonetheless has shortcomings and should be rejected.

i. **OPTION F—deletion of “delivery” in ¶¶ 4a) & b)**

The *Action 7 PDD* asserts it would be difficult to justify application of the exemptions in ¶¶ 4a) & b) “where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online . . . .” It’s axiomatic that maintenance of a stock of goods for delivery constitutes part of the overall process by which many businesses earn profits, but why shouldn’t it be exempted from PE status, as it is currently? The proffered example strongly suggests that, for the PE Focus Group, size matters: presumably the combination of a “very large warehouse” in which “a significant number of employees” work in large part motivates asserted non-application of the preparatory-or-auxiliary exemption in ¶ 4e). Put differently, the Focus Group believes the preparatory-or-auxiliary exemption shouldn’t apply if the enterprise sells lots of goods into a Contracting State (for only then would the enterprise need a very large warehouse with a significant number of employees). But the determination of whether using facilities for the delivery of goods is preparatory or auxiliary shouldn’t in principle turn on the quantity of

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37 *Action 7 PDD*, ¶ 18.

38 We assume continuing availability of this exemption, even if “delivery” is deleted in ¶¶ 4a) & b).
business conducted—i.e., on the scale of business. Why should use of facilities for delivering a million widgets a year not be preparatory or auxiliary if using facilities for delivering a thousand widgets a year is? No rational explanation can be given.

The “decisive criterion” for determining whether using facilities for the delivery of goods is preparatory or auxiliary is (as noted above) “whether or not the activity of the fixed place of business [i.e., delivery] in itself forms an essential and significant part of the activity of the enterprise as a whole.” So OPTION F (and OPTION E, too, as it relates to delivery) rejects the per se exemption for delivery in favor of a case-by-case determination of whether delivery forms “an essential and significant part of the activity” of a cross-border business. As noted above, there’s very little guidance on how this determination should be made. Does it, for example, depend in part on customers’ (subjective) intentions in making purchases? This determination introduces much unhelpful uncertainty for cross-border businesses involving delivery of goods or merchandise—i.e., essentially any businesses to which a treaty would apply. Protracted, fact-intensive disputes will almost certainly arise. Without further guidance tax authorities might leverage this uncertainty either to cast a very broad PE net, or to target selectively certain businesses. Further guidance—beyond “[e]ach individual case will have to be examined on its own merits”—is needed before this rule could even approach practicability.

The proffered example also suggests the PE Focus Group’s conclusion may have been motivated in part by the medium through which the sale was conducted—i.e., online sales versus sales via fax or phone or regular mail. Most enterprises selling cross-border have online-sales

39 Commentary on Article 5, ¶ 24.

40 Id.
options for customers,\textsuperscript{41} and characterization of use of facilities for delivery of goods as preparatory or auxiliary (or not) shouldn’t in principle turn on the medium through which the sales were conducted.

There is also the question of whether using a facility or maintaining a stock of goods in a country for the purpose of delivery of those goods gives rise to any potential base erosion concern in a Contracting State in situations where the goods are being delivered to buyers in a third country, and yet the proposed change would potentially hit those situations as well as ones where the goods in question are being delivered within the Contracting State.

Deletion of “delivery” in ¶¶ 4(a) & b) means the remaining exception for “storage” of goods and merchandise is per se exempted from PE status, but “delivery” of goods or merchandise—including goods or merchandise stored in the same jurisdiction—is (presumably) exempted from PE status only if it’s preparatory or auxiliary. But in virtually all commercial situations goods or merchandise are only stored so they can later be delivered (somewhere, to someone)—i.e., storage and delivery purposes almost always coexist. So the different exemption standards will likely create confusion.

\textit{ii. OPTION G & H—deletion of exemptions for purchasing goods or merchandise, or for collecting information}

OPTION G proposes deleting “purchasing goods or merchandise” from ¶ 4(d), so the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise for the enterprise would only be exempted from PE status if the preparatory-or-auxiliary exemption in ¶ 4(e) applied. The \textit{Action 7 PDD} asserts that this exemption “seems to

\textsuperscript{41} Presumably the Focus Group isn’t tacitly asserting online commerce is conducted for the purpose of “artificial avoidance” of PE status.
have been originally justified by the view that no profits could or should be attributed to such activities,” but there’s no suggestion of that in the original OECD MTC.\footnote{The Commentary on Article 5 of the 1963 Draft Double Taxation Convention on Income and Capital is silent about this exemption.}

Examples in ¶ 26 of the Action 7 PDD apparently motivate OPTION G. In Example 1, the concern is profits attributable to purchasing discounts escaping taxation in both the “source” State (if the purchasing office of an enterprise doesn’t constitute a PE) and the “residence” State (if “the domestic exemption or territorial system of that country attributes the discount” to the source State). In Example 2 the concern is profits seemingly attributable to purchasing functions of experienced employees being subject to low-taxation in a residence State if an agricultural buying-and-selling enterprise resident in a low-tax jurisdiction had in a source State a purchasing office that wasn’t a PE.

These Examples fail to justify OPTION G for three reasons.\footnote{Example 2 also asserts that “it would seem difficult to argue that the purchasing would only constitute a routine function,” but this misses the point. The purchasing office employees in the Example are described as “well paid,” and they’ll presumably pay tax in the source country. In a free-market economy with facts as given in the Example (e.g., other than employee skill & experience, no specific intangibles driving profits) such employees (who are experienced and whose job functions involve a high degree of skill) could be expected to command (as compensation) virtually all profits properly attributable to the selling function. The source State will get all tax properly attributable to the purchasing function, which seems nonroutine.} First, the lesson of Example 1 follows from an assumption the purchasing office will keep the volume discount, but this is contrary to guidance on BEPS Action 8 indicating a volume discount would typically be shared among the group affiliates for which purchases are made.\footnote{¶ 1.101 of BEPS Action 8: 2014 Deliverable—Guidance on Transfer Pricing Aspects of Intangibles.} Second, as explained above, low- or non-taxation of cross-border profits shouldn’t in principle inform the question of whether a PE exists in a source State—degree of nexus of operations should be independent of tax rates.
Third, in making the policy argument that a PE should exist in Examples 1 & 2, the Policy Group is asserting that the activities in the source State aren’t preparatory or auxiliary. But characterization of activities in the source State as preparatory or auxiliary (or not) cannot in principle be justified by tax rates imposed on profits arising in part from those activities.

OPTION G deals with the nexus a foreign enterprise must have in a Contracting State for that State to have the right to tax profits attributable to purchasing activities conducted in that State for the enterprise. It’s questionable whether much, if any, profit could be attributable in general to purchasing activities. Further, almost all OECD Member States levy VAT or other consumption taxes, and so tax revenues already arise from in-country purchasing activities.

OPTION H proposes additionally deleting “collecting information” from ¶ 4d), so the maintenance of a fixed place of business solely for the purpose of collecting information for the enterprise would only be exempted from PE status if the preparatory-or-auxiliary exemption in ¶ 4e) applied. In apparent justification for deleting “collecting information” from ¶ 4d), the Action 7 PDD explains that “[c]oncerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises.”

This explanation fails to justify OPTION H for two reasons. First, if in reality an enterprise is collecting information for other enterprises, the PE exemption in ¶ 4d)—applicable only if the information is collected “for the enterprise [itself]”—clearly wouldn’t apply. Such

We assume continuing availability of this exemption, even if “purchasing goods or merchandise” is deleted in ¶ 4d).

Action 7 PDD, ¶ 28.
enterprise attempts at “disguising” activities don’t rise to the level of “artificial avoidance” of PE status, can be simply addressed by a vigilant tax administration, and certainly don’t justify removing the “collecting information” exemption for all enterprises. Second, and more fundamentally, most of the value from selling information to customers is attributable to filtering, analysis, and other functions performed on raw data, which by itself is of relatively low value. It’s thus entirely appropriate to per se exempt “collecting information” from PE status in ¶ 4d).

2. OPTIONS I–J

In suggesting “anti-fragmentation” rules, OPTIONS I–J would formalize the directive in ¶ 27.1 of the Commentary on Article 5 to cover situations in which an enterprise maintains different places of business in a country, and also extend it to situations in which an associated enterprise either works at the same places of business as the first enterprise, or at a different place within the same country. Both OPTIONS have the requirement that the relevant business operations—whether or not geographically dispersed—must “constitute complementary functions that are part of a cohesive business operation.”

Paragraph 27.1 of the Commentary on Article 5 asserts an anti-abuse policy that is reasonable: An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory and auxiliary activity. By assumption, the enterprise fragmented operations in a country to avoid having a PE—i.e., “artificial avoidance” justifies override of the ¶ 4 PE exemptions.

OPTIONS I–J are troubling, however, for two reasons. First, no “artificial avoidance” intention need be present for the override to work. Second, each OPTION introduces a degree of
subjectivity and uncertainty by not defining either what makes functions “complementary” or what makes them “part of a cohesive business operation.” The example in ¶ 27.1 suggests that complementarity must be with respect to the same property or the same services (each separately), so that for example the functions of receiving & storing computer equipment, on the one hand, and distributing that computer equipment on the other hand, are complementary, but the functions of distributing computer equipment and servicing that equipment shouldn’t be complementary. This uncertainty should be eliminated, either with a definition or with examples. Further, it’s unclear when functions are “part of a coherent business operation.” MNEs would face a risk of a tax administration asserting any functions performed by associated enterprises within the same MNE are part of a coherent business operation. This risk should also be eliminated, either with a definition or with examples.

Assuming the risks associated with uncertainty/subjectivity can be eliminated, OPTION I is preferable to OPTION J. OPTION J would deem non-application of the PE exemption in ¶ 4 in situations covered by OPTION I, and further in situations in which the combination of activities at the same place or at the different locations (as applicable) goes beyond what is preparatory or auxiliary. This introduces more uncertainty for taxpayers and for this reason should be discarded. OPTION I, although flawed because it’s unclear and rests on questionable policy concerns, is preferable to OPTION J.

C. Profit attribution to PEs and interaction with actions points on transfer pricing

The Action 7 PDD states that “[t]he preliminary work . . . done so far on the issue of attribution of profits has focussed on the determination of additional profits that would be allocated to the State of the PE as a result of the changes that could be made to the definition of
PE as a result of the work on Action 7 compared to the profits that would be allocated under the existing definition of PE.**47** This passage raises issues of attribution of profits or losses to a PE under the AOA. The PE Focus Group was tasked with addressing profit attribution issues relating to Action 7 PE definition changes. The *Action 7 PDD* states the PE Focus Group’s preliminary work hasn’t identified substantial changes that would be needed to be made to the AOA if the proposals included in the *Action 7 PDD* were adopted.48 The AOA was the culmination of a multi-year effort to revise application of the prior version of Article 7, and to revise Article 7 itself. The AOA establishes a complex theoretical framework for determining profits attributable to a PE, 49 but it remains largely untested in application. Nothing in the 2010 Report signals a need for modifying the AOA if the underlying PE threshold is changed.50 We accordingly recommend that no changes be made to broaden the scope of the AOA as part of Action 7.

An effect of the *Action 7 PDD* proposing to lower the threshold for what constitutes a PE is that a group of fewer activities can be deemed a PE. A corollary of PEs arising from small sets of activities is that, under the AOA, one can expect in some cases only a small amount of profits (or even losses) would be attributable to the associated PEs, and the administrative costs and burdens associated with such PEs might well outweigh such profits. As a consequence one can expect a chill on cross-border commerce as MNEs forego necessary, but low-profit, activity because of the overall burden they face. In these cases deeming PE status would thus act as a

47 *Action 7 PDD*, ¶ 45 (emphasis added).
48 *Id.*
50 Phrases such as “nothing in this [2010 Report] shall be considered as altering or lowering the existing PE threshold” suggest the AOA was intended to operate independently from the PE threshold.
barrier to trade, contrary to a central purpose of tax treaties. Consequently it’s sensible to use the AOA to inform the determination of PE threshold, recognizing that too low a threshold leads to harmful effects.

As discussed above, we recommend *commissionnaire* structures can be more precisely targeted by changes to Article 5, ¶5, without having to make the imprecise and overly expansive changes to ¶5 suggested in OPTIONS A–D. It’s reasonable to ask that any changes to ¶5 lowering the PE threshold be accompanied with a discussion of how the AOA would apply in representative fact patterns. The language cited above signals a presumption that profits would necessarily be attributable to (new) dependent-agent PEs that would exist under a new ¶5.51 This is, however, inconsistent with the AOA, which is explicit that “there is no presumption that a dependent agent PE will have profits attributable to it.”52 The Focus Group should reverse the apparent presumption in ¶45 of the *Action 7 PDD*. It would more appropriately be warranted—given the nature of activities performed in typical *commissionnaire* arrangements—that the Focus Group clarify that no presumption should arise that any profits attributable to such a PE are other than routine.

The existence of a dependent-agent PE doesn’t justify attribution of profits to the PE under a “force of attraction” principle.53 In many if not most cases, the persons carrying out the activities described in the new varieties of PEs potentially created by the options set out in the *Action 7 PDD* (e.g., acting as a *commissionnaire*, providing warehouse or purchasing services, etc.) already have a taxable presence of their own in the host State and are paying tax there on

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51 The same applies to new fixed-place-of-business PEs that would arise by virtue of raising the PE exemption threshold in ¶4.
the arm’s length remuneration they receive for the functions they perform. Under these circumstances, no further profits are attributable under the AOA to a dependent-agent PE unless “source” State personnel whose activities give rise to a dependent-agent PE perform significant people functions relevant to the assumption and/or management of risks of the foreign enterprise or to determining economic ownership of assets owned by the foreign enterprise.54 Whether or not such functions are undertaken can only be determined by functional and factual analyses of a dependent agent enterprise, and can’t be presumed. We note that it is difficult to imagine what such functions might be in the context of the various proposed forms of PEs, and we urge the Focus Group to provide guidance on when they believe such functions do and do not exist and what the profit attribution implications are in each case. The Focus Group should also clarify in particular that no presumption should arise that such “source” State personnel necessarily perform and control functions, or control risks, related to the development, enhancement, maintenance, protection, or exploitation—as that phrase is used in the BEPS Action 8: 2014 Deliverable—Guidance on Transfer Pricing Aspects of Intangibles55—relating to any intangibles involved in PE transactions. This clarification is consistent with guidance in the 2010 Report.56

55 ¶ 6.32 ff.
56 “[I]t should be noted that the activities of a mere sales agent may well be unlikely to represent the significant people functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the “economic owner” of that intangible.” 2010 Report, ¶ 233.
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59. salesforce.com
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20. ecoATM, Inc.
21. eHealth, Inc.
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25. EnerNOC, Inc.
26. Etagen, Inc.
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36. Lee & Hayes, pllc
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38. Lyft, Inc.
39. Madrona Venture Group
40. Marvell Semiconductor, Inc.
41. MHR International, Inc.
42. Microsoft Corporation
43. MIND Research Institute
44. Morgan Stanley
45. Motor Vehicle Software Corporation
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48. Oracle Corporation
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52. Point Inside, Inc.
53. Qualcomm, Inc.
54. Relevad Corporation
55. Revolution LLC
56. salesforce.com
57. SAP
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59. Silver Spring Networks, Inc.
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61. SV Angel
62. Symantec Corporation
63. TechNexus
64. Uber, Inc.
65. Visa, Inc.
66. WGBH Boston
67. Wilson Sonsini Goodrich & Rosati
68. Yahoo! Inc.
69. Yelp Inc.
General Comments

1. Since disputes between tax authorities and taxpayers frequently occur in various States concerning the interpretation and application of the PE concept, we support the ongoing efforts of OECD to clarify the definition and scope of PE from the perspective of stability and certainty of taxation. We also appreciate the need to focus on actions aimed at artificial avoidance of PE status.

While supporting the abovementioned objectives, we do not agree with the contention that “commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place” (i.e., for artificial avoidance of PE status), nor do we agree with
the proposal for comprehensively and significantly expanding the definition and scope of PE. Not all transactions using commissionnaires and other intermediaries are aimed at avoidance of PE status. The manner in which overseas subsidiaries are involved in the form and flow of transactions is the outcome of various factors that may include requests made by customers and consideration of the level of risk that overseas subsidiaries are able to bear. In other words, the involvement of overseas subsidiaries may reflect valid business reasons and considerations. We therefore cannot support the blanket rejection of all transactions involving commissionnaires and other intermediaries by ignoring such valid business reasons and considerations. For similar reasons, the scope of auxiliary and preparatory activities should not be arbitrarily narrowed, and due attention should be paid to business reasons and considerations.

2. Countermeasures against commissionnaire arrangements cited as a case of tax erosion are already taken in transfer pricing taxation, and therefore we do not feel the need to reconsider the scope of the determination of PE status. Even if there is a concern that transactions that avoid PE status may in fact exist in the digital economy, these can be adequately dealt with through specific rules. If the expanded definition and scope of PE applied to transactions that are totally unrelated to the digital economy, this would broaden the range of the interpretation of PE status in the source State. This may lead to an increase in disputes between tax authorities and taxpayers. Moreover, differences in the interpretation of the definition and scope of PE between the tax authorities of source and residence States may result in increased double taxation. Furthermore, even if source and residence States were in agreement on PE status, because there is no consensus on a methodology for calculating attributable income (for example, while the OECD Model Tax Convention adopts AOA, the UN Model Convention does not accept AOA), this course of action would inevitably generate double taxation. Such a situation must be avoided because it would seriously hamper the promotion of international transactions and the development of economies of the relevant States.

Therefore, actions aimed at artificial avoidance of PE status should be dealt with through specific countermeasures against such artificial cases. An approach that significantly differs from the methodology and thinking underlying in the existing OECD Model Tax Convention and the Commentaries should not be adopted to ordinary transactions that are unrelated to such forms
of avoidance. Obviously, in order to avoid double taxation, a concrete consensus should be reached among States on methodologies for calculating income attributable to PE.

3. The relation to other Actions (most importantly, Action 14) is unclear and it is also necessary to improve systems for resolving disputes between tax authorities and taxpayers on the issue of PE status. The proposals contained in this Draft generally tend to be ambiguous, opening the door to broader interpretation of their provisions. This would increase the frequent PE recognition in various States and may lead to double taxation. We believe there is an urgent need to develop and introduce remedial measures to cope with such situations (for example, bilateral prior consultation systems not limited to cases of transfer pricing taxation and more effective arbitration system).

4. Tax disputes arising from the determination of PE status by tax authorities are occurring even in situations that are completely unrelated to artificial avoidance of PE status. Such incidents are acting as a serious obstacle to cross-border transactions and investment activities. The present proposals increase the range of ambiguities in the interpretation of PE status. If these proposals were to be adopted without revision, tax disputes related to the determination of PE status would increase in the future and could generate very large administrative burdens. We strongly request that views from the business community be sufficiently reflected in the OECD proposals.

Specific Issues

Discussion Draft Paragraph 6-11

Paragraph 10 states “It is clear that in many cases commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where the sales took place.” It is unclear what specific types of agreements are implied by “similar arrangements.” If this statement implies that all transactions involving intermediaries are intended for the purpose of eroding the taxable base, we would have to say that the statement is based on an erroneous understanding. Advances in communication technologies have certainly facilitated communications among enterprises. However, face-to-face communication remains important for maintaining smooth
communications with distant customers or when differences in language or business practices intervene. This means that there are many cases in which transactions are undertaken through intermediaries for the purpose of maintaining relations with customers.

- All of the alternative proposals under A to D would act to expand the scope of PE or introduce highly subjective elements, rendering it more difficult to make a judgment on PE. This would seriously undermine predictability for taxpayers and would result in a marked shrinkage in ordinary overseas economic activities of enterprises, as well as cross-border transactions and investments. Therefore, we cannot support the alternative proposals.

- Delegating overseas subsidiaries to act as intermediaries in transactions is well within the bounds of standard commercial practice, and there is no intent of tax avoidance because such subsidiaries are paid arm’s length compensation based on the functions they perform and the risks they take on. Moreover, these subsidiaries pay adequate amount of corporate income taxes in their State of residence. Furthermore, when a distributor has been restructured into a commissaire, material functions and risks are transferred to this entity. This matter is discussed in Chapter IX (Business Restructuring) of the OECD Transfer Pricing Guidelines and in BEPS Action 9 (Risks and Capital). Ensuring that arm’s length consideration is being paid to/received from related parties is a sufficient countermeasure to the problem of base erosion, and no reason exists here for expanding the scope of PE. In other words, re-definition of PE should not result in taxation that exceeds the scope of the arm’s length principle.

**OECD Model Convention Article 5-5 (Agent of Dependent Status)**

- Expanding the scope of agent PE should be restricted to cases involving artificial schemes for tax avoidance. Instead of comprehensively revising the content of Article 5-5 of the Convention, specific reference should be made to abusive schemes in the commentaries. From this perspective, PE status should not be simply extended to include a group company that is acting as an intermediary with a valid business reason.

- With regard to Article 5-5, Proposals A to D are intended to cope with problems that arise from the wordings “conclude contracts” and “contracts in the name of
the enterprise.” Regarding the former wording, Proposal A (“engage with specific persons in a way that results in the conclusion of contracts”) may result in deeming all intermediating functions involving activities that lead to the conclusion of contracts as PE. Proposal B (“concludes contracts, or negotiates the material elements of contracts”) remains ambiguous on what constitutes material elements and thus introduces subjective factors. The interpretations of “engage with” and “material elements” are particularly ambiguous, which may place undue burdens on both taxpayers and tax authorities.

Regarding the latter wording, both Proposal C (“contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”) and Proposal D (“concludes contracts, or negotiates the material elements of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”) cover an extremely wide scope of contracts and may thus arbitrarily expand the scope of the definition of agent of dependent status.

- From the perspective of eliminating subjective factors and ensuring stability and certainty of taxation, the material element in determination of PE status in Article 5-5 should lie in whether authority to conclude or negotiate a contract binding the principal party has been granted.

- Further, in order to ensure the stabilization of the interpretation of Paragraph 5, various specific examples should be illustrated in the Commentaries. For instance, we believe it will not constitute PE in case an intermediary supports the negotiation of a contract in accordance with specific and detailed instructions from the principal party. (The person is no more than a spokesman and is not authorized to take actions beyond the scope set forth by the specific and detailed instructions from the principal party.)

- The burden of proof of whether or not a certain activity constitutes a material element in negotiating a contract should rest not only on the taxpayer but also on the tax authority. When a tax authority rejects the explanations provided by the taxpayer on why its activities do not constitute a material element in contract negotiation, the tax authority should have the responsibility to present sufficient grounds for its rejection.
**OECD Model Convention Article 5-6 (Agent of Independent Status)**

- With regard to Article 5-6, we cannot agree with using exclusivity as the sole criterion in determination of independence. When an agent has been assigned exclusivity by an enterprise by means of a contractual clause, it is true that the clause can be interpreted to generate an element of dependence. However, the material issue concerning the application of such a contractual clause is whether the agent is using its technologies, knowledge and other factors in taking on risk and receiving compensation. For example, it would not constitute dependent status even if the amount of transactions involved with a single party were to be large.

- Regarding the criterion presented in Paragraph 6 for determination of exclusivity, it should be reconfirmed, as stated in the current Commentaries, that the existence of capital relations has no effect on the exclusivity of agents.

- Based on the points outlined above, we oppose the revision of Article 5-6. It is stated that, “a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises.” However, when an overseas subsidiary is solely engaged in providing services to the parent company or associated enterprises, determination of the independent status of the subsidiary should be based on an examination of the actual situation. We are concerned that determination of dependent status will be uniformly assigned based on income or other criteria with no regard for the actual situation. Therefore, we believe that the proposed revision to Paragraph 6 stating “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 within the meaning of this paragraph with respect to these enterprises” should not be adopted.

**OECD Model Convention Article 5-4 (Auxiliary and Preparatory Activities)**

- With regard to Article 5-4 (Auxiliary and Preparatory Activities), the concepts of “auxiliary and preparatory activities,” which constitute the subject of this paragraph, are also clearly contained in the current a) to d). Therefore, it would suffice to provide supplementary explanations in the Commentaries to the Model Convention. Moreover, because these determinations are based on the
recognition of facts, they are not suited to the revision of the text of the Model Convention.

- Proposal E presented in the Draft would require individual activities to be explicitly identified as being “auxiliary or preparatory in nature,” whereas such identification was not previously required. Determination of whether a certain activity is “auxiliary or preparatory in nature” is based on “whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.” (Paragraph 24 of Commentaries) Consider the case of an enterprise engaged in the buying and selling of goods. The activities of the enterprise would be seriously hampered if such functions as storage and delivery of goods only were to be interpreted to constitute “an essential and significant part of the activity of the enterprise,” thereby exposing the enterprise to the risk of unstable taxation.

- If Proposal E were to be adopted, measures would have to be taken to avoid differences in opinion on the determination of PE status between taxpayers and tax authorities and among the tax authorities of various States. For this purpose, it would be important to reach a consensus among States on what specific auxiliary and preparatory activities do not constitute PE. These instances should be explicitly referred to in the text of Article 5-4 or in the Commentaries. Revising Article 5-4 without clarifying the definition of auxiliary and preparatory activities would increase the probability of international double taxation. This approach is unjustified, as it would contradict the intent of tax treaties.

- An explicit provision should be included stating that so-called “liaison activities,” such as market research and liaising between the consignor and customers, are included in auxiliary and preparatory activities.

- Regarding the burden of proof of whether or not a certain activity constitutes an auxiliary or preparatory activity, when a tax authority rejects the explanations provided by the taxpayer on why its activities do not constitute an auxiliary or preparatory activity, the burden of proof should rest with the tax authority to present sufficient grounds for its rejection.
• Proposal E allows for “delivery” and “purchase” activities that are “auxiliary or preparatory in nature.” However, unless the start and end of “delivery” and “purchase” are clearly defined, this could give rise to unnecessary suspicions.

• Proposals F to H exclude some activities from the scope of auxiliary or preparatory activities by such means as deleting the term “delivery” and by limiting the scope of activities that are purely for information gathering etc. As such, these proposals would expand the scope of PE or render the determination of PE more difficult. We cannot support this approach as this would seriously undermine predictability for taxpayers and lead to the shrinkage of economic activities.

• For Proposals I and J, which address the subdivision of business activities among associated enterprises, tax authorities could consider, based on superficial form, that MNE business activities are subdivided, without grasping the actual situation of MNE business activities. Determination should not be based on such superficial forms. Instead, it is necessary to develop a process for accurately grasping the actual situation and background of business activities.

• In Paragraph 31, the Focus Group assumes that MNEs may establish subsidiaries with ease for the purpose of BEPS. This assumption is not valid in a large number of cases.

**OECD Model Convention Article 5-3 (Construction PE)**

• Application of countermeasures against avoidance of construction PE should be limited to abusive schemes. Similarly, the assignment of PE status to transactions that are not intended for the purpose of PE avoidance must be avoided. Both Proposals K and L expand the definition of construction PE and may result in lack of clarity in taxation. Therefore, we believe the wording of the current Model Convention should not be changed.

• Under Proposal K, even if a construction contract were to be divided among associated enterprises for valid business reasons, it would automatically be included in the determination of the period. We believe this is excessive, and the stipulation should be strictly limited to acts aimed at abuse of tax treaties. Consider a case in which a single contract is divided among multiple associated
enterprises and there is no intent on the part of taxpayers to avoid PE status. If the determination is to be overruled by the tax authority, the burden of proof should rest with the tax authority.

Proposal L is predicated on the introduction of the General Anti-Avoidance Rule (GAAR). This carries the possibility of an inflexible response that does not take actual economic conditions adequately into consideration.

OECD Model Convention Article 5, Commentary Paragraph 39 (Insurance)

It is unclear why specific insurance businesses are addressed. In particular, in the case of Proposal N, we believe there is no reason to designate specific businesses.

E. Profit Attribution to PEs and Interaction with Action Points on Transfer Pricing

If the scope of PE status were to be expanded according to the proposals of the Draft, we believe this would create a heightened need for dispute resolution. Given the resource constraints facing the tax authorities of various States, this gives rise to the concern that tax authorities may not be able to properly handle the volume of disputes. Regarding this point, we believe that full consideration should be given to recommending improvements to member States in the course of forthcoming discussions.

Methodologies for calculating income attributable to PE should be discussed in tandem with arm’s length principle in transfer pricing transactions among associated enterprises (Actions 8, 9, 10). Determination must be based on comparison with arm’s length price while taking into account the risks and functions to be borne by the PE.

OECD has been adopting AOA in the calculation of income attributable to PE since the 2010 Model Tax Convention. However, some non-OECD members have clearly indicated their opposition to AOA. Determination of PE status will give rise to discussions concerning income attributable to PE. Failure to reach a consensus among States on this calculation method in the course of these discussions...
discussions will inevitably generate double taxation issues. Therefore, rules pertaining to the calculation of income attributable to PE should be discussed in parallel to rules on determination of PE status. Limiting the discussion to the latter subject is inappropriate because such a course of action would lead to double taxation.
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Some Comments on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

From Jim Stewart,
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This note argues the absence of detailed rules in relation to the existence of a Permanent Establishment means that firms may claim a permanent establishment exists without any substantial presence. These issues may be exacerbated by the absence of comprehensive data on intra-firm financial flows. The net result is that it will be more difficult to end aggressive tax planning.

1. Permanent Establishment and tax minimisation strategies

Ambiguities and non-commercial factors in defining a Permanent Establishment are central to many tax avoidance strategies, for example the ‘Double Irish’1, or the tax strategies revealed in the Luxleaks (http://www.icij.org/project/luxembourg-leaks). The Luxleaks disclosed that one firm, Shire PLC, had several affiliates operating in Luxembourg (Shire Holdings Europe S.à.r.l., Shire Holdings Europe No.2 S.à.r.l., Shire Holdings Ireland Limited, Luxembourg Branch, Shire Holdings Ireland No.2 Limited, Luxembourg branch, Shire Intellectual Property Ireland Limited, Luxembourg Branch, Shire Luxembourg Intellectual Property S.à.r.l., Shire Luxembourg Intellectual Property No.2 S.à.r.l.). These firms managed over $10 billion in intra company loans, and were managed by two employees. The financing company in Luxembourg earned $1.87 billion over a five year period2.

Shire PLC is incorporated in Jersey, Channel Islands, where there are no employees, it is resident for corporate tax purposes in Ireland, where there are 100 employees, and where losses have been reported for the years 2011 to 2013. Most profits are made in the U.S. where the majority of employees are also located.3

Despite recent changes to tax laws in Ireland the possibility of separating country of incorporation from residence for corporate tax purposes, remains a possibility in cases where a double tax treaty allows an Irish incorporated entity to be tax resident elsewhere.

These examples illustrate two key issues in determining whether a permanent establishment exists:-

2. The location of the “place of management” as in (OECD Model Tax Convention 5.2a).

In the case of Ireland, those firms using a “double Irish” tax strategy were regarded as resident for corporate tax purposes in a low or no tax regime such as Bermuda, where they had no substantial

presence, even though they were incorporated in Ireland, auditors and books of account were based in Ireland and where they may have had employees and paid taxes such as VAT and employers PRSI.

The Netherlands is a major location of financial conduits. The Dutch Ministry for Finance reports that there are 12,000 “special financial institutions” of which 9000 are letter box companies (Ministry for Finance Netherlands, 2013, p.8). Special Financial Institutions’ in the Netherlands, owned by non-residents received and disbursed approximately €4000 billion per annum in recent years. For 2010 outflows from dividends, interest and royalties amounted to €115 billion and inflows €153 billion (Ministry for Finance, Netherlands, 2013, p. 8). Interest and royalty flows are not taxed. The nominal tax rate on dividends is 15%, but the effective tax rate is under 1% (Source: Algemene Rekenkamer Netherlands Court of Audit, Press Release, 6 November, 2014).

A trust office acts as a director of the financial conduit and the trust office is also the location of the conduit (Ministry for Finance Netherlands, 2013, p. 8). A report on the Dutch trust industry notes that the basic services providers “do not always require a high degree of sophistication” (Van den Berg et al, 2008, p.16). The Netherlands Audit Court has recently stated that many of these companies are now being examined to determine if they “satisfy substance requirements, i.e whether they have a real presence in the Netherlands that allows them to use the tax facilities” (Netherlands Court of Audit, Press Release, 6 November, 2014). This and other evidence has been used to argue that while the Netherlands is not a pure tax haven it “does have a tax regime that facilitates aggressive corporate tax avoidance abroad and as such could be considered a tax haven for large multinationals” (Weyzig, 2013, p. 72)4.

Issues relating to lack of substantial activity do not just apply to firms operating in the new economy. ‘Old economy’ firms may also be reorganised so that manufacturing is outsourced, key assets such as brands may be located in low/no tax jurisdiction and key functions and central management are located in a third country. This process is sometimes referred to as ‘slicing’ the value chain.

Rules that allow firms to be ‘located’ without any substantial presence are a key part of tax avoidance strategies but the current draft does not adequately address this issue.

3 Identifying and monitoring Associated enterprises

The discussion draft (OECD, 2014a) focuses on the definition of ‘permanent establishment’ in particular in relation to ‘commissionaire arrangements’. Par. (10) refers to options to extend the ‘taxable nexus’ in order to focus on “what is the object of the contract” and would include cases “where the intermediary habitually interact with identifiable persons in a way that directly results in the conclusion of contracts”. An issue that arises is the feasibility of tax authorities verifying the motive and the identity of contracting parties. It may also be the case that value added tax changes within the EU will reduce ‘commissionaire arrangements’ as VAT rates are determined by the residence of the consumer rather than the provider5.

Suggested amendments to the model treaty (OECD, 2014a, Par. 11 A. 6) require the identification and monitoring of associated enterprises. Another section (Par. 31 4.1 b) requires the identification

4 Weyzig (2013) also identifies Ireland, Luxembourg and Switzerland as being tax havens for large multinational corporations.
of associated enterprises that “constitute complementary functions that are part of a cohesive business operation”.

The Shire case illustrates the complexity of corporate operations. Some complexity may be a result of commercial factors or regulatory/legal factors. Complexity resulting from tax minimisation strategies may be difficult to identify. This is in particular because of the number of affiliates that may be involved, and because ownership chains and operations straddle a number of tax jurisdictions.

Identifying connections between associates is also made difficult by corporate structures subject to constant change. The Huffington Post comments in relation to changes in corporate structure at Microsoft:

“The rotating cast of companies that Microsoft lawyers created and then departed from offers a window into the whack-a-mole game that tax authorities are forced to play in order to collect revenue from multinational companies” Huffington Post (2014).

Cross country restructurings and ownership of affiliates make identification of connections difficult.

OECD proposals will greatly improve overall data collection (OECD, 2014b). In particular taxing authorities will receive far greater details on a country by country basis of the allocation of income, taxes and business activities. However issues as identified in section (1) may still arise:

(1). Entities are required to identify a tax jurisdiction where place of incorporation and location for corporate tax purposes are different. It is possible that corporation tax is due in the corporate tax jurisdiction and VAT and employee based taxes (PRSI) are due in the country of incorporation;

(2). Ambiguities in relation to location may also arise in the case of branch plants. Many US firms in Ireland operated as branch plants of a Dutch incorporated entity. This structure has changed for many firms but is still used by some firms operating in Ireland, for example IBM.

(3). Proposed data collection appears not to include dividends “received from other Constituent Entities” (OECD, 2014, 41). The tax base may as a result be reduced. Financial flows in the form of interest payments from the payor jurisdiction may be transmuted into dividend income in the payee jurisdiction. This is central to the tax minimisation strategy for some firms identified in Luxleaks (Bowers, 2014). Use of hybrid financial instruments so that interest paid in one jurisdiction is recognised as a dividend in another jurisdiction also appears to be a feature of Financial Vehicle Corporations in Ireland referred to as s. 110 firms (Stewart, 2013). There are also examples where a capital contribution is paid to a firm, which is then paid to its parent in the form of a dividend (Stewart, 2008).

Comprehensive cross country data as collected by the US Bureau of Economic Analysis for US affiliates, would be required to deal with these and other aspects of intra-firm payments.

6 A 2009 Tax Ruling for a Pepsi Bottling Group subsidiary in Luxembourg states (p. 10) “the effective management and control of PBG Beverages, an Irish subsidiary of PBG Midwest Holdings S.A.R.L. was, transferred from Ireland its original place of incorporation to Bermuda”. This took place as part of a complex chain of restructuring involving Irish, Bermuda and Luxembourg based subsidiaries (Luxleaks Pepsi Tax Ruling 2009 appendix 1).

7 This structure may be partly explained by a relatively high nominal tax of 25% on passive income in Ireland.
Overall the discussion draft highlights the integrated nature of the problem in changing aspects of the OECD model tax treaty and recognises that “work on other parts of the BEPS Action Plan in particular Action 9 (Risks and capital) might involve a reconsideration of some aspects of the existing rules and guidance” (OECD, 2014a, p. 26).

References


OECD (2014a), BEPS Action7: Preventing the Artificial Avoidance of PE Status, OECD 31st October.


Weyzig, F. (2013), Effects of Dutch tax policy on taxation of multinationals in Developing countries, printed by Ppakamp Drukkers.
Dear Marlies,

Here are my comments to the above draft.

It is true that taxpayers avoid PE’s for tax reasons, but some of these reasons are good. E.g.

1. Avoiding PE’s avoids the double tax that arises when income and cost allocations do not match. E.g. XCo in StateR has a PE in StateS. StateS taxes XCo’s PE income, but disagrees with certain costs allocated to it. If StateR argues that those costs belong to StateS, XCo pays double tax.

2. Avoiding PE’s avoids the double tax arising from a lack of cross border consolidation. E.g. States A, B and R all levy 25% income tax. ACo is resident in StateR and has PE’s in States A and B. ACo makes profit of 100 in State A and losses of 90 in State B. ACo pays 25 tax in State A, has a worldwide EBT of (100-90=) 10 and an effective tax rate of (\(\frac{100\times75\%}{125,000}\)) = 250%. If ACo avoided PE’s, its effective tax rate would be (\(\frac{100\times75\%}{125,000}\)) = 25%.

3. Avoiding PE’s reduces the overall administrative burden:
   - one set of accounts instead of many;
   - one tax return instead of many;
   - no TP documentation;
   - no AOA complexities*;
   - one audit instead of many; and
   - one tax dispute instead of many.

* The AOA is complex: free capital is a vague concept with too many ways to calculate it; it is rejected by the UN/ \(\frac{2}{3}\) of the world’s countries, thus requiring different systems for different countries; and the asset allocation to the place of use leads to complications: e.g. for pipelines or drilling rigs on one year assignments.

It is understandable that governments, as a matter of policy, want to see more tax in the source state and no double non-tax. However, to be credible, they have to be seen caring just as much about double tax and reducing administrative burdens. It would therefore be great if the deliverable on this action also:

a. Strongly recommends (again) that governments include article 7’3 and 25’5 in their tax treaties.

b. Links this action to the adoption of an arbitration clause in the multilateral instrument of action 15. Such a clause should be robust so taxpayer access cannot be frustrated through formalistic arguments.

c. Minimises the compliance burden created by more PE’s through strongly recommending the use of bilateral safe harbours as discussed in the revision of the TPG, Chapter IV, Section E on safe harbours of 16 May 2013.

d. Links this action to the incorporation of these safe harbours into the multilateral instrument of action 15 with default percentages which governments could opt out from on a bilateral basis.

e. Addresses the complexity of the AOA and income and cost mismatching. Many new PE’s will still perform low risk routine functions in centralised business models in order to minimise the double tax mentioned under point 2 here above. The AOA gives little practical guidance on distinguishing between low risk distributor PE’s and fully fledged reseller PE’s and was not written for the new 5’5 and 5’6.

More source taxation should not have to be synonymous with more uncertainty caused by severe complexity.
Further:

i. Please define “exclusively” and “almost exclusively” in the new article 5, paragraph 6. E.g. is “exclusively” 10% of the turnover generated by being an agent for third parties? If countries fear that a clear definition leads to taxpayers targeting it, one should remember that taxpayers have a right to certainty; this should not be compromised by using vagueness as an anti-BEPS tool. It is illogical to argue that a margin is only acceptable when it is hit or exceeded by accident and not by design.

ii. The 4 alternatives to article 5, paragraph 5, seem to imply that if an enterprise acts on behalf of related EnterpriseA, but for the account of related EnterpriseB, then neither EnterpriseA nor EnterpriseB will have a PE, in spite of the new article 5, paragraph 6. Is this intentional?

Thank you for taking the time to read this. I am registering to attend the public consultation of 21 January 2015. Should you wish me to elaborate on any of my points at that meeting, I would be happy to do so.

Yours sincerely,

Johann H. Müller
Keidanren hereby submits its comments on the Public Discussion Draft “BEPS Action 7: Preventing the Artificial Avoidance of PE Status)” published by the OECD on October 31, 2014.

General Comments

1. We are supportive of an approach to prevent an enterprise from engaging in artificial arrangements to avoid a permanent establishment (PE) status when it is considered, based on the current taxation rules, to have a sufficient taxable nexus in the source country. We also understand that the increasing digitization of the economy has created certain issues that are difficult to solve within the existing framework and made us initiate discussions for the review of the system. Keidanren supports the OECD’s efforts for the implementation of BEPS Action 7, which is intended to ensure the prevention of unfair base erosion in source countries, an effective response to the challenges of a digital economy, and fair competitive conditions among companies.

2. However, the Public Discussion Draft has caused a concern over a possible broadening of the scope of PE and increased taxation in source countries, exceeding its primary objective of addressing the BEPS issues. We consider that it is necessary to review the Draft taking fully into consideration the consistency with the BEPS Action Plan, which states that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”

3. We believe that the primary aim of Action 7 is to develop measures that focus on
the prevention of artificial avoidance of PE status (i.e., a recovery of lost tax revenue). The Draft would go too far if it were intended to generate new tax revenues in source countries by assigning a PE status to activities that are not a PE per se. It is already a common practice in some member countries of the BEPS project to give an expansionary interpretation to PE. As a result, enterprises are faced by unfair double taxation. We would recommend the OECD to develop balanced anti-avoidance measures taking into consideration the situations above.

4. We found that the Public Discussion Draft does not necessarily provide clear definitions of the words used in the fourteen options (A through N), which are included in the Draft for changes to Article 5 of the OECD Model Tax Convention. Such a lack of clear definitions may allow tax authorities subjective interpretation and arbitrary application of the Article and thereby cause uncertainties for taxpayers. The scope of PE should be defined as clearly as possible because it plays an important role as a threshold that determines whether an enterprise is subject to a country’s corporate income taxation or not.

5. Further, the Public Discussion Draft does not offer any proposal about the profit attribution to a PE. The interpretation of “attributable profits” varies significantly from member state to member state as their domestic law governs the calculation of profits attributable to a PE. While OECD member states have started and are expected to introduce the Authorised OECD Approach (AOA), non-OECD countries are unlikely to do the same, which has created a concern over the proliferation of income calculation approaches that are not consistent with the AOA (e.g., taxation based on deemed profit rates and worldwide taxation). Under these circumstances, the broadening of the scope of PE will automatically result in an increased double taxation. If the OECD/G20 aims to reach a new agreement among member states in respect of the scope of PE, it would be necessary for the purpose of striking a balance to build an appropriate consensus on the calculation of profits attributable to a PE.

6. Should the Draft be adopted as it is, it will create concern over double taxation. Such a concern could have a significant impact on enterprises’ existing business models and consequently may jeopardize cross-border economic exchanges. Accordingly, we expect that in September 2015, when the OECD compiles a final recommendation for Action 7, it would provide, in conjunction with rules governing the attribution of profits to a PE, a new set of clearly-defined measures that focus on the prevention of BEPS and response to the challenges of a digital
economy. Further, in order to completely solve disputes over PEs, it would also be necessary to develop measures such as making the mutual agreement procedure (MAP) effective under Action 14 (Dispute Resolution Mechanism).

7. The following are our comments on specific issues based on the general comments above.

Commissionnaire Arrangements
(Basic Concept)

8. In the Public Discussion Draft, a commissionnaire arrangement is defined as “an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products” (paragraph 6). In addition, the Draft expressed a view that “it is clear that in many cases commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place,” and that “as a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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” (paragraph 10).

9. However, in our opinion, the view that “it is clear that ...put in place in order to erode the taxable base” is one-sided and does not accurately reflect the actual state of corporations.

10. First of all, the Public Discussion Draft seems to have some concern about the cases in which a buy-sell distributor is changed to a commissionaire to reduce taxable income to an unreasonably low level (paragraph 7). However, we believe that a change of business structure does not always result in a reduced level of taxable income. Rather, when a buy-sell distributor is engaged in marketing activities facing inventory and other risk factors and suffers from high costs and severe marketing competition, it will be difficult for the distributor to secure a sufficient level of income. In such cases, if local distributors are converted to a commissionnaire and inventory risks and inventory management costs are concentrated on the principal, it may allow the commissionnaire to obtain commission income and stabilize its income stream.
11. It is unclear what is meant by the phrase “similar arrangements” (paragraph 10). However, it is often the case that an enterprise is initially engaged in direct sales with foreign companies, but later establishes subsidiaries in the foreign countries not as a buy-sell distributor but as an intermediary. This is a normal activity based on a valid business reason and is not intended for "base erosion". In other words, the subsidiary may be merely performing its function, i.e., communicating on a daily basis with clients who are a resident of a distant country according to a request of such clients. Otherwise, the reason why a subsidiary does not act as a buy-sell distributor may be that the subsidiary is not financially capable of taking credit risks associated with sale and purchase transactions. It is not reasonable to view all of these enterprise behaviors as BEPS.

12. With regard to the change from a buy-sell distributor to a commissionaire, necessary measures have already been taken in the transfer pricing taxation system (Transfer Pricing Guidelines Chapter IX “Transfer Pricing Aspects of Business Restructurings”). If abusive arrangements are one of the reasons for the base erosion, it would be appropriate to resolve the issue in the context of transfer pricing taxation rather than through the expansion of the PE concept, including a review of the appropriateness of the commission level based on the arm’s length price (ALP).

(Comments on Proposals)

13. The Public Discussion Draft offers four options (A through D) for changes to Article 5, paragraph 5 (dependent agent) and paragraph 6 (independent agent) of the Model Tax Convention to deal with the artificial avoidance of PE status through “commissionaire arrangements and similar strategies.” All of these options are designed to strengthen the requirements to be identified as an independent agent. The Draft also provides four (2X2) variations for the changes concerning dependent agent.

14. That is, to deal with issues arising from the phrase “in the name of,” which is found in Art. 5(5) of the current Model Tax Convention, the Draft presents possible approaches that focus on the “subject” of the contracts (transfer of property ownership/provision of services) rather than the authority to conclude contracts, or on the “substance” of the contracts (account and risk). Specifically, the Draft presents two options of “engages with specific persons in a way that results in the conclusion of contracts” or “negotiates the material elements of contracts” to deal
with cases where contract negotiations are held but the contract is not concluded.

15. The following table shows the summary of the previous paragraph:

<table>
<thead>
<tr>
<th>Focus on Contract Subject (Transfer of ownership/ Provision of services)</th>
<th>Focus on Contract Substance (Account and risk)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engages with specific persons in a way that results in the conclusion of contracts</td>
<td>Option A</td>
</tr>
<tr>
<td>Negotiates the material elements of contracts</td>
<td>Option B</td>
</tr>
</tbody>
</table>

16. We reviewed each option based on the understanding above. As a result, we are not supportive of the options focused on the substance of the contracts (Options C and D), as we believe they may broaden the scope excessively.

17. Further, the approach that requires “engaging with specific persons in a way that results in the conclusion of contracts” (Option A) is also unacceptable in view of the possibility to lead to expansionary interpretations. If Option A is to be adopted, a person may be regarded as a PE even if he merely gathers information or makes arrangements for appointments with prospective and existing customers. In contrast to Option A, Option B’s wording will lead to a lower risk of being recognized as a PE. However, it is ambiguous with respect to the meaning of “material elements of contracts.” As mentioned above, we believe that both Options A and B may lead to a subjective or arbitrary application by the tax authorities. We are also concerned that they may impose significant constraints on enterprises’ temporary employee transfers to their overseas subsidiaries and seriously undermine business predictability.

18. According to Article 5, paragraph 6 of the current Model Tax Convention, independent agents are not regarded as a PE. However, in the Public Discussion Draft, a clause “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 this paragraph with respect to these enterprises” was added and the requirements were further strengthened.
19. However, in view of paragraph 38.6 of the current Commentary on Article 5, which states “All the facts and circumstances must be taken into account to determine whether the agent’s activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge,” independent status should not be determined only on the basis of the number of principals that the person acts for.

Preparatory or Auxiliary Activities
(Basic Concept)

20. A fixed place of business through which the enterprise exercises solely an activity which has a preparatory or auxiliary character, is deemed not to be a permanent establishment because “it is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question” as stated in paragraph 23 of the current Commentary on Article 5.

21. Accordingly, if any revision needs to be made to Article 5, paragraph 4 of the Model Tax Convention, which provides for exceptions from PE status for preparatory or auxiliary activities, it would be necessary to build an international consensus that the fixed place in question is at least a place of business to which profits can be allocated. Put differently, if it is still difficult to allocate any profit, it would not be necessary to create a new PE category by imposing additional burden on both the tax authorities and taxpayers.

(Comments on Proposals)

22. The Public Discussion Draft provides Options E through H for the proposed revision of Article 5, paragraph 4 of the Model Tax Convention, describing, in the Executive Summary, that “the fact that some parts of Art. 5(4) do not expressly refer to preparatory or auxiliary activities does not seem to conform with what they consider to be the original purpose of the paragraph, i.e., to cover only preparatory or auxiliary activities.” Of the four Options, Option E is intended to clarify that all the activities currently listed in paragraph 4 of Article 5 are subject to the condition of being preparatory or auxiliary.
23. On the other hand, Options F through H would modify the paragraph on a more targeted basis in the event of Option E being not adopted (paragraph 16). That is, Option F provides for the deletion of the word “delivery” in subparagraphs a) and b) of paragraph 4, for cases, for example, where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online (paragraphs 17 through 20).

24. Option G proposes to delete the reference to “purchasing goods or merchandise” from subparagraph d), to ensure consistency with the AOA, which abolished the provision intended to exempt mere purchases from taxation (paragraphs 21 through 27). Option H provides for the deletion of the entire subparagraph d) and thereby removes the exception for “collecting information,” in addition to “purchasing goods or merchandise.” As the reason for the deletion of information collection activities, the Draft explained that “some enterprises attempt to disguise what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises” (paragraph 28).

25. We have reviewed these proposals based on the “basic concept” stated above and found that there was a logical gap between the concept of Option F, which is seemingly based on a new understanding developed against the background of an increasingly digitized economy (i.e., “online sellers and very large warehouses” are one of the places of business to which business profits are attributable), and the uniform deletion of the word “delivery” from subparagraphs a) and b) of Art. 5(4).

26. In short, adoption of this Option may result in traditional B2B distribution warehouses and small scale warehouses other than “online sellers and very large warehouses” being regarded as a PE. To begin with, there has not yet been adequate discussion as to the taxation of the digital economy. Under such circumstances, it is far from true to say that there has been a consensus that any types of warehouses (including aforementioned traditional warehouses) should be regarded as a fixed place of business PEs to which profits are attributable, and such a consensus is not referred to in the Public Discussion Draft.

27. In reality, it is a common business practice for enterprises to use a warehouse located in a foreign country’s free trade zone to ship and deliver its products as soon and as effectively as possible in response to its international customers’ requests. In this case, the use of a warehouse for delivery is not associated with BEPS as it is not intended to serve the needs of the enterprise/shipper but for the
convenience of its customers. If Option F is adopted, it will become necessary to change business models that make use of these traditional warehouses. In addition, if, as a result of the above, the enterprise decides to leave the free trade zone, the country that owns the free trade zone will also suffer a loss. Further, when an enterprise delivers equipment to a foreign construction site, it may be regarded as a PE merely because of the fact of delivery. We believe that the exception for delivery should be retained.

28. Second, with regard to Option G, we understand the need to ensure the consistency with the AOA that provides for the elimination of the tax exemption for mere purchases. However, we have a fundamental question on how the OECD responds to the fact that the AOA is not adopted by non-OECD countries. Moreover, we do not believe that there has been adequate debate about the question of what amount of profits could be generated from mere purchases. We recommend that very careful consideration should be given to the uniform deletion of the phrase “purchasing goods or merchandise” from Art. 5(4) d).

29. We disagree with Option H, which provides for the deletion of the entire subparagraph d). As a reason for the deletion, the Draft explains that “some enterprises may disguise what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises.” However, we believe that such extreme cases can be dealt with by disapproving them on an individual basis. Furthermore, information collection activities generate no profits. If Option H is adopted, it may lead to mere representative offices and employees’ overseas business trips being regarded as a PE and discourage cross-border economic exchanges.

30. On the other hand, Option E is to clarify the general understanding that Art. 5(4) is applicable only to activities of a preparatory or auxiliary character. It will still contain the words “delivery,” “purchasing goods or merchandise,” and “information collection,” and we understand that an enterprise will not be regarded as having a permanent establishment unless the place of activity is regarded as a place of business to which business profits are attributable in each individual case. However, a lack of uniform interpretation about the condition of being of a “preparatory or auxiliary” character among member countries will allow tax authorities to apply the condition in a subjective and arbitrary manner, which may consequently cause uncertainties for taxpayers.
31. We are particularly concerned about the impact on Art. 5(4) c). For example, in response to a request from a foreign resident client, an enterprise sometimes retains its products or merchandise in a warehouse located in the client’s premises to allow the client to process the product or process the merchandise. These products or merchandise are called vendor-managed inventory (VMI). In the international trade context, they are primarily observed in the manufacturing industry. Although it is a business structure that is not related to BEPS, it may be regarded to be a PE if, under Option E, it is determined not to be of a preparatory or auxiliary character.

32. Therefore, if the OECD adopts Option E, it will be critical to provide detailed examples to clarify which activities are deemed to be of a preparatory or auxiliary character and which are not. It would also be necessary to describe in the commentary that, aforementioned establishments, including “traditional and small-scale warehouses” and “VMI warehouses” are of a preparatory or auxiliary character.

33. For activities of a preparatory or auxiliary character, the Draft also proposes that, to prevent circumvention of Art. 5(4) as a result of fragmentation of activities between associated enterprises, a new paragraph 4.1 should be added, and that the determination of whether an activity is of a preparatory or auxiliary character or not should be made taking into account not only the activities carried on by the same enterprise at different places but also activities carried on by associated enterprises at different places or at the same place (Options I and J). However, the phrase “cohesive business operation” may allow tax authorities to make a subjective and arbitrary interpretation. We believe that abusive cases can be prevented by dealing with them on an individual basis and that a cautious approach should be taken to uniform tightening of rules.

Splitting-up of contracts

34. The Public Discussion Draft refers to a concern about the splitting-up of contract terms between related parties in order to abuse construction-PE and service-PE provisions in paragraph 3 of Article 5. To deal with the concern, it proposes to adopt either Option K or Option L. The former is an “automatic” rule that would take account of any activities performed by associated enterprises (with certain solutions to possible problems, such as an addition of a minimum period of presence) and the latter is the addition of a new example to the Commentary on the “Principal Purposes Test” (PPT) rule proposed as a result of the work on Action 6.
However, as is the case with the fragmentation of activities between related parties, we believe that abusive cases can be prevented by dealing with them on an individual basis.

Insurance

35. The Public Discussion Draft does not provide sufficient reason why only the insurance industry, among all other industries, was subjected to a new proposal. We believe that it would be necessary to clarify where problems exist. Unless there is a BEPS concern that is common to all member countries and cannot be ignored, it would be appropriate to follow the approach outlined in paragraph 39 of the current Commentary on Article 5, which states that the decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. It is at least not desirable to include any insurance-related provisions in a uniform way as in Option M.

Profit attribution

36. As pointed out in the general comments, unreasonable broadening of the scope of PE without international consensus on profits attributable to a PE may result in a further proliferation of double taxation. It is necessary in the first place to disseminate the AOA not only to the OECD member countries but also to non-member countries. At the same time, a uniform guideline should be developed as far as it is possible to provide for a specific formula to calculate profits attributable to a PE, although such a calculation is governed by domestic laws.

Sincerely,

Subcommittee on Taxation

KEIDANREN
Memorandum

To OECD, Centre for Tax Policy and Administration, Tax Treaties, Transfer Pricing and Financial Transactions Division

From Anne Quenedey, Jerome Tsé

Date 9 January 2015

Subject Comments on the Public Discussion Draft entitled “BEPS Action 7: Preventing the Artificial Avoidance of PE Status”

Dear Madam

We are pleased to respond to the OECD request to send comments on the Public Discussion Draft entitled “BEPS Action 7: Preventing the Artificial Avoidance of PE Status” dated 31 October 2014 (hereafter referred to as the “Draft”).

First of all, we are thankful to the OECD for initiating an international and public discussion on ways to develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS.

We agree that the artificial avoidance of PE status is an important source of BEPS concerns. In that context, we welcome the work that has been done by the OECD to take into consideration the concerns from the business community. This effort must be encouraged and strengthened.

1 General comments

The proposals represent a significant shift in international policy and in particular, a shift away from residency and towards source.

The proposed measures move away from terms that have a clear (or clearer) meaning and go beyond the PE issues identified for review in the original BEPS action plan. For example, one proposal considers replacing “conclude contracts” with language such as “engages… in a way that results in” the conclusion of contracts. The increased vagueness in the proposed language is likely to give way to an increase in the number of disputes between interested parties and a potential greater need to rely on mutual agreement procedure (“MAP”). It will also decrease the level of business certainty.

MAP will need to be strengthened for these measures to be most effective.
Thought should be given to transitional relief to enable parties to restructure where the proposed rules create a PE that does not currently exist.

2 Comments on specific parts of the Draft

2.1 Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies

A. Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”; strengthen the requirement of “independence”

The OECD should clarify what it means by “in a way that results”.

The Draft dangerously increases the number of cases in which the activities of a person are considered as a PE. Every case is open for discussion if that definition is implemented.

If the purpose is to address the *commissionnaire* and similar strategies, then the wording should explicitly name the *commissionnaire* and similar schemes, but should not be written in a manner that may include every case in such large manner.

The Draft narrows the independent agent exemption, proposing to remove the possibility than an agent can still be considered to be independent when it acts exclusively on behalf of one party. We do not believe that this fact should be by itself determinative e.g. when the negotiation of contracts requires the joint intervention of staff of a parent company A and an expert of the local market of its subsidiary B, does it mean that B would be a PE of A? (same comment for options B, C and D below).

B. Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”; strengthen the requirement of “independence”

The OECD should clarify what it means by “negotiates the material elements”. What is material and what is not material? Such reference introduces greater subjectivity into the determination of whether a PE exists.

C. Replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”; strengthen the requirement of “independence”

Option C increases the level of vagueness beyond Options A and B. It introduces many concepts that will be the subject of dispute and discussion and should not be preferred. This is especially so given the simple words “conclude contracts” are already the source of many disputes – further vagueness will only increase uncertainty and possibly the number of disputes.

D. Replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”; strengthen the requirement of “independence”

Same as per Option C comment above.
2.2 Artificial avoidance of PE status through the specific activity exemptions

E. Amend Art. 5(4) so that all its subparagraphs are subject to a “preparatory or auxiliary” condition, and

F. Removing the reference to “delivery” from subparagraphs a) and b), and

G. Delete the exception for purchasing, and

H. Delete the exceptions in subparagraph d)

The removal of delivery will require greater focus on the remaining words “storage” and “display”. Will there be an increase in parties seeking to argue their services are akin to storage and display if delivery is removed? It may also result in new instances of PEs that potentially go beyond the scope of the proposed policy change.

There will be instances where the broader Option E will be better than Options F to H, and vice versa. KWM’s view is that if the policy intent is to restore the “preparatory or auxiliary” nature of the article, then Option E should be preferred to Options F to H. This will allow preparatory activities of a nature referred to in Options F to H to be included within the PE definition. It also places less emphasis on the specific words used in each paragraph, e.g. “delivery”, and more on their character as “preparatory or auxiliary”. This should arguably counteract concerns around the ‘warehouse’ example given.

I. Provision that would address the fragmentation of activities for the purposes of paragraph 4

The OECD should clarify what it means by “cohesive business operation”.

Combining fragmented activities may give rise to unintended consequences where there is no tax avoidance motive. If it is a policy that there should be no required motive, this should be made clearer.

J. Variation of the provision that would address the fragmentation of activities for the purposes of paragraph 4

See Option I comments.

Our concern regarding unintended consequences under Option I is magnified under Option J given the latter is noticeably broader (there being no need to have at least one of the enterprises carrying on a business at a permanent establishment). There is scope for a greater number of unintended outcomes to occur if an avoidance motive is not required.

2.3 Splitting-up contracts

K. Provision to address the splitting-up of contracts, and

L. No specific rule for the splitting-up of contracts; relying on the general anti-abuse rule proposed as part of the work on Action 6

There may be instances where taxpayers are caught under Option K without the intent of splitting up contracts to avoid tax. A GAAR would be able to distinguish between genuine activities and those established to avoid tax.

We acknowledge that there will be scope for tax authorities to use the GAAR proposed in Option L more broadly than if Option K were adopted and for that reason, understanding that some commentators have said that Option L is worse than Option K.
Is it better to have a GAAR to avoid application in genuine circumstances, albeit with greater uncertainty for taxpayers?

2.4 Insurance

M. Provision that deems a PE to exist with respect to certain insurance activities

The insurance sector is highly regulated by EU and domestic rules, including the ability to collect premiums on another country. In that respect, EU directives define situations where an EU company is subject to the freedom to provide services regime and therefore does not need to create a branch, or conversely where an EU company is subject to the obligation to create a branch (freedom of establishment regime).

Therefore, there is no need to add specific rules from a tax standpoint for this sector of the economy. We believe that references to the legal definitions as used in the EU Directives should be followed.

2.5 Issues related to attribution of profits to PEs and interaction with Action Points on Transfer Pricing

Although the OECD recognises that the issue of profit attribution to PEs is of key importance, no clarification is given in the Draft on the method on which such attribution would be based.

Given the proposals in the Draft which aims at lower the PE threshold in many situations, attribution issues may arise and it would be therefore useful to give more details on that topic.

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We are at the disposal of the Tax Treaty, Transfer Pricing and Financial Transactions Division of the OECD in order to contribute further.
OECD / G20 BEPS Project

Response To

Action 7: Preventing the Artificial Avoidance of PE Status

9 January 2015

From

Representatives of the Aviation Leasing Industry
Dear Ms de Ruiter

RE: Response to Action 7: Preventing the Artificial Avoidance of PE Status

We are writing on behalf of representatives of the aircraft finance and leasing industry (see Appendix I) in response to the OECD’s public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status. We support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. It is, however, important that any changes introduced are appropriately targeted, workable and proportionate. It is our view that the discussion paper, as drafted, could have significant implications for businesses operating within the big ticket asset finance and leasing sectors, e.g. the aircraft leasing sector.

While paragraph 3 of the Discussion Draft states that the proposed actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income, a clear consequence of the proposed actions is to attribute a greater element of profit from transactions to the country where the customers are based. It also appears from paragraph 4 of the Discussion Draft that a significant driver of the proposed actions is to address commissionaire structures and the tax challenges of the digital economy. Any changes should be confined to address only the areas of concern.

Background

To better articulate some of the issues with the proposed actions, we have set out below some details of how big ticket lessors, such as aircraft lessors, generally conduct their business.

- This is a truly global business with airlines and aircraft based all over the world. Given the nature of the asset, it is also very mobile with aircraft moving around the world constantly.
- An aircraft lessor will typically have very few customers (mostly less than five) in any one country with a relatively low volume of transactions carried out with these customers.
- For these reasons, the number of employees in a lessor are relatively low.
- These transactions are not retail transactions that rely on a large local customer base. This is a very specialised industry where the airlines look to lessors as a source of financing for aircraft.
- An aircraft leasing company will typically have a master servicer company which will be responsible for all key decisions taken by the group with regard to buying, selling, leasing
and maintaining aircraft. This is typically where the significant and essential part of the business is carried out from.

- For regulatory and/or financing reasons, the aircraft are often owned in separate companies.
- As lessors are leasing to/financing customers worldwide, some will have offices in the main regions to support customers in the countries in those regions, e.g. US, Ireland, Hong Kong/China/Singapore, and Brazil. The offices may have a head of marketing for the region and some customer relationship marketers. There may also be some technical people. While these offices would be responsible for maintaining and supporting relationships with airlines in the regions, any transaction that is negotiated and approved with the airline is done so by the master servicer and the asset owning company. Such offices typically submit opportunities to the master servicer and may compete with one another for transactions. The master servicer will make the decision as to which transactions to progress with and will provide the material terms within which the regional marketing office will negotiate. While the regional team would often visit the customer to present the terms, parts of transactions can be negotiated in other countries, e.g. at some of the big ticket asset finance and leasing conferences held around the world. Ultimately everything gets signed off and approved by the master servicer and the asset owning company.

It is important to note that lessors are organisationally structured in this way to address market needs. They are not structured in this way to erode the taxable base of a country where sales take place (a concern outlined in paragraph 10 of the Discussion Draft) – it would not be practical to establish an operation in each country given the low volume of transactions and small customer base.

**General**

As mentioned, it is important that any measures introduced are targeted and do not alter the settled international taxation of transactions outside of the specific areas of concern, namely commissioner structures and the digital economy. In the context of aircraft leasing, under the current rules, the purchase, sale, lease or delivery of an aircraft by a lessor with no presence in a country would not, in of itself, create a permanent establishment in that country.

The changes to the definition of permanent establishment (“PE”) are, however, widely drafted and consequently are open to interpretation. This will create the following difficulties:

(i) **Uncertainty** – As definitions are widely drafted they are open to different interpretations by States. The uncertainty is likely to result in increased challenges with local authorities and more MAP cases which will use up considerable resources. This uncertainty could also dissuade companies from transacting with potential customers in some States – a result that would have a considerable negative impact for both States (compared to the current position).

(ii) **Administration** – The proposals could result in a very significant compliance burden on lessors due to PE’s arising in countries where (i) parts of a contract are negotiated, (ii) aircraft are purchased or delivered, and (iii) information is gathered. Lessors would have to firstly track where individuals and aircraft are, secondly establish what the individuals are doing, thirdly determine what value is attributable to the activity
and finally file tax returns in each of these jurisdictions. Given the truly global nature of the business, lessors could end up with PE’s in most countries.

(iii) Cost – the changes will result in a significant increase in compliance costs. In many cases the profit attributable to a PE would be negligible. The Contracting State would therefore not gain much if anything and the profitability of the business reduces due to the additional administration and compliance costs.

Assuming that transfer pricing is applied correctly, the activities of a foreign marketing office should be taxed on the value that it is contributing to particular transactions. We therefore do not see any requirement for changes to be made, particularly where there is already a related company being taxed on the value of services being provided.

We also do not believe that Action 7 intends to tax the purchase, sale or lease of big ticket assets in the circumstances above. As mentioned, the time spent with the customer is relatively small and aircraft will be continually moving all over the world. We would strongly suggest that guidance surrounding the application of the provisions to big ticket leasing is included in the Commentary which reflects the inherent cross border and multi country aspects of leasing mobile assets. This should include a safe harbour test so that the actions proposed are workable from a practical and administrative perspective. Given the high degree of mobility of personnel and the potential multi country nexus for a single transaction, some States include leasing within the Shipping, Inland Waterways Transport and Air Transport Article and cede full taxing rights to the State of residence of the lessor (which other States also do under the Royalties article).

The proposals as outlined could drive a less efficient business model going forward whereby customers have to travel to the lessors to negotiate and close a transaction. Any regional presence that a lessor has, which is currently taxed on the value it generates, could be slimmed down due to the change in the model. This would be to the detriment of the Contracting States.

Turning to the specific proposals, our comments are as follows:

1 **Artificial Avoidance of PE status through commissionaire arrangements and similar strategies**

The proposals focus on changes to two clauses in the current paragraph 5:

(1) The nature of the activities performed for the lessor (in this case) in the State, and

(2) The consequences of those activities (in economic and legal terms) on the lessor.

Two different alternatives are presented with respect to each of these clauses which results in four options – A, B, C & D.

*Clause 1 - Options A & C*

The first proposal with respect to Clause 1 above proposes to expand the nature of the activities performed by the dependent agent by replacing “conclude contracts” with “engages with specific persons in a way that results in the conclusion of contracts”.

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Our view is that this is extremely broad and imprecise and could literally apply to anybody involved in the negotiation of a contract. That language would not create a standard that taxpayers could reliably interpret and apply and would lead to disputes among Contracting States as to whether activities resulted in the conclusion of contracts. It could result, without any materiality test, in PE’s being deemed to arise in many countries. We would suggest that this is rejected outright as it would create an undue administrative and cost burden on the companies concerned for likely very little revenue for many of the Contracting States.

Clause 1 - Options B & D:

The second proposal with respect to Clause 1 proposes to expand the nature of the activities performed by the dependent agent by replacing “conclude contracts” with “concludes contracts, or negotiates the material elements of contracts”.

We would favour this proposal over the proposal in Options A & C as it is more targeted. The language, however, may be read to imply that any negotiation of the material terms in a State could give rise to a PE, even if the material terms are not concluded through those negotiations. The Option should therefore be amended to include “negotiates and agrees the material elements of contracts”. Otherwise the Commentary should confirm that the phrase is intended only to cover the negotiation and agreement of the final material terms of a contract in a State, and not situations in which only preliminary or interim discussions of terms occur in a State.

Where the material elements of the contract are negotiated through a local marketer acting under the instruction of a company or person based outside of the State, this type of arrangement should not be considered to be the negotiation of the material elements of a contract by a dependent agent. The Commentary should confirm this.

Finally, various elements of the contract can be negotiated (within its real meaning, i.e. not presented) in different places as the decision makers are frequently travelling (albeit will spend most of their time where the master servicer is based). It would be very difficult to track the activities of all the decision makers in order to determine whether a PE had been created in a Contracting State just because a decision maker was travelling at the time the transaction was being negotiated and was located in a particular country at the time a decision on part of the contract was taken and agreed.

The term “habitually” is used to add some proportionality to the test. It should be clear that “habitually” applies not only to the conclusion of contracts but also to the negotiation and agreement of the material elements of a contract – the comma may need to be removed. We would suggest that the Commentary should provide guidance on its application to this business model. Given the highly mobile nature of the activity, a safe harbour should be provided in the Commentary in order to give businesses more certainty of their position. We would suggest that if a person is involved in the material elements of no more than 100 transactions a year in a State, then a PE should not be created.
**Clause 2 - Options A & B:**

The first proposal with respect to Clause 2 above proposes to broaden paragraph 5 by providing that a person may create a PE for a non-resident enterprise not only when the person acts in the name of the enterprise, but also when the person contracts for the supply of goods owned by the enterprise or for the provision of services by the enterprise. This alternative would cover sales, licenses, and leases by commissionaires, in line with the stated intention of the changes.

**Clause 2 - Options C & D:**

The second proposal with respect to Clause 2 proposes to broaden paragraph 5 by replacing “contracts in the name of the enterprise” with “contracts, which by virtue of the legal relationship between that person and the enterprise, are on the account and risk of that enterprise”.

The wording in Options C & D appears tailored to the goal of creating an equivalency between disclosed agencies, commissionaires, and other commercial relationships, such as a partnership, in which a person acts in a way to promote and manage the commercial interests of a non-resident enterprise in a State. That said, both proposals in respect of clause 2 are likely to have similar implications for aircraft lessors.

Based on the above, therefore, Option B or D (subject to the additional comments above) would be the preferred option. We would recommend that the Commentary clearly states not only the intended additional reach of the broader language (contrasting “negotiating” terms with “presenting” terms) but also the limits of that reach (which would include guidance on a safe harbour and focusing on the place where the final material negotiations and agreement takes place). In summary, it should be a clear conclusion from the Commentary that the activities of a lessor as outlined above should not create a PE.

**2. Specific Activity Exemptions**

Many lessors will incorporate a resident company in a State when their activities rise to the level of a PE. The specific activity exemptions provide useful guidance on when a company should establish a local resident company in a State. Because the specific activity exceptions provide clear limitations on the ability of a Contracting State to assert a PE, they reduce the potential conflict between States as to whether a nonresident company has established a PE. Without such clarity, States may find themselves in conflict over whether a PE exists, often requiring burdensome enquiries and discussions over the existence of a PE and, if such a PE is considered to exist, the proper attribution of profits to the PE. The administrative costs, both to the Contracting States and taxpayers that are avoided as a result of the specific activity exceptions should not be underestimated. This cost must be weighed against the relatively small income, and hence tax, likely attributable to such activities in most cases.

The Commentary to the 2010 Model Treaty indicates relative unanimity on the appropriateness of the specific activity exemptions just a few years before the start of the BEPS project. Only two countries, Mexico and Chile, voiced reservations over Article 5(4), and both of these objections related to subparagraph (f), which permits the aggregation of P&A activities.
The Discussion Draft contains a general Option (Option E), as well as a series of targeted Options (Options F to H) that may be adopted in lieu of Option E. In our view, a revised version of the Option E, described below would be preferable to the version contained in the Discussion Draft, insofar as it would create a presumption that the specific activities described in subparagraphs (a) to (d) of Article 5(4) continue to qualify for exemption unless they are core to the enterprise’s business activities. Furthermore, we suggest that expanded guidance in the commentary could provide a ‘safe harbour’ and increased certainty for businesses like these that a PE should not be created.

**Option E**

Option E proposes that all of the specific activity exemptions apply only where they are preparatory or auxiliary in character. This proposal would make the specific activities described in subparagraphs (a) to (d) superfluous as subparagraph (e) permits the maintenance of a fixed place of business for any activity that is preparatory or auxiliary.

An exemption for activities that are “preparatory or auxiliary” would not provide taxpayers or Contracting States with any clear exemptions. This would increase the potential for disputes between Contracting States. If, however, the intention is that the specific activities described in subparagraphs (a) to (d) are presumed to be preparatory or auxiliary in nature, then we suggest that Option E is redrafted along the following lines to make that presumption clear:

4. Notwithstanding the preceding provisions of this Article, unless the activities conducted at a fixed place of business form a significant and essential part of the enterprise as a whole, the term “permanent establishment” shall be deemed not to include:

The remaining language of the current Article 5(4) would be retained. This would be the preferable option. The Commentary should confirm that activities that do not contribute significantly to a company’s core capabilities or fundamental risks of success or failure should not be considered to form a significant and essential part of the company’s business as a whole. The Commentary should also include detailed examples (which should not be exhaustive) which would provide companies with guidance on interpretation to provide a ‘safe harbour’ and certainty on their position.

**Options F, G & H**

Options F, G & H focus on the removal of specific activities that are of concern, namely, delivery, purchasing and collecting information. For the reasons outlined below, these specific activities should be retained and consequently these options should be rejected.

I. **Purchase and Leasebacks**

Aircraft lessors will often buy and lease assets back to airlines. The lessor will send a team to the airline to discuss the terms of the purchase and leaseback. Again typically the main elements of the contract will be determined by the head office and the regional team will be operating under the instructions of head office. The aircraft in these circumstances may be physically located in the country where the customer and the team are based. It would be important that the purchase and delivery back to the airline would not create PE for the lessor.
II. Delivery of Aircraft

Negotiation and execution of a contract in many cases will not be in the country that the aircraft is at delivery. In these cases the physical delivery of the aircraft is incidental to the overall transaction. In many cases the delivery of multiple aircraft can take place in multiple countries.

Given the number of aircraft that are delivered every year, if delivery was removed as an exempted activity this could create an undue administrative burden for the parties involved.

III. Purchases of Aircraft

Lessors have relationships with the OEM’s and in many cases place large orders. A discount may be obtained for large orders. The aircraft will ultimately be placed with airlines around the world. There are a number of practical issues with attribution of value to such an activity, namely:

- The price obtained for the purchase of aircraft is very confidential information. Determining whether and what discount you are getting would therefore be extremely difficult.
- The aircraft are sold around the world, typically they will be placed in the year coming up to delivery. Market conditions change, customers and lessors change and so the value in a purchase order changes. This is completely unconnected to the activity conducted by the team that interfaced with the OEM’s. As mentioned these teams will be acting under instructions from the master servicer in any event.
- Lessors can purchase aircraft from other lessors. It would be very difficult to determine whether a discount is obtained on such purchases and ultimately what value is realised by the purchase as opposed to the team responsible for the sale, or subsequent realisation of value through lease.
- Purchase and leasebacks – as mentioned lessors often buy aircraft from airlines and leaseback the aircraft to them. Again it would be very difficult to ascertain whether the value is ultimately in the purchase price paid for the aircraft or the lease rates negotiated on the leaseback and the remarketing efforts when the aircraft comes off lease.

IV. Collecting Information

The regional offices will often collect information on customers in the region. The gathering of information helps promote trade between States. It is also difficult to see how such an activity creates BEPS concerns. The proposal to remove this activity from the specific activity exemptions could result in significant compliance costs with little or no revenue generated for the State.

In summary, a redrafted Option E along the lines above with additional clarity in the Commentary would be the preferable option. As outlined above, we suggest that the Commentary could, in the context of cross border leasing operations, reflect the auxiliary role that the above activities play in the context of the activities of the lessor/master servicer.
3. Fragmenting Activities or Splitting Contracts

In our experience lessors do not fragment activities or split contracts that would collectively constitute a PE among various affiliates and then manage each affiliate’s activities to prevent any of them from having a PE by taking advantage of the specific activity exemptions. This is likely the case for most companies. In order to avoid increasing the cost of administration unnecessarily, we suggest that the term “associated enterprises” is narrowed and any PE arising under these provisions should be attributable to the group member that has a PE.

4. Conclusion

In conclusion, we believe that the current proposals are very broad and open to interpretation. In the context of the aviation leasing industry, given the potential for a transaction to involve activities in multiple countries and the high degree of mobility of the assets and the individuals (conducting activities in multiple States), it is important that any measures introduced are targeted, proportionate and workable and do not bring such activity within its scope. Guidance to this effect should also be included in the Commentary. The changes should not alter the settled international taxation of transactions outside of the specific areas of concern, namely commissionaire structures and the digital economy.

We would be delighted to discuss further should you have any questions.

Yours faithfully

Tom Woods
(on behalf of representatives of the Aviation Finance & Leasing industry as set out in Appendix I)
Appendix I – Signatories to this Paper

KPMG Ireland

Aldus

Macquarie

AWAS
KPMG International (“KPMG”) very much appreciates the opportunity to present our collective feedback to the Organisation for Economic Co-operation and Development (“OECD”) on the Public Discussion Draft on “Preventing the Artificial Avoidance of PE Status” (the “Discussion Draft”).

General Observations

A. BEPS Action 7 is focused on artificial avoidance of permanent establishment (“PE”) status. While the focus of the BEPS project is preserving the ability of a source State to tax nonresident enterprises that engage in significant business activities within its borders, the OECD must balance the BEPS concerns with other policy goals that the PE standard of Article 5 of the OECD Model Tax Convention (“Model Treaty”) has historically advanced, including:

1. Economic Efficiency—The PE standard should not discourage exploratory or preparatory activities related to the possible establishment of a business activity in a State, as such a standard would benefit neither taxpayers nor the source State. Similarly, the PE standard should not cause an enterprise to relocate or restructure activities that are peripheral to its main business simply to avoid a PE.

2. Fairness—Similarly situated enterprises should be treated similarly. The PE standard generally should not treat competitive investment differently based upon differences that do not relate to the degree that an enterprise is taking advantage of economic presence within a State to generate profits.

3. Consistency—Equivalent economic activities should be subject to the same PE standard regardless of the source State. As a result, for example, the standard should attempt to reach the same results regardless of whether the source State has a common law or civil law system.
4. Clarity—The PE standards should be clearly articulated, both to permit taxpayers to self-assess their liability correctly and to prevent conflicts between Contracting States.

5. Administrability—The Focus Group should consider the additional burdens, both on taxpayers and the Contracting States, which will result from the adoption of any proposal that lowers the PE threshold. In this regard, the Focus Group should consider that whenever a PE is determined to exist, a determination of the profits attributable to that PE under the authorized OECD approach (“AOA”) will be required.

B. The alternative Options advanced in the Discussion Draft would all achieve, to a considerable degree, the goal of limiting taxpayers’ ability to artificially avoid PE status. However, in our view, the Options vary considerably in achieving the other appropriate goals of Article 5. Our comments assess alternative Options based upon our assessment of how well they balance the various goals of Article 5. In some cases, we suggest a modification to Options to accommodate better the competing policy goals.

Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies

A. Background and General Observations

1. The considerations in BEPS Action 7 in respect of commissionaire and similar arrangements focus on paragraphs 5 and 6 of Article 5, governing activities of dependent and independent agents. The historic premise of these provisions is that while under certain conditions an agent may give rise to a PE of its principal, only persons who have authority to bind the principal by contract should be treated as creating a PE for the principal. Paragraph 5 thus provides that a nonresident enterprise will have a PE only where an agent (other than an independent agent, as described in paragraph 6) acts on behalf of the foreign enterprise and has and habitually exercises an authority to conclude contracts in the name of the foreign enterprise.

2. An agent, whether or not disclosed, typically performs its duties for a fixed or limited fee, with any value of its services above that fee accruing to the benefit of the principal. This is true regardless of whether the agency is disclosed to third parties, or undisclosed, as in the case of the commissionaire. Thus, for example, a principal may accrue profits in a source State as a result of an agent developing a clientele for its benefit, or from maintaining a stock of goods in a
country from which it derives profits. Under existing paragraph 5, the source State may tax these profits when a principal acts through an agent who has the power legally to bind the principal (whether or not disclosed), but not when the principal acts through a commissionaire. This is because the principal is not bound by the contract the commissionaire concludes with the customer. Rather the principal is bound by its own agreement with the commissionaire to deliver the goods at whatever price the commissionaire agrees with the customer.

3. A buy/sell distributor, unlike a dependent agent, acts on its own behalf. Any clientele a distributor builds in a State is for its own account and the distributor is entitled to any profits attributable to that clientele. While a nonresident enterprise selling into a State through a buy/sell distributor may benefit indirectly from those sales, it is properly subject to business taxation in the source State only if it has established a PE without regard to the activities of the entrepreneurial buy/sell distributor.

4. The Discussion Draft expresses concern over the application of these concepts to commissionaire and “similar arrangements,” suggesting that in many cases these arrangements are implemented to erode the tax base of the source State. We agree that the objectives of fairness and consistency support the principle that a principal should be attributed the activities of a dependent agent that contracts “on its behalf,” regardless of whether the agent contracts “in the name of” the principal. In other words, the paragraph should apply to both disclosed and undisclosed dependent agencies, e.g., commissionaires.

5. This said, certain aspects of the Options described in the Discussion Draft extend beyond what may be necessary to address the stated concern. We believe that the Options would create uncertainty as to the scope and application of the proposed concepts and terms. We further believe that they could lead to the improper assertion of PEs where a profitable enterprise has dealings with a source State but does not directly operate through a fixed place of business, either directly or through a dependent agent. The Commentary to the Model Treaty (the “Commentary”) should make clear that a foreign enterprise does not, by dealing through a buy/sell distributor or other independent enterprise, create a PE in a source State merely because it benefits commercially from those dealings.

6. Similarly, the Commentary should make clear that an enterprise that enters into a customer relationship for its own account does not, merely by subcontracting some or all of the performance or risk to another enterprise, create a PE for that
second enterprise. For example, an insurance enterprise that enters into a contract of primary insurance with an insured should not create a PE for a reinsurer that assumes some or all of the risk under the primary policy. In such a case, the primary insurer remains solely liable to the customer. In other words, in selling the primary insurance contract, the primary insurer has acted solely for its own account and not “on behalf of” the reinsurer. The primary insurance contract does not create a relationship with the insured for the account of the reinsurer.

B. Specific Comments on the Options for Amending Paragraph 5

1. The Options in the Discussion Draft focus on changes to two clauses in current paragraph 5: (1) the nature of the activities performed for the nonresident enterprise in the state and (2) the consequences of those activities (in economic and legal terms) on the nonresident enterprise. Two different alternatives are presented with respect to each of the clauses under discussion. The four Options presented in the Discussion Draft (Options A through D) represent the four possible combinations of these alternatives.

2. One clause in current paragraph 5 considered for possible revision requires that a person habitually “concludes contracts” on behalf of the nonresident enterprise. The concern with respect to this clause is that some taxpayers may take the position that a dependent agent may negotiate the key terms of contracts without creating a PE for its nonresident principal as long as it is careful to send the contracts back to the principal for formal execution.

3. The first alternative would replace the existing phrase “concludes contracts” with the phrase “engages with specific persons in a way that results in the conclusion of contracts”. This alternative is contained in Options A and C.

4. The second alternative would replace the existing language with the phrase “concludes contracts, or negotiates the material elements of contracts”. This alternative is contained in Options B and D.

5. As outlined in more detail below, we believe that the concern with the current wording of paragraph 5 may be adequately and appropriately addressed by the second alternative, which would expand the current language to also include the negotiation of the material elements of contracts. By contrast, the language of the first alternative, which would expand the activities potentially creating a PE to engaging “with specific persons in a way that results in a conclusion of contracts”, is overly broad and imprecise. In our view, that language would not
create a standard that taxpayers could reliably interpret and apply and would lead to disputes among Contracting States as to whether activities resulted in the conclusion of contracts.

6. The language of the second alternative, which would alter the clause to read “concludes contracts, or negotiates the material elements of contracts”, may appropriately address the concern with the current language to the extent that it would capture situations in which a person negotiates all the material terms of a contract for an enterprise in a source State and then sends the contract to the enterprise for a “rubber stamp” execution. However, the language may further be read to imply that any negotiation of the material terms in a State could give rise to a PE, even if the material terms are not concluded through those negotiations. The Commentary should confirm that the phrase is intended only to cover the habitual negotiation of all of the final material terms of a contract in a State, and not situations in which the negotiations that occur in a State are limited to preliminary or interim discussions of terms that do not reflect the final agreement.

7. If the second alternative is adopted, the Commentary should also clarify which terms are “material.” In this regard, the Commentary should provide that the material terms of a contract are those that are essential to create a binding legal commitment. For example, in a contract for the delivery of goods, the material terms would include a description of the goods, quantity and price.

8. The second clause in current paragraph 5 considered for possible revision requires that the person acting on behalf of an enterprise act “in the name of” the enterprise. This clause involves the issue, discussed above, of whether a nonresident principal should be treated differently depending upon whether, as a matter of law, it is directly bound by contracts concluded by the agent.

9. One alternative (contained in Options A and B) would broaden paragraph 5 by providing that a person may create a PE for a nonresident enterprise not only when the person acts in the name of the enterprise, but also when the person contracts for the supply of goods owned by the enterprise or for the provision of services by the enterprise. Hence, this alternative would cover sales, licenses, and leases by commissionaires, in line with the stated intention of the changes. However, arguably this wording would also cover sales by buy/sell distributors that take “flash title” to goods, as such a distributor may contract for the sale of goods that, at the time the contract is concluded, are still owned by the foreign supplier.
10. This alternative also would arguably cover services that a nonresident enterprise performs as a subcontractor. For example, where the resident affiliate of a multinational construction firm enters into a master contract to construct a building within its residence State, and then subcontracts a portion of the contract, e.g., architectural design, to a nonresident affiliate, the resident affiliate may be considered to have entered into a contract for the nonresident’s provision of services if those services were required under the master contract. Such a result would be inappropriate if the resident affiliate compensates the nonresident affiliate for the value of its services with an arm’s length fee and the nonresident affiliate does not assume the risks and rewards of performing the master contract.

11. Finally, the first alternative to the second clause of paragraph 5 also could arguably lead inappropriately to a PE where a person enters into a contract in a State and then assigns some or all of the responsibility of the contract to one or more nonresident enterprises under an arrangement in which the person retains the risks and rewards of its agreement with the customer. Multinational enterprises (“MEs”) that supply commodity products often conclude the supply contract with the customer in, e.g., the customer’s home State, but then assign the performance obligations under the contract to affiliates in the States where the commodities are to be delivered. Under the terms of the assignment, the affiliates generally take only a small margin for their delivery function, and the balance of the profit (or loss) on the contract is retained by the originating enterprise. For example, in line with normal industry practice, an ME’s German affiliate may conclude a contract with a German company to supply a commodity at various locations throughout Europe. The German affiliate may then assign the obligation to deliver the commodity at UK locations to the ME’s UK affiliate. Under the terms of the assignment, the UK affiliate takes flash title of the commodity and is remunerated with a small margin that is its arm’s length compensation. The German affiliate retains the balance of the profit (or loss) on the transaction. Under these facts, we do not believe that Germany should be able to assert that the UK affiliate has a German PE.

12. The second alternative to the second clause of paragraph 5 (contained in Options C and D) would replace the language “contracts in the name of the enterprise” with the phrase “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account of and risk of the enterprise”.

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13. We believe the second alternative is preferable to the first, subject to clarifications recommended to be made in Commentary. The second alternative is more appropriately tailored to the goal of creating an equivalency between disclosed agencies, commissionaires, and other commercial relationships, such as a partnership, in which a person acts in a way to promote and manage the commercial interests of a nonresident enterprise in a State.

14. Moreover, we understand that the second alternative is not intended or otherwise likely to encompass commercial arrangements in which a person, acting to promote and manage its own entrepreneurial activities in a State, collaterally benefits those of a nonresident enterprise. For example, when a buy/sell distributor purchases merchandise from a nonresident manufacturer, the distributor’s success in developing its market in a State may collaterally benefit the manufacturer’s business by increasing demand for its products. However, because the manufacturer is selling the goods on its own account, and not for the account of the manufacturer, the provision would not apply. Similarly, when a service enterprise that sells services in a State decides to subcontract a portion of those services to a nonresident enterprise, it should not be considered to have acted on the account of and at the risk of the nonresident subcontractor. Thus, in the examples discussed above, the contracting construction company’s subcontract of architectural services to a nonresident affiliate should not cause the nonresident affiliate to have a PE in the source State. Similarly, the German company’s assignment of the U.K. rights and obligations under a contract to sell a commodity in the United Kingdom should not cause the U.K. affiliate to have a German PE when the German affiliate has retained the entrepreneurial risks and rewards of the contract.

15. Based on the foregoing, we believe that of the four options presented, Option D would most appropriately amend paragraph 5 to achieve the goals of Action 7. However, because the amended language is potentially susceptible to overly broad interpretation, as discussed above, we believe that the Commentary must clearly state not only the intended reach of the broader language, but also the limits of that reach.

C. Amendment to Paragraph 6

1. Each of Options A through D would amend paragraph 6 to provide a new second sentence indicating that "[w]here, however, a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises, that
person should not be considered to be an independent agent within the meaning of this paragraph with respect to those enterprises.”

2. Under the existing Commentary, an agent’s representation of a single principal is a factor in assessing whether the agent is independent. In our experience, enterprises generally take a cautious approach about concluding that an agent with a single principal is independent. Nonetheless, in certain circumstances an agent representing a single principal, and in particular one who is unrelated, may appropriately be characterized as independent. For that reason, we believe that the facts-and-circumstances approach of the current Model Treaty is preferable to a strict rule.

3. For example, an agent that generally acts on behalf of a number of enterprises, but temporarily acts exclusively for a single enterprise for a limited period of time, should still be able to qualify as independent. Similarly, an agent that has its own enterprise and that acts as an agent for a single principal in the same business line may be economically and legally independent of the principal. Finally, an agent that is building a new business will likely for a period of time act exclusively or almost exclusively for its initial client. Where such an agent assumes the risk of its own success, it may be neither economically nor legally dependent on its initial client, and therefore should be treated as independent. Moreover, from a practical perspective, a principal dealing with an unrelated agent may not know whether it is the agent’s only client.

4. We note also that proposed Article 5(6) would adopt the concept of “associated enterprises” used in Article 9 and treat all principals that are associated enterprises as a single principal. As applied under Article 9, the concept of “associated enterprises” is very broad. The term could encompass companies with overlapping members of their board of directors or companies that are managed by a single private equity management company, even if the companies have limited ownership overlap. Additionally, under a broad definition of “associated enterprises”, all the member firms of an international accounting firm could be aggregated if they appoint an international Board or management committee, even though each firm is owned by a separate set of partners who do not share in the other member firms’ profits.

5. In the context of a transfer pricing determination, treating enterprises as associated does not, in itself, give rise to any adverse consequence to a taxpayer. Associated enterprises may still avoid a transfer pricing adjustment by demonstrating that they have dealt with one another on arm’s length terms.
6. By contrast, where the proposed amendment to paragraph 6 applies, the taxpayer would always suffer the consequences. For that reason, a narrower definition of association should apply to the determination whether two enterprises should be aggregated for these purposes. Specifically, we recommend that two persons be aggregated only if they are connected through greater than 50% equity ownership, by vote or by value. Appendix A contains proposed language to a new definition of the term “related” that could be used for these purposes.

7. If, contrary to our recommendations above, paragraph 6 is amended, we recommend conforming language to reflect the definitional terms be included. Appendix B contains a proposed new sentence to be added to paragraph 6 that is consistent with the proposal contained in Options A through D, but utilizes the definition of “related” rather than the concept of associated enterprises.

Artificial Avoidance of PE Status through Specific Activity Exemptions

A. General Observations

1. The perspective of the Discussion Draft seems to be that MEs inappropriately use the specific activity exceptions to tailor their activities in a manner that avoids the creation of a PE. In our experience, the exceptions for specific activities provide clear guidelines that permit MEs to manage effectively their tax reporting obligations. Many MEs follow a policy of incorporating a resident company in a State when their activities would otherwise rise to the level of a PE. That resident company then reports the income attributable to those local business activities in the State that create a taxable business presence. The specific activity exemptions thus provide useful guidance on when an ME should establish a local resident company in a State. Moreover, after an ME has established a local resident company, the specific activity exemptions provide relatively clear guidelines for the activities that other group companies can conduct in the State when dealing with their fellow group member (or third parties) without themselves becoming subject to local taxation on their business profits.

2. The specific activity exceptions are also beneficial to Contracting States. Because the specific activity exceptions provide clear limitations on the ability of a Contracting State to assert a PE, they reduce the potential conflict between States as to whether a nonresident company has crossed the preparatory and auxiliary (“P&A”) threshold and established a PE. Without such clarity, States
may find themselves in conflict over whether a PE exists, often requiring burdensome enquiries and discussions over the existence of a PE and, if such a PE is considered to exist, the proper attribution of profits to the PE. The administrative costs, both to the Contracting States and taxpayers that are avoided as a result of the specific activity exceptions should not be underestimated. This cost must be weighed against the relatively small income, and hence tax, likely attributable to such activities in many cases.

3. The Commentary to the Model Treaty indicates relative unanimity on the appropriateness of the specific activity exemptions, and was issued just a few years before the start of the BEPS project. Only two countries, Mexico and Chile, voiced reservations over Article 5(4), and both of these objections related to subparagraph (f), which permits the aggregation of P&A activities.

4. The Discussion Draft contains a general Option (Option E), as well as a series of targeted Options (Options F through H) that may be adopted in lieu of the general Option E. In our view, preserving clarity for both MEs and Contracting States has significant value. Hence, we believe that before the OECD abandons the current version of paragraph 4, it should weigh the potential loss in clarity and administrability against the generally nominal potential revenue gain for a Contracting State. Moreover, one Contracting State’s gain will be the other Contracting State’s loss.

5. Nevertheless, if Option E is adopted, then a revised version of Option E, described below and contained in Appendix C, would in our view be preferable to the version contained in the Discussion Draft, insofar as it would create a presumption that the specific activities described in subparagraphs (a) through (d) of Article 5(4) continue to qualify for exemption unless they are core to the enterprise’s business activities. Moreover, if one or more of the targeted Options (F through H) were adopted, we believe that the Commentary should make clear that those Options do not imply that activities formerly covered by specific activity exemptions may no longer qualify as P&A. Rather, the Commentary should contain examples illustrating when such activities would or would not be P&A. On balance, we would prefer the adoption of a modified general Option (Option E) to the adoption of one or more of the specific Options (Options F through H).

B. The General Option (Option E)
1. Option E would add to paragraph 4 a requirement that an activity be of a preparatory or auxiliary character to qualify for the P&A exemption. In other words, each of the specific activity exemptions would be subject to a “preparatory or auxiliary” condition.

2. At first blush, Option E seems to create a two-prong test under which an activity must be (1) an activity described in subparagraphs (a) through (e) and (2) P&A. However, under closer inspection, this Option creates a single test: Is the activity P&A?

3. In this regard, subparagraph (e) would exclude from the definition of PE “the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity” (emphasis added) not described in subparagraphs (a) through (d). As a result, subparagraphs (a) through (e) literally encompass any activities a taxpayer may engage in, causing the first prong of the two-prong test to be superfluous. Under this reading, the subparagraphs are unnecessary: Any and all business activities conducted at a fixed place of business would be described in subparagraphs (a) through (e); therefore, whether the exemption applies would be determined solely by reference to whether the activity is P&A.

4. An exemption for activities that are “preparatory or auxiliary” would not provide taxpayers or Contracting States with any clarity. Inevitably, the determination of whether an activity was P&A would be made by the State asserting the PE, and the taxpayer and its residence State would bear the burden of demonstrating that the activities were P&A. Hence, the standard would deprive taxpayers of the planning comfort they currently enjoy and increase the potential for disputes between Contracting States.

5. If, contrary to the interpretation above, the Focus Group intends that the specific activities described in subparagraphs (a) through (d) should presumptively qualify as P&A, the general option should be redrafted to make that presumption clear. The redrafted option might, for example, retain the language of the current Article 5(4) but add new language providing that, notwithstanding the general rule, activities described in subparagraphs (a) through (d) could create a PE if the activities in the State are demonstrated to form a significant and essential part of the enterprise as a whole. The new language places the burden on a State proposing a PE to demonstrate that a taxpayer engaging solely in an activity described in subparagraphs (a) through (d) should nonetheless be treated as having a PE. This burden is designed to protect taxpayers and the
other Contracting States from unwarranted assertions of PEs. Proposed language is contained in Appendix C.

6. The Commentary should encourage States that assert a PE under this additional language not to impose any penalties when the taxpayer reasonably concluded that it qualified for a specific activity exemption.

7. Activities should not be considered to form a significant and essential part of an enterprise as a whole unless they contribute significantly to the enterprise’s competitive advantages, core capabilities, or fundamental risks of success or failure. The Commentary to the Model Treaty should be revised to provide examples illustrating the rule. For example, the maintenance of a stock of goods within a State would not create a PE if the maintenance of the stock of goods in the State is for convenience or routine cost savings.

C. Targeted Options

1. Option F
   a. Option F would remove the reference to “delivery” from subparagraphs (a) and (b) of Article 5.4. Consequently, those specific activity exemptions would be narrowed to permit the use of facilities to store or display goods or merchandise (under subparagraph (a)) and the maintenance of a stock of good or merchandise under subparagraph (b)) solely for purposes of storage or display. In other words, a taxpayer’s maintenance of a warehouse from which it delivers goods or merchandise to customers would give rise to a PE unless the taxpayer could demonstrate that such activity otherwise qualified as P&A.

   b. While theoretically a taxpayer could still demonstrate that the maintenance of a warehouse from which it delivers goods and merchandise should be treated as P&A, the removal of the word “delivery” from the subparagraphs (a) and (b) may create a presumption that such activities should not, as a general matter, be treated as P&A. The Discussion Draft seems to acknowledge this risk, stating that under Option F, “[t]ax authorities might be led into attributing too much income to this activity if they do not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties.”
c. The proposal appears to be motivated by a desire to expose e-retailers to local taxation in States where they sell, but otherwise do not have a PE.\footnote{Discussion Draft at ¶ 18.} While the proposal may well achieve that result in some cases, the question remains whether the result is necessary or appropriate. One may question for several reasons why a specific activity exception that enjoyed widespread approval as recently as 2010 should no longer qualify as a P&A activity. First, the economic contribution of a warehousing operation for an electronic commerce business is not likely to differ from the same activity conducted by another enterprise. In fact, as noted by the Discussion Draft, the profit attributable to even a large warehousing operation is likely to be routine and relatively small. Thus, while the proposal may expose an e-retailer to some tax in the source State, that tax is likely to be relatively small. Second, while the change would permit a source State to tax e-retailers that sell tangible goods or property through a local warehouse, it would not similarly expose the sale of digital goods to local tax. Finally, eliminating this specific activity exemption may simply cause e-retailers to consolidate their warehousing footprints in fewer countries.

2. Option G

a. Option G would delete the specific activity exception in subparagraph (d) for the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise.

b. The Discussion Draft states the exception for purchasing activities seems to have been originally justified by the view that no profits could or should be attributed to such activities.\footnote{Discussion Draft at ¶ 22.} However, under the separate entity approach of the AOA, every commercial activity conducted in a country would attract \textit{some} profit.\footnote{See 2010 commentary at ¶ 23 (It is recognized that such an office [i.e., an office engaged in P&A activities] may well contribute to the productivity of the enterprise ….”).} For example, a separate entity retained to conduct a market feasibility study for a client considering entering a State certainly would charge a price for the study that would yield an expected profit. Yet such activities, if conducted directly by an enterprise, should be considered preparatory. Hence, the relevant enquiry should not be
whether an activity would be entitled to an expected profit, but rather whether the revenue loss from exempting the activity is justified based upon competing considerations, such as economic efficiency and administrability.

c. The Discussion Draft considers the policy issues on the basis of three examples. These examples illustrate that in some cases (as in example 2) a purchasing office may make a significant contribution to the profitability of a business, whereas in other cases (as in example 3), the purchasing office’s contribution may be auxiliary. We believe that our recommendation concerning the general option—providing that activities described in paragraph 4, subparagraphs (a) through (d), create a PE only in situations where the activities in the State form a significant and essential part of the enterprise as a whole—would result in appropriate treatment for these cases.

d. Example 1 illustrates a situation that is ambiguous based on the limited facts presented. In Example 1, a member of an ME resident in State T maintains a purchasing office in an emerging economy, State S. The group member purchases the output of four factories operated by its group (presumably by a State S resident member) and the purchasing office claims that it is entitled to a large discount based on the volume of its purchases. The purchasing discounts reduce the profits attributable to the manufacturing plants. The profits would escape taxation in State S if that office did not constitute a PE.

e. While the conclusion in Example 1 is true, the facts do not clearly indicate that the purchasing office should create a PE. If the nonresident group member is purchasing for itself, the purchasing office may well be auxiliary to the nonresident enterprise. In this case, a conventional transfer pricing analysis would determine whether and to what extent the nonresident’s purchasing power would justify granting the nonresident price discounts. Traditional transfer pricing would protect State S on this issue, as it could adjust the income of the manufacturing plants if it considered the claimed discount to be excessive. If, on the other hand, the enterprise maintaining the purchasing office were a procurement company selling to other group members, the purchasing office likely would be a core business activity of the enterprise. In this case, State S would be justified in asserting a PE. However, in this case, the profits attributable
to the PE might be small, as the benefits of scale may properly accrue to its customers, rather than to the activities of the PE.

3. Option H

a. Option H would delete subparagraph (d) in its entirety. Hence, it not only would remove the specific activity exception for maintaining a fixed place of business for purchasing activities (as under Option G), but also the exception for the maintaining a fixed place of business for purposes of collecting information for the enterprise.

b. Option H is described in the Discussion Draft as a response to some enterprises attempting to extend the scope of that exception, e.g., by disguising what is in reality the collection of information for other enterprises (when the exception is applicable only to information collected for itself). However, if some taxpayers are exploiting an otherwise appropriate exemption by applying it too broadly, the more appropriate response may be to amend the Commentary to make clear that the offensive applications are unwarranted. Eliminating the exemption altogether deprives taxpayers and the States from the benefits of the appropriate application of the existing exemption.

c. The concerns to which Option H is directed include activities of enterprises engaged in digital commerce, which may earn significant profits by providing the information they collect within a State to their customers. However, the gathering of such information does not necessarily require a fixed place of business within the State; hence, it would affect enterprises haphazardly based upon whether, for example, they maintained servers within the State. As a result, a digital business may easily avoid creating a PE simply by maintaining its servers outside the State.

d. If insurers and reinsurers are to provide insurance coverage into new jurisdictions, they have to gather some information on local markets. Such activities are typically conducted and treated as P&A, and they are not considered to be core insurance functions. This treatment should continue to apply.

4 Discussion Draft at ¶ 28.
e. Historically, the specific activity exemption has permitted international media enterprises to maintain offices for the purpose of gathering of information. We believe that the policy considerations relevant to permitting the gathering of information for publication abroad outweigh the interest of States in taxing the profits attributable to those activities.

D. Fragmentation of Activities between Related Parties

1. Option I

a. Option I would add a new paragraph 4.1 to Article 5 under which, if one member of an ME conducts activities that create a PE in a State, the activities of an associated enterprise through a fixed place of business would also create a PE if they constitute complementary functions that are part of a coherent business enterprise, notwithstanding that the activities otherwise would qualify as P&A.

b. The explanation to Option I provides that “it would be clarified that the definition of permanent establishment is not restricted to situations where an enterprise of one Contracting State carries on business in the other Contracting State and can apply to situations where an enterprise of either State or even a third State carries on business in that State” (emphasis added). The explanation suggests that even the activities of an associated enterprise resident in the source country could be considered in determining whether a PE exists.

c. As noted earlier in our comments, many MEs incorporate a resident company in a State to report income attributable to activities in that State that would otherwise give rise to a PE. If activities of a resident enterprise are taken into account in determining whether a PE exists, many nonresident enterprises may have a PE in the source jurisdiction, even though they engage only in activities that, standing alone, are P&A. In particular, because a source State may in many cases take the position that the facilities of the resident enterprise are “at the disposal of” its associated enterprises, Option I could create a broad “force of attraction” rule under which the profits attributable to P&A activities of nonresident enterprises are swept into the local tax net. In our view, this Option should provide that it applies only to the aggregation of activities of nonresident enterprises of the ME and not the activities of a related resident company.
d. Moreover, we believe that the scope of the term “associated enterprises” is broader than necessary to achieve the purposes of this option. We recommend that the provision apply only to nonresident enterprises that are “related” within the definition contained in Appendix A.

e. We note that Option I creates the risk of significant penalties due to the fact that MEs might be unaware of certain P&A activities that should be combined with PE activities conducted by a related entity. This risk is even higher if the broad measurement of relatedness contained in “associated enterprises” is used. See our comments and recommendations above in respect of the scope of the term “associated enterprises” for purposes of these rules.

f. Appendix D contains proposed language for our modified version of Option I.

2. Option J

a. Option J is a broader alternative to Option I. Under Option J, a State could assert a PE where the combined activities of the associated enterprises are not P&A. Hence, under this Option none of the associated enterprises has to conduct activities that in themselves would create a PE.

b. In our experience, MEs do not fragment activities that would collectively constitute a PE among various affiliates and then manage each affiliate’s activities to prevent any of them from having a PE by taking advantage of the P&A exemption. Hence, the expanded reach of Option J over Option I would appear to address a fact pattern of little or no revenue concern to source states. However, it would impose on MEs an obligation to assess all their contacts with each State in order to ensure that the group’s collective activities could not be aggregated in a manner that arguably fell within the new paragraph 4.1. We do not believe that the additional scope of Option J as compared to Option I would justify the additional administrative burden it would impose.

c. As in the case of Option I, the “associated enterprise” concept used in Option J is too broad and should be limited to the more restricted concept of related parties, consistent with our earlier recommendations.

d. Option I, particularly as modified to reflect our recommendations above, is preferable to Option J because it would find a PE only when one of the
fragmented activities would itself be a PE. Such an approach would provide much more certainty for taxpayers and make the provisions much more administrable.

**Splitting Up of Contracts**

A. General observations

1. Under Article 5(3), “[a] building site or construction or installation project constitutes a PE only if it lasts more than twelve months.”

2. Paragraph 18 of the OECD Commentary on Article 5 states that enterprises, mainly contractors or subcontractors working on the continental shelf, divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was owned by the same group (ostensibly to avoid the definition of a PE).

3. The splitting of contracts in order to avoid a PE is also a concern in treaties that contain a service-PE provision, such as the alternative provision found in paragraph 42.23 of the Commentary and in Article 5(3)(b) of the UN Model Treaty.

4. The Discussion Draft contains two alternative Options for dealing with the artificial avoidance of PE status through the splitting of contracts (Options K and L). Options K and L would use very different approaches to addressing the issue. Option K would add a provision to Article 5 under which the activities of associated enterprises would be automatically aggregated for purposes of applying the 12-month rule. Option L would not add a specific rule to Article 5 dealing with the splitting of contracts. Instead, a State could rely on the general anti-abuse rule proposed as part of the work on Action 6 to deny treaty benefits when the contracts have been split to avoid treaty benefits.

5. We believe that the automatic aggregation rule of Option K would be overly harsh. We discuss below some modifications that would tailor the option more appropriately to the abuse it is designed to address.

6. As discussed above, we believe that incorporating the concept of “associated enterprises” from Article 9 into PE determinations is overly broad. We recommend that the determinations made under both Options K and L be made using the narrower concept of related parties as described above.
B. Option K

1. Option K would address the concern raised by the splitting of contracts by adding to Article 5 a rule under which all the activities of associated enterprises would be aggregated in determining whether an enterprise’s activities at a building site or construction or installation project last more than twelve months.

2. The activities of associated enterprises would be aggregated solely for purposes of determining whether one or more enterprises has a PE. Once an enterprise is determined to have a PE, its income attributable to the PE would be determined separately under Article 7 based on its activities alone.

3. Option K is overly broad in at least several respects. First, when an ME has a resident entity in a State, every other member of the group could have a PE even if its involvement lasts for a single day. The same is true if a single nonresident group member is present in the State for the entire year. In order to prevent multiple members of an ME from having PEs to which minimal profits would be attributable, we recommend that if Option L is implemented, a member would have a PE only if it is present in the State for a minimum number of days in a 12-month period (e.g., 30 days) and its revenues attributable to the PE exceed a de minimis threshold (e.g., 1% of the ME’s revenues for the 12-month period). If these thresholds are not exceeded, the ME likely has not structured its operations to avoid PE status. Creating the prospect of a PE under such circumstances, on the other hand, would be counter to the goals of economic efficiency and administrability.

4. Second, as discussed above, the concept of “associated enterprises” used in Option K is broader than necessary for purposes of Article 5 and should be narrowed to the concept of “related parties” as proposed in Appendix A.

5. Finally, Option K is also overly broad insofar as it would aggregate activities of enterprises based solely on the basis of their affiliation or, under our recommendation, ownership relationship. This could cause complex MEs, which engage in a number of distinct engineering and
construction businesses, to create PEs in cases when simpler enterprises, with which they are competing for various pieces of a large project, would not have a PE. Hence, the aggregation rule should not apply, for example, when a taxpayer can demonstrate that its activities were not split to avoid a PE, but rather were split as a result of the way contracts related to the project were awarded. Factors that a taxpayer may present would include, for example, (1) the project sponsor invited bids for different aspects of a project, (2) winning one portion of a project did not guarantee success in winning another part of the project, (3) the ME operates different businesses through different entities in the ordinary course of its business and did not establish special purposes entities for purposes of this project, (4) no personnel were seconded or otherwise transferred between associated entities, (5) the associated entities did not issue performance guarantees to one another. These factors should be illustrated by examples in the Commentary.

C. Option L

1. As discussed above, Option L would not add a specific rule to Article 5 to deal with the splitting of contracts. Instead, a State could rely on the general anti-abuse rule proposed as part of the work on Action 6 to deny treaty benefits when the contracts have been split to avoid treaty benefits. Option L would add an example illustrating when the anti-abuse rule may be applied to deny treaty benefits.

2. If Option L were adopted, the Commentary should also indicate factors that would indicate that a principal purpose of using associated entities was not to obtain treaty benefits. These factors would include those noted above with respect to Option K, such as de minimis activity by an enterprise in a State and the independent contracting of separate aspects of a complex project by an ME.

3. Option L is an appropriate alternative when Contracting States include a general anti-abuse rule in their treaty.

Insurance

A. General Observations
1. The Discussion Draft states a concern currently reflected in the OECD Commentary that insurers can write significant amounts of business in a State without having a PE in that State and, in particular, do so through exclusive agents.

2. The Discussion Draft contains two Options (Options M and N) to address this concern. Option M would provide a specific provision for insurers, whereas Option N would apply the general PE rules to insurers.

3. In our view, the specific provision for insurance based on Option M is not appropriate. Option M is not appropriate because it would give rise to significant substantive and administrative burdens for insurance groups by creating PEs where they do not conduct key entrepreneurial risk-taking (KERT) functions (as set out in the OECD Part IV 2010 Report on the Attribution of Profits to Permanent Establishments for Insurance Companies).

4. Option N would, in the context of the changes discussed above, address the concern stated above. Without clarification, however, these provisions go too far and compromise at least some of the policy goals that the Model Treaty has historically advanced, as outlined in more detail below.

B. Option M

1. Option M would add paragraph 5(6), which is equivalent to what is now provided in the UN Model Treaty, to provide that “Notwithstanding the preceding provisions of this Article, an insurance enterprise shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collect premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 6 applies.”

2. In short, although Option M would not go so far as to create a PE with respect to representation by an independent agent, it would result in dependent agent PEs whenever premiums are collected or alternatively risks are insured within the source State through a dependent agent. Hence, a dependent agent would not be required to habitually conclude, or to negotiate the material terms of, contracts on behalf of an insurance company for a PE to exist.
As paragraph 39 of the Commentary to Article 5 notes, the creation of a PE by virtue of premium collection or locally sited risks would be contrary to the factual and legal situations in many countries, and therefore it will not be appropriate in many circumstances. We believe that this comment continues to be valid.

3. If adopted, Option M could easily lead to a very large number of PEs for some insurance groups, creating a large administrative burden. The result would be increased cost of writing business, which might have unintended consequences, including discouraging insurance groups from providing insurance in countries with a small market base.

4. Option M on its own also may not lead to any material increase in the level of local taxable income. The newly created PEs likely would not perform any KERT functions, and therefore the administrative costs would not be justified by the amount of additional tax revenues attributable to the newly created PEs. Where the only functions performed in a country are as straightforward as premium collection, significant profit should not be attributed to such a PE.

C. Option N

1. If no special rule applies for insurance companies, the general rules will apply, including the changes proposed under Options A through L that may be adopted. Options A through D have been developed in the context of “commissionaire” arrangements, which “were put in place primarily to erode the tax base of the country where the sales take place.” Insurance and reinsurance, which involve genuine risk transfer out of a country, are fundamentally different.

2. Where an insurance risk is underwritten in the policyholder’s State, the insurance company is likely to be regulated in the country and the risks will be reflected on the company’s balance sheet for the source State. Tax will already follow as a PE should generally exist for tax purposes.

3. In a cross-border insurance arrangement, the insured does not contract with any person similar to a commissionaire in the source State, but instead contracts directly with the non-resident insurer. Genuine risk is transferred under the insurance contract and is taken off the economic balance sheet of the country concerned. This economic reality is generally recognised in the regulatory analysis.
4. The changes proposed to paragraphs 5 and 6 have been developed primarily to address commissionaire and other similar arrangements. The application of those changes to the insurance industry could have unforeseen consequences. Any changes to Article 5 (or to Commentary guidance) should be developed in close conjunction with the industry. We believe that a sensible framework for insurance companies needs to clearly reflect the economic reality of cross border insurance and reinsurance and the regulatory confines in which the industry operates.

5. We have discussed above how the Commentary should apply the concept of “negotiation of material elements of contracts.” In respect of insurance contracts, we recommend that the Commentary make clear that an insurer without a physical presence in a State will have a PE only if it carries on KERT functions in the State.

6. Alternatively, the OECD may consider aligning the tax approach to determining whether a PE exists with the local law approach for determining whether an insurance company is subject to local insurance regulation.

**Profit Attribution to PEs and Interaction with Action Points on Transfer Pricing**

A. General Observations

1. The Discussion Draft notes that the question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE.

2. While we agree with this statement, we believe that if a proper attribution of profits to an enterprise’s activities in a state is likely to be relatively minor, the PE standard should exempt those activities (even though the profits are not zero) if the competing objectives of Article 5 indicate that such an exemption is appropriate.

3. We endorse the AOA. We will comment on the aspects of the BEPS project related to other Actions, such as Action 9, at the appropriate time.

**About KPMG**

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.
Appendix A

New paragraph defining the term “related”

Add the following new paragraph 8 to Article 5:

8. For purposes of this Article, a person is a related person with respect to a person conducting an enterprise, if--

a) the first person controls, or is controlled by, the second person, or

b) the first person is controlled by the same person or persons that control the second person.

For these purposes, control means the ownership, directly or indirectly, of equity interests possessing more than 50 percent of the total voting power of, or of the total value of the equity interests in, a person.
Appendix B

Provision that states that an agent could not qualify as independent unless it acts on behalf of at least two or more persons that are not related.

Add the following sentence at the end of paragraph 6:

*Where, however, an agent acts exclusively or almost exclusively on behalf of one person or related persons, that agent should not be considered to be an independent agent within the meaning of this paragraph with respect to those persons.*
Appendix C

Provision that would amend the exception for preparatory or auxiliary activities

Amend paragraph 4 to read as follows:

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character,

unless, in the case of an activity described in subparagraphs a) through d), it is demonstrated that such activity forms a significant and essential part of the enterprise as a whole.
Appendix D

Provision that would address the fragmentation of activities for the purposes of paragraph 4

Replace the preamble of paragraph 4 of Article 5 by the following:

4. Notwithstanding the preceding provisions of this Article and subject to paragraph 4.1, the term “permanent establishment” shall be deemed not to include: ...

Add the following new paragraph 4.1 to Article 5

4.1 Paragraph 4 shall not apply to activities attributable to a fixed place of business that is used or maintained by an enterprise in a Contracting State if the same enterprise, another enterprise conducted by the same person, or an enterprise conducted by a related person that is not resident in such Contracting State,

a) carries on business activities at the same place or at another place in such Contracting State, and

b) that place or other place constitutes a permanent establishment for any such enterprise under the provisions of this Article, and

c) the business activities carried on by the two enterprises constitute complementary functions that are part of a cohesive business operation.
January 2015

Dear Ms. de Ruiter

BEPS Action 7: Preventing the artificial avoidance of PE status

Lloyd’s welcomes the opportunity to comment on the OECD’s Public Discussion Draft “BEPS Action 7: Preventing the artificial avoidance of PE status” (“the Discussion Draft”) released on 31 October 2014.

Lloyd’s is supportive of the objectives of the OECD BEPS Action Plan to combat double non-taxation and to prevent cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. Lloyd’s also supports the specific objective of Action 7, to prevent the artificial avoidance of PE status in relation to BEPS.

Our comments below are intended to help ensure that changes to Article 5 of the OECD Model Tax Convention are workable in the context of the insurance industry and the Lloyd’s market and that any increase to insurers’ tax compliance obligations is proportionate to the tax risks the sector presents and the additional tax that the changes will actually collect.

We have set out our comments below and have addressed the parts of the Discussion Draft that are of most relevance to Lloyd’s first. These are Proposals M and N (the insurance specific proposals) and Proposals A – D. We have then provided comments on the remaining parts of the Discussion Draft where relevant.

We have included an Appendix to this letter which sets out, at a high level, how the Lloyd’s market operates.
Proposals M and N

Lloyd’s believes that Proposal N provides the most appropriate way in which to address any BEPS concerns about the PE threshold in relation to insurance activities.

It is stated in paragraph 3 of the Discussion Draft that the BEPS Action Plan does not aim to change the existing international standards on the allocation of taxing rights on cross-border income. However, by deeming there to be a PE in any jurisdiction in which an insurance enterprise collects premiums or insures risks situated therein through a dependent agent, Proposal M appears to be departing from this principle. It is not clear why.

As outlined in the Appendix, Lloyd’s members write re/insurance business by delegating underwriting authority to managing agents which may in turn sub-delegate underwriting authority to a global network of coverholders. Local brokers may introduce business to those Lloyd’s coverholders or alternatively through Lloyd’s brokers in London on an “open market” basis. Depending on the line of business and the syndicate writing the business, many coverholders and brokers may be involved in the collection of premiums on behalf of managing agents and the members of Lloyd’s.

If Proposal M is adopted and Part IV\(^1\) is unchanged, the likely outcome would be as follows:

- Profits will continue to be attributed mainly or wholly to the underwriting function. This is because the key entrepreneurial risk-taking (“KERT”) function under Part IV is the assumption of insurance risk and those activities that constitute the most important active decision-making functions relevant to the assumption of insurance risk typically fall within the category of underwriting activities described in section B-2(i)(c) of Part IV\(^2\).

- Other functions such as the collection of premiums will attract an arm’s length reward under Part IV. This should be unchanged from the current position under which the collection of premiums should already be remunerated on an arm’s length basis under transfer pricing principles (but without giving rise to a PE and therefore without giving rise to a corporate income tax filing requirement of the insurer).

As such, any additional profit allocated to a PE deemed to exist because of the collection of premiums or the insurance of risks would be negligible or nil. The result of Proposal M would therefore be to significantly increase the number of PEs created by an insurance enterprise (including Lloyd’s members) but make little or no change to the profit arising in the jurisdiction where premiums were collected. Lloyd’s submits that this would create a tax

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\(^1\) Part IV: Special considerations for applying the authorised OECD approach to permanent establishments of insurance companies (of the OECD 2010 Report, “The attribution of profits to permanent establishments”).

\(^2\) Paragraph 69, paragraph 94, paragraphs 34-37 Part IV.
compliance burden wholly disproportionate to any perceived loss of tax in any particular country.

As a result, Lloyd’s submits that no specific rule for insurance enterprises should be added to Article 5 and that it is more appropriate to deal with all industry groups in the same way through the more general changes proposed to Article 5(5) and 5(6) in Proposals A – D (as provided for in Proposal N).

Proposals A – D

Lloyd’s believes that Proposal B provides the most appropriate way in which the concerns about the use of commissionaire arrangements and similar strategies might be addressed and the requirement of independence might be strengthened.

We have addressed each of the three parts of Proposals A – D separately below:

I. “Habitually concludes contracts, or negotiates the material elements of contracts” / “Habitually engages with specific persons in a way that results in the conclusion of contracts”

The use of the wording “habitually concludes contracts, or negotiates the material elements of contracts” as proposed by B and D is more easily defined than the alternative wording proposed by A and C, “habitually engages with specific persons in a way that results in the conclusion of contracts”. The wording in A and C would give rise to significant uncertainty because, while the Discussion Draft explains that a direct causal connection between the interaction and the conclusion of the contract would be required, “direct causal connection” would in itself require definition. This raises several important questions; for example, how would causation be defined and how remote would the engagement with specific persons need to be in order for that action not to be held to have resulted in the conclusion of a contract? An insurer undertakes marketing, client relationship building and many other activities that are remote from the final conclusion of a specific insurance contract but that interaction may still be argued to form part of the chain of events that eventually results in the conclusion of an insurance contract.

The current close alignment of regulatory and tax definitions in this area is helpful to business since it provides a broadly consistent view of what can be done in a country without requiring regulatory permission or triggering a tax presence. Additionally, the current wording of Article 5 (5) – “… habitually exercises … authority to conclude contracts…” is often taken to include negotiation of the material elements of contracts such that the change proposed by proposal B would be a less significant departure from well-understood concepts and should therefore interfere less with established business models of MNEs. The uncertainty inherent in the wording in A and C may however result in organisations being reluctant to allow their employees or agents to travel overseas until the full potential impact of a sea-change to the rules is well understood.
The wording in B (and D), “habitually concludes contracts, or negotiates the material elements of contracts”, should ensure that the activities to which a significant attribution of profits should be made under Part IV should be captured.

II. Contracts for the provision of property or services by the enterprise / “Contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”

The wording used in A and B is clearer and would provide more certainty to businesses as to what is covered. The wording proposed in C and D, “conclusion of contracts, which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”, would require much clearer definition.

III. Strengthen the requirement of independence

Where a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises, we agree that that person is less likely to be independent of the enterprise or associated enterprises. However, we do not consider that this factor should in itself be determinative; we consider that the better approach is for all of the facts and circumstances relevant to each case to continue to be weighed up.

With all the proposals we would emphasise the importance of defining the terms used in a clear way so as to provide sufficient certainty and to avoid the risk of variations in interpretation.

Proposals E – H

Lloyd’s believes that Proposal E provides the most appropriate way in which artificial avoidance of PE status through the specific activity exemptions might be addressed.

Proposal E avoids the piecemeal approach proposed in F – H. Proposal E would ensure that the concerns discussed in section B2 and section B3 of the Discussion Draft are addressed; under Proposal E, delivery activities, the purchasing of goods or merchandise and the collection of information would only be exempt from giving rise to a PE where those activities are of a preparatory or auxiliary character in relation to that enterprise’s business.

Proposals I and J

Lloyd’s understands what the OECD is trying to achieve with these proposals but is not supportive of either. Insurers will often have several ways to market in a country. Some of these may create a PE and some may not. Both proposals may create PEs in countries simply because there is activity by a related party yet, in the insurance context, produce little or no extra tax since the profits attributable to that new (or extended) PE would still be governed by Part IV.
If either proposal is adopted, we would again emphasise the need for clear definitions, particularly of the term “complementary functions that are part of a cohesive business operation”.

**Profit attribution to PEs and interaction with action points on transfer pricing**

The attribution of profit to PEs of insurance companies is governed by Part IV. This took a number of years to develop; we would therefore echo the ABI’s comments that caution should be exercised before making substantial changes to the authorised OECD approach.

Yours sincerely

Simon Claydon  
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Lloyd’s

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Appendix: an introduction to Lloyd’s

Lloyd’s is organised as a society of members, both corporate and individual, who underwrite in syndicates on whose behalf professional underwriters accept risks proposed to the market by Lloyd’s authorised brokers.

Corporation

The Society of Lloyd’s (“Lloyd’s”) is a statutory corporation made up of Lloyd’s Members. It was incorporated by the Lloyd’s Act 1871. The activities of Lloyd’s are governed by this and subsequent statutes including the Lloyd’s Act 1982. It is managed by the Council of Lloyd’s and does not carry on insurance business.

The objects of the Society of Lloyd’s are defined in Section 10 (as amended) of the Lloyd’s Act 1871

“The objects of the Society shall be:-
“The carrying on by Members of the Society of the business of insurance of every description including guarantee business;
“The advancement and protection of the interests of Members of the Society in connection with the business carried on by them as Members of the Society…”

The Society of Lloyd’s provides the premises and other services to permit the carrying on of insurance business by Lloyd’s Members. Through its Council (and those acting on its behalf) it also manages and supervises the Lloyd’s market.

Members

Every insurance contract arranged in the Lloyd’s market is a contract between an insured and one or more Lloyd’s Members. Lloyd’s Members may take one of four different forms: individual persons, limited companies, English Limited Liability Partnerships (“LLPs”) and Scottish Limited Partnerships (“SLPs”). Members that are not individuals are prohibited from carrying on any other activity than underwriting business as Lloyd’s Members.

Lloyd’s Members are liable for their own portions of any insurance business underwritten, not for any portions underwritten by other Members. Nevertheless, the financial structure of Lloyd’s incorporates arrangements to meet any valid claims that go unpaid due to a Member’s insolvency, and the financial strength of the Lloyd’s market is therefore assessed on an aggregate basis – further information regarding Lloyd’s Chain of Security is available on Lloyd’s website.

For the underwriting year beginning 1 January 2014 there were over 2100 Members underwriting at Lloyd’s: approximately 450 individuals, 720 LLPs, 85 SLPs, 750 Namecos and 140 larger corporate Members (e.g. insurance groups with a Lloyd’s Member).
Historically a small number of individual Members (and a small number of partners in LLPs and SLPs) have been non-UK tax resident. From 1 January 2015 every Member must be UK tax resident in order to underwrite at Lloyd’s.

**Syndicates**

Every Member of Lloyd’s underwrites at Lloyd’s as part of one or more syndicates. A syndicate itself has no legal personality and is not a partnership (because there is no such agreement among its members) and is not an unincorporated association (as there is no central code of rules): it is merely a vehicle through which its Members underwrite insurance. Every syndicate is managed by a managing agent. A Member of a syndicate is required to delegate absolute discretion to the syndicate’s managing agent regarding the insurance underwritten on the Member’s behalf. Each syndicate is an annual venture through which Members participate for a specific “year of account”. In practice, some syndicates have the same Member or Members year after year.

**Managing agents**

Lloyd’s managing agents are companies whose function is to manage Lloyd’s syndicates. They employ the underwriters and other staff who carry out the activities necessary for the syndicate’s insurance business. All these activities are carried out on behalf of the Lloyd’s Members who are members of the syndicate(s) concerned. A managing agent may manage more than one syndicate.

**The business model**

About 25% - 30% of business comes to the market through coverholders. Coverholders are locally regulated intermediaries to whom the Members of one or more syndicates have delegated their authority, within pre-determined parameters, to accept (re)insurance risks on behalf of those Members (known as “binding authority”). Coverholders are appointed by Lloyd’s managing agents with the approval of Lloyd’s. Where the coverholder is owned by a Lloyd’s managing agent it is known as a service company. The coverholder or service company performs activities such as underwriting, issue of policy documents, collection and payment of premiums and in some circumstances may be authorised to handle claims.

The remaining “open-market” business is negotiated directly by a Lloyd’s broker with an underwriter in the Underwriting Room at Lloyd’s (in London). The Lloyd's broker acts on behalf of the insured. The Lloyd’s broker may be in direct contact with the insured, or the insured may have employed a local insurance intermediary, who in turn has contacted the Lloyd’s broker.

**Tax**

In several territories Lloyd’s has negotiated central tax arrangements for calculating and paying income tax on behalf of Members. These arrangements are principally an administrative convenience benefitting both Lloyd’s Members and the local tax authority to manage the unique structure of Lloyd’s and its broad membership. Tax under these
arrangements may be calculated in a number of different ways depending on the territory, for example at Member-level on actual profits or on deemed profits (% of premiums) of the business written in that territory.

In other territories Lloyd’s has no central arrangement for calculating and paying income taxes on behalf of Members. In those countries Members settle their own liability based on local tax rules and any applicable Tax Treaty between the country and the UK.
Milan, 9 January 2015

Dear Marlies de Ruiter,
Head Tax Treaties,
Transfer Pricing and Financial Transactions Divisions
OECD/CTPA

Public Discussion Draft – BEPS Action 7: Preventing the artificial avoidance of PE status

Dear Ms. de Ruiter,

We are pleased for the opportunity to submit our comments on the OECD Public Discussion Draft BEPS Action 7: Preventing the artificial avoidance of PE status (the Discussion Draft), which includes the preliminary results of the work carried out by the OECD with respect to the issues related to the artificial avoidance of the permanent establishment (PE) status referred to in action 7 of the 2013 OECD Action Plan on Base Erosion and Profit Shifting (the BEPS Action Plan).

In this respect, we respectfully provide hereinafter our observations in relation to the proposed amendments to Art. 5 of the OECD Model Tax Convention on Income and Capital (the OECD Model) made in the Discussion Draft.

General remarks

1. As specified in the OECD report Addressing Base Erosion and Profit Shifting (the BEPS Report) and in the BEPS Action Plan, the purpose of BEPS Action 7 is to prevent the artificial avoidance of PE status where taxing rights on business profits are not fairly allocated and, especially, profits go untaxed anywhere.

2. To this purpose, the BEPS Report and the BEPS Action Plan suggest to develop changes to the PE definition. We believe that significant amendments to the PE definition provided for under Art. 5 of the OECD Model are not appropriate to the extent they are mainly or solely driven by such an anti-abuse purpose. Art. 5 of the OECD Model has indeed historically represented a fundamental systemic provision
having the purpose of establishing a minimum threshold for source State taxation on business profits in a context of certainty. The decision to address transactions aimed at circumventing the PE status as part of the work on Action 7 through amendments to the PE definition (as remarked in the discussion draft Preventing the granting of treaty benefits in inappropriate circumstances in relation to splitting-up of contracts) shows a lack of confidence on the effectiveness of the anti-abuse tools. Enlarging the PE definition without addressing the weaknesses shown by the anti-abuse measures, shifts on the PE definition the uncertainties and interpretative issues otherwise associated to the application of the anti-abuse provisions adding uncertainties and potential risks for inconsistent application by different tax authorities with resulting increased likelihood of double taxation (or double non-taxation).

3. Changes to the treaty PE definition leaves room for asymmetrical positions by the Contracting States that may originate situations of abuse or double non-taxation leading to BEPS. For example, for those States where treaty provisions cannot override domestic rules and that have a domestic PE definition narrower than the treaty definition any revision of the treaty definition might not be sufficient to eliminate BEPS concerns. This might be the case where under the PE domestic definition of State S a person resident in State R does not maintain a PE in State S whilst under the PE domestic definition of State R it does and income therefrom is exempted. Similarly, an amendment to the treaty PE definition would not affect cases involving persons that are resident in non-treaty States, as in the examples provided in the Discussion Draft referring to situations of abuse or double non-taxation involving low tax jurisdictions that are likely not treaty States (e.g., example 2 in par. 26). In these situations, BEPS concerns cannot be addressed by simply expanding the scope of the treaty PE definition, unless the States of source automatically adopts the treaty definition for domestic tax purpose.

4. In our view, a more substantive way to accommodate BEPS concerns might be to establish a coordination or linking rule between the definitions of permanent establishment of the Contracting States and providing for a defensive rule in situations involving non-treaty States. The principle is indeed not different from the idea behind the measures suggested in the discussion draft Neutralise the effects of hybrid mismatch arrangements to target hybrid financial instruments and hybrid entity payments, where the residence State shall acknowledge the characterisation of a certain item of income in the source State and, for example, deny a dividend exemption for payments deductible in the source State. Based on the same idea, State R may consider that a resident of State R maintains a PE in State S only if State S takes the same view. Such alternative approach would probably allow to target in a more effective way cases of abuse or double non-taxation mentioned in the Action Plan without providing for a too broad PE definition that may disrupt
existing international standards and add uncertainties and potential for inconsistent application by different tax authorities with resulting increased likelihood of double taxation.

5. Even though a number of paragraphs of the Discussion Draft refer to the abuses of the PE definition as unintended consequences of the “interpretation of treaty rules” by certain States, the way to achieve better results in this respect has been identified in changes to the treaty PE definition. This may not however give a solution to the issues arising from possible asymmetrical interpretations of the amended treaty definition by the Contracting States, leading to similar situations of abuse or double non-taxation. In this respect, the introduction of a mutual agreement procedure entailing an obligation for the competent authorities of the Contracting States to resolve such contrasting interpretations may be considered (consistently with the suggestions made in discussion draft Preventing the granting of treaty benefits in inappropriate circumstances, §53, in relation to residence issues).

6. It would also be in our view important for the Discussion Draft to take a clearer position on whether the proposed amendments to Art. 5 of the OECD Model should be considered as a mere recast of the wording without any consequences on their meaning or, alternatively, a change which amends/enlarges the scope of application of the provisions. The legal consequences are indeed deeply different, since under the latter solution the changes are applicable only to those double tax conventions that will implement the new wording. The former solution seems to be endorsed by the general premises to the Action Plan where it is stated that the actions provided therein are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.

7. Lastly, in our view any amendment to the definition of permanent establishment has to be linked with a thorough analysis of the provisions regarding the attribution of profits as currently provided for in Article 7 of the OECD Model and the related Report endorsing the authorized OECD Approach, as the two provisions are inextricably linked with each other. In particular, it is our view that any amendment focusing on establishing, e.g., that commissionaire structures are deemed to fall within the scope of para. 5 of Article 5 of the OECD Model should also set some clear rules regarding the most appropriate transfer pricing methodology to be adopted. As the options currently included in the Discussion Draft will inevitably require a fact-intensive and resource consuming approach by the tax administration, such an approach would risk of being not effective from a taxpayer’s compliance cost standpoint where the attribution of profits to a deemed agency permanent establishment would eventually be minimal, taking into account the facts and circumstances of each case.
A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

8. Based on the indications provided in the BEPS Action Plan, changes to the PE definition “are not directly aimed at changing the existing international standards on taxing rights on cross-border income” (§ 3 of the Discussion Draft). However, the suggestion made under options A and B of the Discussion Draft proposing to add a reference to contracts concerning property or service to be provided by the foreign enterprise does not seem consistent with such approach. Overcoming the issue of who is bound by contracts concluded with the customers in the source State by focusing on what is the object of the contracts would indeed in our view represent a major departure from currently existing international standards. An agent acting on behalf of a foreign enterprise may indeed represent a PE of a foreign enterprise only if it involves the foreign enterprise to a particular extent in business activities in the State concerned, being it acknowledged that “It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise” (§ 32 of the Commentary to Art. 5 of the OECD Model).

9. The fact that a person anyhow facilitates the sale of goods or the provision of services by the foreign enterprise to customers in a certain State shall not therefore by itself be sufficient for it to determine the existence of a PE of the foreign enterprise, being it necessary that the latter is legally or, at least, economically bound by the activity performed by that person vis-à-vis the customers. Amendments proposed under options A and B would instead probably broaden the scope of the PE definition to include cases that - under current international standards - should rather be addressed through transfer pricing adjustments. In particular, to the extent a person is providing services to a foreign enterprise, no PE should arise (as clarified in the OECD Commentary to Art. 5, § 42) even if the services provided relate to contracts between the foreign enterprise and its customers. In an intragroup scenario, tax authorities may challenge the level of taxable income by applying ordinary transfer pricing rules ensuring that the functions performed, assets used and risks assumed by the service provider are remunerated at arm’s length, but should not deem a PE to exist. This seems consistent with the indications provided in the discussion draft Revisions to chapter I of the transfer pricing guidelines (including risk, recharacterisation, and special measures) that addresses business models involving fully owned subsidiaries providing services to the parent company as transfer pricing cases, requiring the determination of the actual functions performed by the service provider and their arm’s length remuneration (e.g., new par. D.1.6 of the Transfer Pricing Guidelines illustrating the case of a company licencing IP rights to its wholly owned subsidiary.
that is re-characterized as principal benefiting from the services provided by the subsidiary).

10. The alternatives proposed in the Discussion Draft employ different languages that can be interpreted in different ways in the various Contracting States, thus potentially reproducing the issues that raise the BEPS concerns. In particular, alternatives B and D add a reference to the negotiation of “the material elements of the contracts”. Negotiation of the contracts (referred to under § 33 of the Commentary to Art. 5 of the OECD Model) proved however in the past not to represent a clear “bright line” test to identify the minimum level of involvement of a dependent agent. Uncertainties may, in particular, arise in the cases mentioned in the discussion draft OECD Model Tax Convention: revised proposals concerning the interpretation and application of Article 5 (Permanent establishment) of 2011 and 2012 (§ 112), when sales are governed by framework contracts applicable to all group companies or when the activity of the agent is subject to detailed instruction and guidance from the principal. In addition, the negotiation of the contract does not represent a relevant test in cases where no negotiation of the contract is required for the contract to be concluded, such as when contracts are in standard form for all customers.

11. Similar interpretative issues may in our view arise in relation to the formulation suggested in alternatives A and C referring to the case where a person “habitually engages with specific persons in a way that results in the conclusion of contracts”. Reference to “specific” persons (and hence not to any person) seems to restrict the ensemble of the persons with which the engagement shall occur, by requiring such persons to meet specific requirements. However, no guideline is provided as to the nature of such requirements and hence how the “specific” persons should be identified. It would also be necessary to specify the nature of the direct causal connection that is required between the interaction with specific persons and the conclusion of the contracts. Such interaction may indeed represent a condition sufficient for the conclusion of the contracts (so that the foreign enterprise would be bound by the interaction) or a condition necessary for the conclusion of the contract (requiring further actions or decisions being taken by the foreign enterprise for the contract to be concluded) or a mere facilitation of the conclusion of the contract by the foreign enterprise.

12. We finally respectfully disagree with the amendments suggested in the Discussion Draft.

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1 For example, in the Italian Philip Morris case, the Italian Corte di Cassazione held that the mere attendance by officers or representatives of the foreign enterprise to the negotiation or conclusion of contracts is sufficient to trigger the existence of an Italian PE of the foreign enterprise (Decisions of 7 March 2002, no. 3367, 3368, 3369), thus leading Italy to make an observation to § 33 of the Commentary to Art. 5 of the OECD Model Tax Convention, whereby it clarifies that its jurisprudence is not to be ignored in the interpretation of cases falling in such paragraph (§ 45.10).
Draft to strengthen the “independence” requirement. In our view, providing for an automatic exclusion of independence whenever a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises lacks the flexibility required to deal with the specific cases that may arise in the ordinary business practice. A more balanced approach is provided in the OECD Commentary clarifying that the number of principals is just one of the factors to be considered in determining independent status (§ 38.6 of the Commentary to Art. 5 of the OECD Model).

13. The proposal may in our view result in a flurry of PEs around the world that is probably inconsistent with the objectives of the OECD Model and the BEPS project with an inevitable rise in international tax disputes which, to date, are not timely resolved in the context of mutual agreement procedures (as acknowledged also in the context of Action 14 of the BEPS Action Plan). This is for example likely to be the case in relation to asset managers, who manage local investments of foreign funds, unless the independent status of the local fund manager is determined in relation to the investors in the fund rather than by reference to the fund itself (unlike specified in the discussion draft OECD Model Tax Convention: revised proposals concerning the interpretation and application of Article 5 (Permanent establishment) of 2011 and 2012, § 125). Such conclusion may de facto jeopardize the operations of the asset management passport recognized by European Law (Directive 2009/65/EC) that explicitly allows an asset management company to establish and manage funds in other States of the European Union, unless a solution is provided in this respect in the domestic tax laws or administrative practices of the respective States of the European Union.

14. The materiality of the number of principals as an indicator of independence should in any case be appraised taking into account the various stages of the business cycle of the agent. The limited number of principals may indeed be physiologic - and not hence entail a lack of independence - in start-up or declining phases. Interpretative issues may also arise in relation to the timing for the recognition of the plurality of principals, in situations where the plurality test is met over a prolonged period of time, but not in a specific moment.

B. Artificial avoidance of PE status through the specific activity exemptions

15. We would express a preference in favour of option E. Alternatives proposed under letters F, G and H seem indeed to be justified by issues arising only in relation to specific industries or transactions that do not in our view justify an indiscriminate broadening of the scope of the PE definition. For example, not all “delivery” warehouses may amount to a PE capable of generating significant profits, let alone the circumstance that, as stated earlier, often MNE groups tend to incorporate
separate taxable entities in the country where the warehouse performing e.g. logistics and delivery services are carried out, due to the economic need of being “closer” to the market of distribution (in particular in instances where sales volumes are significant). On the other side, under option E, Contracting States should still consider whether the “delivery” warehouse is just auxiliary or is core to the business of the company.

16. The BEPS (or double taxation) issues potentially arising from an asymmetric interpretation of the preparatory or auxiliary nature of a fixed place of business seem however particularly relevant. In this respect, further work would in our view be appropriate to achieve a wider consensus, possibly by providing a non-exhaustive list of situations where the activities mentioned in Art. 5, para. 4, do not normally have a preparatory or auxiliary character.

17. As for the fragmentation of activities between related parties, we agree with the principle stated in par. 30 of the Discussion Draft. However, it would in our view be appropriate to clarify that the anti-fragmentation rule should not apply in the lack of a fixed place of business of the enterprise in the State concerned. In particular, the rule should not apply in a case where the enterprise concerned (enterprise A) does not maintain a fixed place of business, but the associated enterprise (enterprise B) maintains one. In such a case, the anti-fragmentation rule should not apply in relation to enterprise A. In this respect, the explanation to alternative I is not entirely clear where it specifies that “a group of associated enterprises must have at least one fixed place of business”. Such a position would not however be consistent with the principle (that we understand should not be affected by the proposed amendments) whereby the determination of the PE existence shall be done separately for each group company (§ 41.1. of the Commentary to Art. 5 of the OECD Model).

18. In any case, and from a more general standpoint, we believe that the fragmentation issue should be more properly addressed in the context of the application of transfer pricing methods between associated enterprises. In our view, the OECD has already made that clear in the context of Action 10 of the BEPS Action Plan, which is considering the development of rules clarifying the application of transfer pricing methods, in particular profit splits, in the context of global value chains. To this end, paragraphs 26 of the recently released discussion draft on the use of profit splits in the context of global value chains confirms that fragmentation of functions in the context of an integrated value chain gives rise to issues more linked with identification of third party comparables rather than to the existence of a permanent establishment. Therefore, we would like to respectfully suggest to avoid overlaps at this stage of the projects and, if possible, to concentrate the discussion on fragmentation solely from a pure transfer pricing standpoint within the context of
Action 10 of the BEPS project.

C. Splitting-up of contracts

19. We would express our preference for option L. We believe indeed that anti-abuse rules – rather than amendments to the PE definition leading to “automatic” approaches – should represent the physiological tools to counter situations of artificial circumventions or abuses of the PE thresholds. There might indeed be situations where the involvement of related parties in the same project was not conceived from the beginning and/or may be business motivated: in such cases there should be no reason to derogate the 12-month threshold. Considering Example E mentioned under option L, there might for example be cases where the other contract is initially entered into by an un-related company, which may fail to perform its activity or may genuinely sub-contract the activities to SubCo or even may become subsequently a related party to RCO because of being involved in mergers or acquisitions.

20. Furthermore, option K seems to imply that all related enterprises maintain a PE in State S no matter how long they will stay in State S for the purpose of the project. This comment is already raised in the explanations to Option K, but the wording of the proposed new paragraph may raise interpretative uncertainties in this respect.

D. Insurance

21. We tend to prefer Alternative N. Depending on the type of amendments proposed in relation to paragraphs 5 and 6 of Article 5, such provisions should indeed cover also the case relating to insurance business. On the other side, the enlargement of the PE definition to cover the collection of premiums or the insurance of risks situated in a certain State seems to go beyond the scope of the Action Plan to contrast the artificial avoidance of PE status.

* * *

We remain at disposal for any further clarification on the above comments.

Yours sincerely

(Paolo Ludovici)
This paper sets out our comments on the Public Discussion Draft published on 31 October 2014.

General comments

1 The Discussion Draft on artificial avoidance of permanent establishment (“PE”) status deals with four main areas where there are concerns that a business operating across borders can avoid becoming subject to tax outside the jurisdiction where it is resident by structuring its business to prevent the creation of a taxable presence:

- commissionaire and similar arrangements;
- exemptions for specific activities (such as preparatory or auxiliary activities);
- fragmentation of contracts; and
- insurance.

2 It must be noted at the outset that business may, for legitimate business reasons, choose to adopt structures that may be potentially affected by the Action 7 proposals. For example, commissionaire structures are not solely used for tax avoidance, but are a tried and tested means for introducing products to new and wider markets. Similarly, groups of companies often establish separate entities to conduct separate business functions for good commercial reasons, and activities do not cease to be “preparatory” or “auxiliary” simply because they are conducted by a related party. The proposal to deny the specified activities exemption for related parties implies that a “cohesive operating business” should be taxed as a single entity – that is, it seems, in essence, a move towards a form of unitary taxation.

3 Also, coordination is required with other BEPS Actions that cover similar ground. Artificial structures that attempt rely on double tax treaties can be attacked under anti-avoidance rules (for example, the principal purpose test proposed in Action 6); and allocating income and profits between related parties should be undertaken through correct transfer pricing (within Actions 8 to 10), rather than treating a related party as a PE when a third party would not.

4 Finally, any changes should not lead to additional uncertainty. If implemented, several proposals in the Discussion Draft are likely to lead to areas of greater subjective interpretation and potential for disputes. In particular, widening the tests for a PE are also likely to lead to more situations when an apportionment of profits is required, yet the Discussion Draft indicates that no changes are needed to the existing rules for attributing profits to a PE, but those rules themselves contain subjective elements that can be difficult to apply in practice.

Specific comments

Commissionaire and similar arrangements

5 It has long been possible to do business in a jurisdiction without a physical presence there, and without the presence of a dependent agent – that is, without a taxable presence in traditional terms. New business structures, such as internet commerce, are in many ways little different to traditional forms of business, such as mail order.
Under commissionaire arrangements, a third party (the commissionaire) is appointed in a jurisdiction to sell products on behalf of a business that is not otherwise established there (a manufacturer, say). Typically, the commissionaire acts in its own name as regards customers, but bears little risk in relation to the goods, which continue to be owned by the manufacturer and will be returned to the manufacturer if they are not sold. The commissionaire is usually remunerated by way of a commission on sales, reflecting the relatively limited commercial risks it bears.

The apparent concern with commissionaire structures is that the commissionaire is usually not a dependent agent of the manufacturer (and in particular does not conclude contracts “in the name of” the manufacturer), and the commissionaire does not own the goods. As a result, only the small commission is taxed where the sale is made (and were the customer typically resides), and none of the (relatively larger) profit made by the manufacturer is taxed there. However, it should be noted that the manufacturer would usually be subject to tax in full on its profits in the jurisdiction where it is established.

The concept of a commissionaire exists in many civil law countries. It is often not well understood in common law countries, where a commissionaire is usually interpreted as a form of undisclosed agent. For example, a UK “commissionaire”, selling in its own name on behalf of a third party principal, would typically be regarded as an agent of the principal, concluding contracts that bind the principal. A commissionaire in the UK that is not independent – that is, it is not dealing with its principal on an arm’s length basis – could then be treated as a PE of the principal in the UK.

The Discussion Draft suggests that such structures are “artificial”. However, there may be good, legitimate business reasons to appoint a commissionaire, rather than a manufacturer choosing to set up its own sales and distribution business or to appoint a full sale agent. A local intermediary may understand the market better, have better local contacts, and provide some protection from local legal liabilities, but the commissionaire may prefer not to expose itself to the full commercial risk of buying and reselling the product.

In principle, there is no reason why a corporate group may not choose to carry on a commissionaire activity “in house” in a dedicated subsidiary. Determining income and profits on transactions between related parties should be undertaken through correct transfer pricing, rather than by treating a related party as a PE when a third party would not. The activities of related parties interacting on a proper arm’s length commercial basis should not be aggregated or attributed to each other. If the arrangements are no on arm’s length terms, that is a matter for transfer pricing.

Proposals

Page 11 to 14 of the Discussion Draft contains four alternative but somewhat similar proposals, A to D.

Proposal A seeks to replace the current and clear “conclude[s] contracts” test with a vaguer one of “engag[ing] with specific persons in a way that results in the conclusion of contracts”.

Proposal B is similar to proposal A, but avoids the vagueness of the Proposal A test of “engagement resulting in conclusion of contracts” by replacing it with a test of negotiating material terms. However, there is no guidance on what elements of a contract should be considered “material”.

Proposal C is similar to proposal A, but extends the concept of concluding contracts to include contracts which are not in the name of the principal, but which are for the account of and at the risk of the principal. Unlike Proposal B, it retains the uncertainties inherent in the test of “engagement resulting in conclusion of contracts”.

Finally, Proposal D is similar to Proposal B – negotiation of material terms, not a causal “resulting in” test – but brings in the element of proposal C on risk and reward.

Comment

In Proposals A and C, it remains unclear how to establish a causal connection between the activities of an intermediary and the conclusion of contracts. Is it simply sufficient that the customer was introduced by the intermediary, with all negotiation and the final decision to conclude the contract occurring outside of the jurisdiction? As proposed, it seems that pure marketing or referral arrangements could be caught – is that the intention? For that reason, we prefer the “material terms” formulation in Proposals B and D, but with modifications.
Under all four proposals, an intermediary would be deemed to be a PE, unless similar activities conducted through a fixed establishment of the principal would not create a PE. This proposal begs the question of whether there is an establishment in the first place, and essentially treats an intermediary as a fixed establishment of the manufacturer.

All four proposals also include an exclusion for an intermediary acting independently in ordinary course of its business of representing several principals, which will continue to be treated as not creating a PE. The exclusion does not apply where a commissionaire only acts for one customer, even if exclusivity is agreed as a commercial matter between wholly independent parties. Is it really the case that a sales distributor ceases to be independent if it only sells goods for one principal?

In our view, only one significant change is required, to deal the technicality of whether contracts are “in the name of” an enterprise. We would suggest adapting the part of Proposals C and D, replacing the phrase “conclude contracts in the name of an enterprise” with the phrase “conclude contracts in the name of an enterprise or which, by virtue of the legal relationship between that person and the enterprise, are for the account and risk of the enterprise”.

We do not see a need for an intermediary to be deemed to be a fixed establishment, nor for the causal test in Proposals A and C. In particular, any element of artificiality can be dealt with by other means, such as anti-avoidance rules, and provisions that are not on arm’s length terms should be dealt with through transfer pricing.

Preparatory and auxiliary exemption

The second area considered in the Discussion Draft is the exemption for specified activities, which allows taxpayers to conduct some limited activities in a jurisdiction to facilitate its business, without being exposed to tax there on a portion of its overall profit, on the basis that the limited activities have a relatively low value. However, there is a concern that some activities traditionally treated as “preparatory” or “auxiliary” could be significant components of some businesses.

Proposal E on page 15 will make sure that all activities – including storage, display or delivery of goods, or a purchasing or information gathering function – can only benefit from the exemption if they truly are “preparatory” or “auxiliary”. We have no objection to this suggestion, which should limit the exemptions to their intended targets.

Proposals F, G and H are alternatives to Proposal E, and would see targeted changes to the specified activities list to remove delivery, and/or purchasing goods, and/or collection of information. Provided that such activities are actually “preparatory” or “auxiliary”, we see no reason to remove them from the list of specified activities, which is why we prefer Proposal E.

Two further consider the splitting of a single “cohesive business operation” in between separate related entities. As is noted on page 19, the commentary on Article 5 already considers separate fixed establishments of the same entity (which must be considered separately, and not aggregated, if they are separated locally and organisationally).

Proposal I would prevent an enterprise relying on the specified activities exemption if it or an associated enterprise already has PE in that jurisdiction, and the activities are “complementary functions that are part of a cohesive business operation”.

Proposal J is similar to Proposal I, but also applies where neither entity already has a PE but the overall activity resulting from aggregating the activities of the related enterprises is not of a preparatory or auxiliary character.

It is one thing to aggregate the activities of a single taxable person, but quite another to aggregate the activities of separate entities. The proposal to deny the specified activities exemption for related parties implies that a “cohesive business operation” should be taxed as a single entity – that is, it seems, in essence, a move towards a form of unitary taxation. The proposals contain no clear guidance on when separate activities, conducted by separate companies on an arm’s length basis, constitute a “cohesive business operation”. We would suggest that these concerns are best dealt with through anti-avoidance rules and transfer pricing, not by amending the definition of a PE.
Fragmentation of contracts

28 The third area considered in the Discussion Draft is the splitting of the activities of contractors, etc., between related companies, so that each entity does not conduct the activity for more than 12 months. This would appear to be an area that could be covered by the proposals on treaty abuse in Action 6. For that reason, we prefer Proposal L on page 23, instead of adding the separate targeted anti-avoidance rule suggested in Proposal K.

Insurance

29 Finally, there seems to be a concern that insurance companies can engage an independent agent to collect premiums from a jurisdiction, or cover risks in a jurisdiction, without the insurance company being taxed there. It is not clear to us that a special rule is required to deem an insurance company to have a PE in a situation where another business would not have a PE. For that reason, we prefer Proposal N, which would apply the usual rules, rather than the new rule suggested in Proposal M.
Dear Ms de Ruiter

BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Matheson welcomes the opportunity to comment on the public discussion draft issued under BEPS Action 7 (the “Discussion Draft”).

Matheson is an Irish law firm and our primary focus is on serving the Irish legal and tax needs of Irish and international companies and financial institutions doing business in Ireland. Our clients include over half of the Fortune 100 companies. We also advise seven of the top ten global technology companies and over half of the world’s 50 largest banks. We are headquartered in Dublin and also have offices in London, New York and Palo Alto. More than 600 people work across our four offices, including 75 partners and tax principals and over 350 legal and tax professionals.

Comments made on this letter are made solely on our own behalf.

1 Commissionaire arrangements – general comments

1.1 Is change to the PE definition required?

The permanent establishment (“PE”) concept is well-understood by taxpayers and tax authorities. The clear parameters of the PE concept enable it to be widely relied on by business in managing foreign activities and by tax authorities in assessing those activities. The certainty in application of the PE concept is good for taxpayers and for tax authorities. Before dismantling this long-established legal concept and replacing it with a new concept that is fundamentally uncertain, perhaps the Focus Group on the Artificial Avoidance of PE Status (the “Focus Group”) could consider whether transfer pricing would be the most appropriate way of dealing with the perceived issues raised by commissionaire arrangements.
Re-defining the parameters of the PE concept will result in additional on-going administration costs for taxpayers, increased tax disputes (not only between taxpayers and tax authorities but also between different tax authorities on a bilateral and multilateral basis) and significant restructuring by taxpayers seeking to achieve certainty in the tax treatment of their foreign activities. It is not something that should be undertaken lightly, in particular, if other avenues are available to challenge abusive arrangements.

1.2 Broader reasons for implementing commissionaire arrangements

There are many commercial reasons why commissionaire arrangements might be preferred by multinational organisations over other distribution arrangements, including:

- commissionaire arrangements enable all administrative, management and non-sales functions to be centralised in one area and therefore result in cost savings;
- this centralisation of activities ensures that the commissionaires in the various countries are focussed only on selling and is more likely to result in a streamlined and consistent approach to distribution for a multinational group;
- the commissionaire provides all the benefits of an agency function while maintaining a local signatory; and
- structuring distribution arrangements in this way often means the commissionaire is not a commercial agent for the purposes of the European Commercial Agents Directive (although this factor may be less significant in a group context).

The example outlined in paragraph 7 of the Discussion Draft is quite simplistic. It does not reflect the usual position that arises when commissionaire arrangements are implemented. Generally commissionaire arrangements are implemented across a number of jurisdictions (rather than in just one jurisdiction). They are implemented with a view to centralising as many administrative and non-sales functions as possible in the jurisdiction of the principal and streamlining distribution in the sales jurisdictions. Achieving certainty of tax treatment of the foreign activities (which the PE concept currently permits) will be a factor that is taken into consideration when implementing commissionaire arrangements.

1.3 Implementing changes to the PE concept – practical considerations

Multinational organisations that have implemented commissionaire arrangements for genuine commercial reasons will equally be affected by the proposals in the Discussion Draft. It is inevitable that, if changes are made to the PE concept, they will restructure their existing arrangements (most likely by incorporating those businesses locally) with a view to achieving certainty in their tax treatment. It will be important that sufficient lead-in time is allowed to taxpayers to adapt their existing business models to take account of any changes to the PE concept.

1.4 Cost / benefit considerations

Where commissionaire arrangements are concluded on an intra-group basis, the commissionaire must be remunerated on an arm’s length basis. The profit earned by the commissionaire is taxable in the source jurisdiction in the usual way. It seems to us that in
the majority of cases, on the assumption that the commissionaire is currently appropriately remunerated, re-characterising the commissionaire as a PE will not result in additional tax revenue for the source state. If the Focus Group considers that the commissionaire arrangements are currently incorrectly priced, we suggest that that this would more appropriately be addressed under the transfer pricing rules. This is recognised in paragraph 41 of the Discussion Draft in the context of insurance companies.

If the proposed changes must be made to the PE definition, the Focus Group should be aware that those changes will materially affect those multinational organisations that operate their distribution function under commissionaire arrangements (where the commissionaire is appropriately remunerated). Having a PE in each of the jurisdictions where the principal has appointed a commissionaire will mean additional administration for the principal, the burden of which should not be underestimated. The new PE status will give rise to new tax registration and compliance obligations in each sales jurisdiction. The principal will be required to prepare and maintain a separate suite of books and records for each PE. Not only will the principal assume additional obligations in each of the source jurisdictions, the re-characterisation will have to be reflected in the principal’s own tax return in its jurisdiction of residence and in many cases will involve complex foreign tax credit computations. It is difficult to see the merit in increasing taxpayers’ compliance burden in particular if the perceived abuse can be dealt with through changes to the profit allocation rules.

1.5 Increased multilateral tax controversy

Where jurisdictions believe that re-characterising commissionaires as PEs will result in additional tax being levied in source jurisdictions (even in circumstances where commissionaires are currently appropriately remunerated), then additional work on multilateral dispute mechanisms will be required to address the situation where a taxpayer has PEs in different countries.

Currently profit allocation to PEs is determined on a bilateral basis. There is a risk that this will be inadequate in circumstances where a taxpayer has PEs in different jurisdictions and faces challenges from different revenue authorities in respect of profit allocations. A series of bilateral resolution mechanisms will likely be insufficient (and will certainly be inefficient) in a multilateral dispute.

2 Commissionaire arrangements – suggested revisions to Article 5(5) and 5(6)

2.1.1 Proposal A

In our view the suggested language in Proposal A is too vague, would be difficult to apply and consequently will create uncertainty for taxpayers and tax authorities. In particular, it is difficult to identify precisely what activities “engages with specific persons in a way that results in the conclusion of contracts” is intended to capture. The explanation accompanying Proposal A clarifies that a direct causal connection is required between the intermediary’s interaction with a person and the conclusion of a contract with that person. This is not evident from the proposed language which could apply to a much broader range of interactions with potential customers.

The stated aim of the proposed language in each option is to address commissionaire arrangements and “similar strategies”. Commissionaires are typically involved in sales.
However, the language in Proposal A potentially applies to a much broader range of activities, including for example, marketing. We note that a carve-out is included in paragraph 5 for activities of a preparatory or auxiliary character. In most cases you would expect that marketing activities undertaken locally would be considered to be preparatory or auxiliary and so would not give rise to a PE. However, under the proposed language the burden of proof shifts and rests with the taxpayer to establish that any marketing activity is of a preparatory or auxiliary character. It is difficult to understand the rationale for this shift. We believe that the better approach is to more precisely identify the activities that should be treated as giving rise to a PE.

Overall, we believe that the language in paragraph 5 of Proposal A is too broad, is weighted against the taxpayer and includes concepts that are too vague to be workable in practice.

The language in paragraph 6 which defines when an agent will be considered to be independent has been significantly narrowed by the inclusion of exclusive agents. Genuine third party agents often act exclusively in a jurisdiction on behalf of a non-resident principal for genuine commercial reasons. In certain sectors, the industry norm is to appoint only agents who agree to act exclusively. In other cases, although acting exclusively is not a term of the agent’s appointment, due to the level of activity undertaken by the agent on behalf of the third party principal, the agent cannot act for any other clients. We do not believe that the activities of an agent who is unrelated to the principal should give rise to a PE. This should be clarified and an appropriate carve-out included in paragraph 6.

2.1.2 Proposal B

The range of activities identified under Proposal B (“habitually concludes contracts, or negotiates the material elements of contracts”) more closely reflects the activities that are typically identified as giving rise to a PE. Revising Article 5(5) in this way would retain much of the certainty of interpretation associated with the existing concept without drawing genuine commercial arrangements into the remit of the provision.

However, detailed commentary will be required to clarify what constitutes negotiation for this purpose and what should be viewed as the material elements of a contract. For example, where an agent presents a standard set of terms and conditions to a potential customer, will the agent be considered to “negotiate the material elements of contracts” where the terms and conditions are accepted in full by the customer without any discussion with the agent?

2.1.3 Proposal C

As noted at 2.1.1 above we consider that the phrase “habitually engages with specific persons in a way that results in the conclusion of contracts” is too vague, is weighted against the taxpayer and goes further than is necessary to address commissioner arrangements. The new language proposed in C “contracts which by virtue of the legal relationship between that person and the enterprise are on the account and risk of the enterprise” is also very broad and vague. The combination of language proposed in C removes the certainty that is inherent in the application of the existing PE concept. This will cause problems for taxpayers and tax authorities and likely will give rise to inconsistent results from jurisdiction to jurisdiction.
2.1.4 **Proposal D**

We have no comments on proposal D additional to those set out above.

3 **Artificial avoidance of PE status through the specific activity exemptions**

It seems reasonable to confine the specific activity exemption to activities that are of a preparatory or auxiliary character. However, whether activities are preparatory or auxiliary is quite subjective. Accordingly, additional detailed commentary should be included on when activities should be considered to be preparatory or auxiliary in character.

3.1 **Anti-fragmentation rules**

We believe that the anti-fragmentation rules would cause difficulties in practice for taxpayers and tax authorities. It is not clear what amounts to "complementary functions that are part of a cohesive business operation". The language is quite subjective and could be interpreted broadly by tax authorities considering the activities of multinational organisations with a number of different business lines operating under the same brand and in the same business sector. Applied at its extreme and in the absence of clear guidance, the language in Proposals I and J potentially could significantly enhance a source country’s taxing rights against taxpayers with limited presence in that country. If either proposal is introduced, given it will extend the application of a source state’s taxing rights, detailed commentary will be required.

The Focus Group should confirm how Article 7 should apply to allocate profits to new PEs identified under Proposals I and J.

Thank you for the opportunity to comment on the Discussion Draft. Should you wish to discuss any of the comments raised, please let us know.

Yours faithfully

Sent by email, bears no signature

MATHESON
Comments on the Discussion Draft on Action 7 of the BEPS Action Plan on Preventing the Artificial Avoidance of the Permanent Establishment (the ‘PE’) Status

Dear Ms De Ruiter,

Dear Marlies,

Thank you very much for the opportunity to provide comments on the Discussion Draft on Action 7 of the BEPS Action Plan (the ‘Discussion Draft’) which was released by the OECD for public comments on 31 October 2014. Mazars Global International Taxation and Tax Policy professionals (‘Mazars’) are impressed by all the progress that the OECD has made to date and we are very pleased to provide our input on the Discussion Draft.

Mazars welcomes the preliminary results of the work performed by the OECD with respect to issues related to the artificial avoidance of PE status, including the proposals for changes to the definition of permanent establishment found in the OECD Model Tax Convention.

We appreciate the Committee of Fiscal Affairs’ work on the Report Addressing the Tax Challenges of the Digital Economy which has identified issues in the digital economy that need to be taken into account in the course of the work on Action 7, namely ensuring that core activities cannot inappropriately benefit from the exception from PE status and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status. We also agree that the BEPS concern around PE rules cannot be addressed successfully without coordination between the work on PE status mandated by Action 7 and the work on other aspects of the BEPS Action Plan.

Our specific comments on the Discussion Draft are provided below:

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The Focus Group on the Artificial Avoidance of PE Status (‘Focus Group’) loosely defines a commissionaire arrangement as an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without having a permanent establishment to which such sales may be attributed for tax purposes; since the person that concludes the sales does not own the products that it...
sells, it cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission).

Mazars would encourage a more detailed review of the implications of the proposed amendments, especially as there are significant discrepancies in the commissionaire concept between jurisdictions (for instance Europe versus China). The application of a broad definition could result in a(n) (unintended) collateral impact on various other commissionaire structures and similar arrangements, as there is a wide scope of these structures in the market. Structures such as, but not limited to, low risk distribution agreements, could be hit by the proposals.

We agree with the Discussion Draft that in many cases commissionaire structures and similar arrangements may have been put in place primarily in order to erode the taxable base of the State where the sales took place. Changes are therefore proposed to the wording of paragraphs 5 and/or 6 of Article 5 in order to address such strategies.

However, it is also important to point out that commissionaire structures and similar arrangements may have been implemented for genuine business reasons. One of the reasons that commissionaire structures and similar arrangements have been set-up in the market is to increase the influence of the head-quarters and not with tax evasion, tax avoidance or abuse as the principal motive or one of the principal motives. Thus, it should be taken into account that some structures have been set-up for companies active in a volatile market where in some countries losses were incurred. By setting-up such a structure, some of the companies successfully could have stable profitable enterprises in all jurisdictions. In some of these agreements, double non-taxation may not be the issue, but tax rate arbitration could be an unintended effect. We are concerned whether it is desirable (and intended) to bring such structures and arrangements (arising from business reasons) in scope of the Discussion Draft.

The Focus Group initially stresses the importance of the signing of a contract, but also other factors should be taken into account, such as, but not limited to: i) the business of the group and where the risks are run; ii) where are the activities taken place; and iii) in connection with the signature of the contract the following should be considered: who has the authority to negotiate the contracts, which information is available to whom and why, etc. These factors are reflected in the four alternatives, which have been presented as various alternative formulations of paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention. Mazars would strongly recommend Option D above the other ones.

Nevertheless, pursuant to the OECD Transfer Pricing Guidelines, the profits that can be allocated to these permanent establishments still seem rather limited. Thus, we raise the concern whether one of goals of the discussion draft, minimising tax arbitrage by preventing the artificial avoidance of the permanent establishment status and increasing the total tax revenues globally, will be achieved by the current proposal if the TP element will not be elaborated and discussed in more detail. We are aware that this has been flagged in section E of the Discussion Draft, but we have nevertheless recorded this comment to stress the importance of proper TP allocations.
B. Artificial avoidance of PE status through the specific activity exemptions

We welcome the four alternative modifications of the ‘specific activity exemptions’ included in paragraph 4 of Article 5 of the OECD Model Tax Convention proposed by the Discussion Draft. We – in particular – support the application of Option E.

Nevertheless, we are concerned that the proposed modifications could create uncertainty for both entities and tax authorities. As done in the previous discussion draft of the OECD – especially the revised discussion draft that was submitted on 19 October 2012 (OECD Model Tax Convention: revised proposals concerning the interpretation and application of article 5 (permanent establishment, 19 October 2012 to 31 January 2013) – examples would reduce the uncertainties and would minimise potential discussions. Therefore, we encourage the Working Group to provide for detailed examples or extend the commentary. In this respect, we have noted the remarks in the Discussion Draft – if and when Option E is not adopted – regarding delivery and “warehousing” (page 16). We understand that the deletion of the word “delivery” reflects the majority view of the Committee that a “warehouse” used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment. Thus, the word “delivery” seems to be key for the question whether or not there is a permanent establishment. As there has been a lively debate on this topic, it may be – as an example – be appropriated to provide for more guidance on the several types of warehouses (private, public, automated, climate-controlled warehouses and distribution centers), in particular as the digital economy develops itself rapidly as well. We underwrite the view expressed in the Discussion Draft, which states that only limited income should be allocated to this activity. As such, transfer pricing is again a significant item that needs further explanation and elaboration.

C. Splitting-up of contracts

We support the work done on preventing the splitting-up of contracts in order to abuse the exception in paragraph 3 of Article 5 and the application of service PE. Mazars appreciates that developing countries and other non-OECD / non-G20 economies have been extensively consulted and their input has been considered by OECD. While we agree that BEPS is a global issue and thus requires a global solution, it is also very important to recognise that the risks faced by developing countries from BEPS, as well as the challenges in addressing them, may be different (both in scale and nature) to those faced by developed countries. Therefore, we share the concern of the Working Group in connection with the application of the 183 day threshold of the services-PE provisions in the Commentary, as well as in paragraph (3)(b) of Article 5 of the United Nations Model Treaty.

The Focus Group’s concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by paragraph 3 of Article 5 could be addressed either by the general anti-abuse rule (i.e. the “Principal Purposes Test” rule) proposed as a result of the work on Action 6 or by a more “automatic” rule that would take account of any activities performed by associated enterprises. Subsequently, alternative approaches are proposed.

We suggest continuing the work on the implications of the proposed amendments in the light of that situation where the PE concept could result in either double taxation and
potential discussions between tax authorities. The wording of this paragraph has been agreed some time ago and may be ‘outdated’. We have a concern that the wording of the Discussion Draft in its current format may have a bit too negative approach; it is not only non-taxation, but also the effects of double taxation should be reduced (saving a mutual agreement procedure or entering into an appeal by applying the EU Arbitration Treaty).

It is important to consider that the concept of PE could differ under the national law and that countries are free to negotiate and apply different rules in the convention. For example, some tax treaties adhere to a thirty day rule, whereas others have adopted a twelve months period. Furthermore, several tax treaties have a special offshore paragraph included. Therefore, we encourage the further elaboration and clarification of the PE concept. A well-defined concept would better position the wider community to oversee all possible consequences for current and future tax arrangements.

Options K and L address situations where an entity divides its contract into two or more contracts between separate entities for the sole purpose of abusing the PE exceptions. Where Option K follows and would address the issue by adding ‘automatic approach’, option L would apply and rely in the application of the general rule proposed as part of the work on Action 6. Mazars supports option L and we note that we are concerned that, under option K, the rule that ‘automatically’ combines activities, would negatively affect genuine / legitimate businesses in situations where the splitting-up of contracts has a genuine commercial reason.

For contractors and subcontractors working on the continental shelf, engaged in activities connected with the exploration and exploitation of the continental shelf or construction, installing and offshore companies in general, it is quite common to establish joint ventures, also to combine the expertise of specialized companies and minimizing the risk in large projects. These joint ventures are commercially driven.

In order to reduce the uncertainty, Mazars encourages further work on guidance on the definitions ‘group’ and ‘control’. The current wording of the Principal Purpose Test would not help these companies when working with more than one joint venture party. Moreover, we believe that the current wording may leave too much room for discussions: tax-motivated differs from principal motive or one of the principal motives to tax evasion, tax avoidance or abuse (and the latter results in uncertainty as well).

We understand that OECD Working Party continue its work on the TP part of the Action plan and we strongly encourage further guidance should be provided as well.

Finally – as a separate note – we also recommend further work on the concept of so-called ‘sub PEs’ in order to provide clarification on the question whether a permanent establishment could have its own permanent establishment. In the academic literature, a theoretical outline has been made between a hierarchy approach (super-ordinated head PE and a sub PE) and a non-hierarchy approach (a PE in each state). For the offshore sector, the hierarchy approach could – within the European Union – create possible benefits, for instance if and when a foreign head office in one state has a physical PE (article 5 paragraph 1) in another state where all the equipment and personnel is located, whilst via this PE in a third state ‘drilling and casing activities’ are performed. Mazars supports and welcomes the Focus Group input on – among others – this and other matters.
D. Insurance

Mazars welcomes the OECD concern raised by the insurance sector. We support and encourage that the taxation of the insurance industry should follow the principles set up in Part IV of OECD 2010 Report on the Attribution of Profits to Permanent Establishments (Insurance) as a guideline. Insurance Premium Taxes based on a percentage of premiums and where risks are located, already exist in a number of territories.

We are of the view that the introduction of a similar tax system through the taxation of permanent establishments could result in uncertainty and extra (administrative) burden for the insurance sector. Insurance Premium Tax already exists in a number of jurisdictions and this is already based on a percentage of premiums of risks located in those jurisdictions. It is not clear how such tax would interact with a similarly based tax through creation of new PEs, nor why the introduction of a new tax system is necessary. Therefore, we recommend that the accompanying guidance to any changes is very detailed to ensure consistency of application between jurisdictions over all of the new terms and how they could apply to the insurance industry.

The concern outlined in the Discussion Draft is that insurers can conduct a large scale business in a jurisdiction whilst no permanent establishment is recognised. This is consistent with the freedom to provide services, one of the key freedoms in the EU, which allows insurers to provide cross-border services within the EU member states whilst being regulated only in their state of origin where they hold the necessary capital, and perform the KERT functions as outlined in the OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance). The activities of collecting premiums or those of an agent through whom risks in a territory are insured do not create significant value for insurance groups. In either of these scenarios, very little value would be attributed to a PE. Therefore, we assume that the result of this would be a significant administrative burden for insurance groups and tax authorities in each jurisdiction without any significant increase in tax revenues.

In our view, the definition of independent agent as provided in Option M significantly changes the current understanding of the independent agent concept. It replaces guidance under which the number of principals represented by the agent was not a deciding factor and that only went as far as to say that independence was less likely if the agent acted wholly or almost wholly for one enterprise over the life of the business or a long period of time. Potentially this would mean that, in a start-up scenario, an agent may fail this test if it has only one big insurance client at the start the business. Additionally, it leads to the possibility of an independent agent becoming dependent on the loss of a client but acting in the same way as when they were independent. Furthermore, where there is consolidation in the market, which is currently a common occurrence in the insurance industry currently, an independent agent could become dependent overnight.

In particular, it is common for an insurer to have multiple Delegated Underwriting Authorities in place with unrelated third parties. We are of the view that the limited authority granted under such arrangements should not create a PE, but note that the document does not
specifically address this type of arrangement. It would be helpful to have clarification over whether this type of arrangement is being targeted. If it were to be potentially a PE then it would put an additional layer of administrative burden on an insurer where they have a Delegated Underwriting Authority arrangement in place with small agents as they would need a process to determine whether that agent had sufficient other contracts in place for them not to be considered a dependent agent. A detailed set of guidance would be necessary to ensure consistency in the application between jurisdictions if specific insurance measures were introduced.

Commissionaire arrangements are different to insurance business structures, as insurance activities are regulated, and results in a real transfer of risk (i.e. not artificial). As such, the insurer cannot decide to de-risk activities in a jurisdiction as would be possible with a typical commissionaire arrangement. Additionally, a broker and an insurer have commercially distinct roles in any insurance transaction, and the customer has no legal contract with the broker and no legal recourse to them. Any attempt to tackle offensive commissionaire arrangements should therefore be specifically targeted at them, and not be drafted in such a manner that insurance business models are also affected. Please note that these remarks regarding commissionaire arrangements are general in nature and for our comments on the commissionaire arrangements and the like, we refer to paragraph A above.

Our comments on options A through D amending paragraph 5 of Article 5 are the followings: Option A is about replacing “conclude contracts” with “engages with specific persons in a way that results in the conclusion of contracts”. We are concerned that the amount of new definitions introduced results in a significant amount of uncertainty. Questions that need guidance may be, but not limited to, as follows: what is considered as “engaging”; whether “specific persons” mean a job title, or a named individual or individuals; whether there is a timeframe implied in “results in the conclusion of contracts”; and for instance, if it takes a number of years to win an account – the question is in which year(s) the PE is created. Moreover, Option A may ‘catch’ all forms of relationships outside of commissionaire arrangements and has an affect on potentially non-sales related activities such as conducting a site visit etc.

Option B provides an alternative option to replace the current wording of “conclude contracts” with “concludes contracts, or negotiates the material elements of contracts”. This shouldn’t be seen as being as wide, but there is a lot of room for interpretation in “negotiates the material elements” and the risk would be that any meeting in a jurisdiction could be seen to be caught by this. We suggest that detailed examples should be provided in order to facilitate the interpretation.

Option C replaces “contracts in the name of the enterprise” with “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”. This could potentially catch Quote Share reinsurance contracts. These are commercial contracts and are not a mechanism for tax avoidance. We are of the view that this should not create a PE for the reinsurer in the territory of the cedant.

As a concluding remark we note that this Discussion Draft in particular addresses the consequences for insurance companies. Needless to say a new PE concept or threshold is relevant for the Financial Services industry as a whole, including the banking sector and other financial institutions. Many genuine commercial business models and services
common in this industry will most likely be affected by the new PE thresholds. The Financial Services industry is generally speaking heavily regulated. The recognition of a PE, to them, would have wider spread consequences than simply recognising a PE and, potentially, the filing of a tax return. Such (deferred) tax liability will immediately have an effect on the regulatory position of this particular company including relevant capital computations under the Basel rules. We feel that the Discussion Draft should address these issues and concerns as it affects an industry only now recovering slowly from recent events.

**E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing**

We support the remarks recorded in item E of the Discussion Draft. As, pursuant to the OECD Transfer Pricing Guidelines, the profits that can be allocated to these permanent establishments still seem rather limited, this Action 7 should be coordinated with other Actions. However, as indicated above, also in this Action 7, the TP element should be further elaborated upon and discussed in more detail in order to successfully achieve one of the goals of the Discussion Draft; minimising tax arbitrage by preventing the artificial avoidance of the permanent establishment status and increasing the total tax revenues globally.

On behalf of the global network of Mazars Member Firms, we submit our response to the Discussion Draft on Action 7 of the BEPS Action Plan on Preventing the Artificial Avoidance of the Permanent Establishment Status. For any clarification of this response, please contact the undersigned.

Yours sincerely,

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Dick van Sprundel
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Comments on BEPS action 7: Permanent Establishment

Dear Marlies,

MEDEF is pleased to provide comments on the Discussion Draft “Preventing the Artificial Avoidance of PE Status” issued on the 31st October (hereafter “the draft”).

French companies consider OECD’s work in general and BEPS Action Plan in particular as crucial if it provides a fair, competitive and coherent global fiscal landscape. The forthcoming changes are numerous and will have a gigantic impact on their business’ running. Companies are in the best position to identify difficulties related to implementation, to give a feedback on the practical feasibility and to geographically and temporally assess the OECD proposals. They believe, however, that the operating mode, process and time-frame are inadequate to ensure a full and comprehensive analysis of the draft submitted to consultation. They regret the strengthening of that trend which will be detrimental to all: companies and Governments.
The draft intends to update the treaty definition of permanent establishments and more specifically to “Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues”.

As a general comment, MEDEF understands the need to address the PE issue as business structure - including value chains- has evolved significantly during the last decade due to the globalisation of the economy. We believe any update or change should be effected with full respect for basic principles ensuring simplicity, security, feasibility and foreseeability.

However, the draft in its current state does not seem consistent with the aforementioned principles:

1. Complexity: by suppressing many of the former exclusions and extending the scope of existing definitions, the draft considerably enlargens the number of potential PEs. A negative consequence can be easily anticipated: the obligation for each group to reassess all its entities (some have several thousand) in order to verify whether former branches or subsidiaries are now to be considered as PEs. This will obviously be time-consuming and have direct consequences on business structures/investments.

2. Insecurity: joint claims from State A (parent company) and State B (PE) on the same taxable base especially as subjectivity is clearly introduced in the draft (see for example § p.23 “it is reasonable to conclude”). Moreover, some emerging countries are currently more and more aggressive concerning the possible existence of PEs. They already have a high propensity for creating PE where it is not justified. This project may give them more legitimacy to do so at the expense of the OECD countries. This is probably the main concern for businesses.

3. Feasibility: creating new PE situations will have negative financial impacts by introducing new administrative burdens: (return filings, bookkeeping...) and the creation of new support functions (accounting) not to mention that all this will take place retroactively, which also tends to increase above mentioned insecurity.

4. Uncertainty: attribution of profits to PEs is not clearly explained whereas considered as key to the process. Although the BEPS plan regularly reiterates the conservation of the arm’s length principle it seems the allocation would be based on an apportionment of the group global profit. In any case, business needs more information on the OECD view about it and especially on the application of the arm’s length principle and related Transfer Pricing actions otherwise taken under the BEPS initiative to PE.

The proposed changes to the definition of PE will inevitably lead to new double taxation issues and disputes between States which is a true area of concern for business given that in most OECD countries dispute resolution procedures have no suspensive effect and tax authorities are not compelled to resolve disputes. This leads companies to bear the related financial consequences.
This draft intends to tackle fraud and abuses: it does not always seem targeted towards these objectives as it will also be applicable to non-abusive cases (see our examples below). In order to fight certain specific identified fraudulent or abusive cases, broadening the definition is contemplated instead of adding specific targeted anti-abuse provisions which would take into account key considerations such as substance.

Considering that businesses performing activities involving true substance concentrate more on avoiding double taxation issues than trying to avoid jurisdiction to tax, it is likely that the proposed options will create adverse effects in many situations which should not fall into the scope of the BEPS action plan.

We hope our contribution will give you a clearer insight into our expectations. We remain at your disposal and are willing to speak during the public consultation on the 21st of January, on the splitting-up of contracts.

Yours sincerely,

Vanessa de Saint-Blanquat
Specific comments

1. **Artificial avoidance of PE status through commissionnaire arrangements and similar strategies**
   (§ 5 & 6 of article 5)

   We understand the objective, which is to clamp down on abuses. However, the draft states “It is clear that in many cases commissionaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place” (p.6 and p.11§10).

   Ex: Some groups keep the stock at the parent company level: this is particularly appropriate for products with a high risk of obsolescence. It enables just-in-time production that storage at the subsidiary level would not allow.

   Therefore, the quoted sentences should be deleted as there are also many cases where commissionaire structures were put in place primarily to meet customers’ needs.

   **Option A:** Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”; strengthen the requirement of “independence”

   A PE would then be characterised if interaction with these persons results in the conclusion of contracts. We understand that it will be so according to the reality of functions assumed by those persons, the volume of sales/services/transfer of property or degree of activity. The underlying assumption moves towards a more economic understanding of the roles and responsibilities of the persons effectively involved in the process of contracts’ negotiation rather than focusing only on their conclusion.

   It raises many questions:
   - definition of “specific persons”. Additional details will be required on the types of interactions which would be considered in this context, (type of interactions, starting date), in order to reduce uncertainty for businesses and tax authorities as well;
   - value of the contractual elements (specific clauses) binding the “persons” to the principal;
   - timing issue: what if the conclusion of contracts, leading to the identification of a PE, takes place several months after the first initiatives took place in the source country?;
   - allocation of costs incurred in the source country, and thus possibly losses as well, the treatment of associated costs being subject to the outcome of the contract negotiations.

   **Option B:** Add a reference to contracts for the provision of property or services by the enterprise; Replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”; Strengthen the requirement of “independence”

   The idea is to avoid situations where elements are negotiated by the PE while the parent company only signs the contract.
There is a need for clarification on what is meant by “material element of the contracts”. Such “material elements” are indeed very likely to raise technical issues from one business to the other. On the one hand, clarification and security would require getting precise identification of such elements, but they are by nature variable from one type of business to another and as such, one material element in an industry could be irrelevant for other types of industries.

If a precise identification is not relevant due to variations from one industry to the other, a proper objective definition of material criteria with respect to the conclusion of the contract could help (i.e. for instance, the elements to be included in the head of terms and which would reasonably prevent the contract from being concluded if no agreement were reached thereon). On the other hand, leaving a single mention of “material elements” will raise controversial situations and numerous potential disputes with tax authorities and possibly also between them.

It is also unclear whether the reference to “the material elements” shall lead to the consideration of all of them or only some of them (and in such cases in what proportion)? In this case, and considering the above what are, if any, the predominant common elements? And how can the evidence be provided?

**Option C:** Replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; Replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”; Strengthen the requirement of “independence”

We see difficulties in many situations:

**Ex:** A French parent company pays part of the wages of its expatriates in China without recharging the local subsidiary: China considers that there is a PE in its territory.

**Option D:** Replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; Replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”; Strengthen the requirement of “independence”

Based on the above comments, we consider that no option can be used as such, as they all create strong uncertainty for business operators and will lead to increase disputes between tax authorities without providing the sufficient criteria to reach dispute resolution. An economic approach, such as under option B, but with more details on the concepts used (“material elements”), or an economic back-up in the case where a legal relationship would not properly reflect the underlying economic forces, would probably help reach the objective while avoiding increasing uncertainty.

**For options A, B, C, D:**
The sentence: “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 within the meaning of this paragraph with respect to these enterprises” is problematic.

Indeed, there is a growing risk of emergence of new PEs in highly internationalised groups with multiple interlinked functions. Their organisation is not geographical but by sector. In such cases, several PEs of multiple principals would be potentially identified, and even more in the case of multi-country commercial contracts.

**Ex:** one independent agent centrally negotiates a multi-country service contract for the benefit of subsidiaries in 40 different countries. If that agent is qualified as a PE, apart from the existing TP issue, double taxation will arise as its state will claim taxation on the allocated profit.

It is not unusual that different enterprises of a group may not necessarily run connected businesses or take part in the same value creation process. There is no reason in such situations to consider that the above mentioned person should not be regarded as independent.

**Ex:** it is not uncommon that subsidiaries be specialized in the distribution of products acquired almost solely from affiliates. Such a local distribution entity should not constitute a PE of the provider(s). Under the condition that the subsidiary receives a fair remuneration for its risks and functions, the source State already receives its share of the value chain of the product sold locally. It is not through a PE definition that abuse, if any, should be tackled but through transfer pricing.

**Ex:** it is not uncommon that the negotiation of contracts requires the joint intervention of the support staff of the headquarters (e.g. a lawyer), the sales personnel of a local subsidiary (e.g. an expert of the local market) and the technical staff of another operational entity who will sign the contract for the parent company.

It is not clear whether the participation of the local subsidiary has a direct impact on the contract or whether it contributed to the negotiation of material elements. If the tax administration of the country where the subsidiary is located claims the existence of a PE, how will its contribution to the negotiation be assessed? What margin shall be attributable to each party? How is the company supposed to retroactively allocate a profit to the new PE?

2. **Artificial avoidance of PE status through specific activity exemptions**

NB: these activities are not income generating

We are concerned about the fact that introducing changes as mentioned in this section will not help meet common criteria and shared understanding with the UN PE definition and associated comments.

**Option E:** Amend Art. 5(4) so that all its subparagraphs are subject to a “preparatory or auxiliary”
The OCDE itself said that defining what is preparatory or auxiliary is difficult. How is a company supposed to prove it?

**Option F**: In the case where option E would not be adopted, *Removing the reference to “delivery” from subparagraphs a) and b)*

**Option G**: In the case where option E would not be adopted, and in addition to F above, *Delete the exception for purchasing*

**Option H**: In the case where option E would not be adopted, and in addition to F above instead of G, *Delete the exceptions in subparagraph d)*

Thus, the purchase of goods and the collection of information would be PEs. What about tracing offices?

**Ex**: it is important to preserve the exemption for the mere collection of data. Otherwise, it would reduce the appetite of foreign entities to enter a market (complexity, cost) and would create endless discussion on the value of the raw data collected. In an engineering activity, it is not rare to send employees or ask a subcontractor to collect data locally to help the foreign engineering entity assess its capacity to enter into the project. Those data do not have any value by themselves but are necessary to allow the engineering company to build up its proposal/project. The collection of data could be performed at different steps of the process. Adding the condition that this collecting activity be preparatory will increase the uncertainty for businesses since it is likely that at a certain step it will no more be preparatory.

We should absolutely avoid an activity becoming a PE retrospectively because with hindsight e.g. a couple of years later an activity is no longer considered as preparatory or auxiliary, since this will increase the number of cases where enterprises are not compliant without any abusive intention.

Compared to the current situation, option E is the most extreme as it exclusively limits the exemptions to activities which are either preparatory or auxiliary while such a condition is not required for all types of activity exemptions today.

It seems that certain types of precise situations are targeted by the OECD when amending this paragraph. As already mentioned, we think that introducing a general rule to all types of activity exemptions will generate strong organizational challenges for Groups whose structures will have to be entirely reassessed.

In this way, and considering that the key issues at stake seem to be focused on delivery and purchasing activities, an intermediate way could be to introduce the preparatory/auxiliary condition for these activities as is already the case for other subparagraphs of the article. This is close to cumulated option F & G as deleted activities could still be part of the other activities mentioned in the subparagraph f) of the article.
It should also be noted that allocation of profit to PE will need to remain subject to the application of the arm’s length principle and underlying functional and economic analyses.

3. **Fragmentation of activities between related parties** (§4 of article 5)

**Option I**: proposes to prevent the application of the exceptions of §4 art. 5 when complementary activities are divided into various related companies located in the same or several countries.

If several services are provided successively by different entities in different countries for the same project, they would be considered as forming a coherent whole. This entails a high risk of double taxation as several countries will claim taxes on the same basis.

**Option **J: also applies where none of the places to which it refers constitutes a permanent establishment but the combination of the activities at the same place or at different places go beyond what is preparatory or auxiliary

**Ex**: A Chinese entity provides marketing services and product demonstrations. All its costs are reinvoiced to another company in the group using a Cost plus method. The entity has no other income and acts only as a service provider without being involved in the negotiation of contracts. Will tax authorities consider that the entity constitutes a PE?

We believe that in both cases it could be envisaged in order to prevent the artificial application of the exceptions through an appropriate anti-abuse clause. As such it should be noted that fragmentation may result from sound business organisation and thus must not get hit by adverse tax impacts whose purpose is rather to prevent artificial fragmentation. Only in the case where fragmentation results from a strategy to artificially avoid PE status should the above options apply. In the analysis that will be required to determine to what extent fragmentation results from sound business reasons, each party’s activities in their own State of residence will also need to be considered under a full functional and value chain analysis, not only the activities performed in the Source Country.

Substance and arm’s length principle will also need to be considered in such an analysis on a case-by-case basis to give appropriate consideration of each specific situation.

The last sentence of § 30 “should not be restricted to cases where the same company maintains different places of business in a country but should be extended to cases where places of business belong to related parties” is problematic.

**Ex**: In large MNEs, it could be difficult for an entity to know what happens in a related entity. They might not be active on the same segment of the value chain and therefore intervene at different steps of the project and act with great autonomy. Entity A intervening first could be below the PE threshold and therefore not declare any PE. If it happens that afterwards entity B of the same Group works as well on this project also during a period lower than the threshold there
is no reason at all to declare a PE. Should the combination of both interventions exceed the PE threshold both entities would fail to be compliant under this new approach whereas there is no abuse.

This approach would be detrimental to integrated MNEs which can provide their services on a large number of occasions throughout a project (designing, engineering, building, operating, maintaining, decommissioning ...). To be compliant, MNEs would need to create new internal reporting to check whether other related entities have already worked on the same project at a different phase or intend to work at a later stage. How would an entity be sure that a related entity might not intervene later on? Some projects could last over several years and it is not possible to have a mechanism which depends on what could happen several years down the road.

4. **Splitting-up of contracts** (§3 of article 5)

**Option K:** aggregate different time periods of associated enterprises on the same building site or construction or installation project.

This will inevitably lead to uncertainty in many situations.

**Ex:** A company in response to a tender for dam construction has two subsidiaries: F1 dealing with engineering (design) and F2 for pipe laying (construction). Their business purpose, skills, staff, budget etc... differ totally from one another. This is all the more true in that one of them can obtain the public contract (F1 for example) and not the other. Will they be considered as “connected”? If this answer is positive, then a late order to F2 (the following year) would lead to retrospectively constituting a PE if the 12 month period is exceeded.

How is the company supposed to deal with the administrative and accounting issues? Once the remuneration has been made to F1, how is the company supposed to retroactively allocate a profit to the new PE? Why should the company bear the consequences of having a new PE although it is not responsible for the decision taken by the principal?

Comparable comments as above regarding fragmentation are applicable in these situations. The above comments on associated enterprises which may not be involved in the same business must also be considered. As such, the simple fact that two companies are associated from a shareholding perspective does not necessarily mean that they run connected businesses under a common contract with one single client. Taking an arm’s length perspective, two associated companies must not be placed in a worse situation only because they are associated, if they are effectively in a situation comparable to third parties with each other.

**Ex:** It is frequent to set up a local entity to perform the onshore activity of a contract. This is sometimes necessary in countries that do not apply the OECD principle allocating to the PE only the remuneration of the local part (ex Saudi Arabia). In such a case it will be key not to add up the time spend by this local entity plus the time of the foreign entity in charge of the offshore part of the project that is supposed to be taxed in the residence State. The mere fact that
employees of the foreign entities may come to the source State for a few days, should not jeopardise the allocation of the remuneration between the onshore part and the offshore part.

**Ex:** Consortium ("Groupement momentané d’entreprise"). It is frequent to have several entities, of the same Group or not, entering separately into a contract with a local client and being jointly and severally liable vis-a-vis this client. The members have complementary activities or similar activities (when one entity does not have sufficient resources to assume all of the work or when an entity wants to share the risk with others). They split the performance of the work into several items to clearly specify the responsibilities of each contractor.

**Option 1:** No specific rule for the splitting-up of contracts; relying on the general anti-abuse rule proposed as part of the work on Action 6

As explained above, the splitting up of contracts is frequently done for legal or operational reasons and only abusive situations should then be tackled via a general anti-abuse mechanism. There should be no presumption of abuse where several entities of the same MNE intervene on the same project. If an interruption of several months (to be specified) exists between the interventions of two related entities or if the contractualisation of the second intervention happens after the performance of the first is carried out there, should be a presumption of no abuse.

On the contrary, abusive situations should be defined: for instance, a typical abuse could be when the same employee intervenes on the same project but intentionally use the name of different employers of the same Group.

Since the certainty and the avoidance of double taxation or penalty for non-compliance are key for businesses, it should be mentioned that on the contrary to the phenomenon of “splitting of contracts” to avoid the creation of a PE, there are situations where businesses could be tempted to extend their work locally to be sure that a PE exists and that it will not be denied by the residence State. So behind the source State concern, it is important to ascertain that the residence State will share the same view. The more objective the criteria are, the better.

We have already raised the problems created by this clause (see our comments on action 6) in terms of uncertainty and subjectivity.

5. **Insurance**

Objective: except for reinsurance, for which domestic rules apply, consider collecting premiums and risks undertaken by a dependent person, as a PE.

The sector is already highly regulated and the ability to collect premiums on another territory is controlled by the local authorities. In addition, within the EU, the authorising directive already defines the situations where the company would be subject to the regime of freedom of establishment (concretely, obligation to create a branch).
6. Issues related to attribution of profits to PEs and interaction with Action Points on Transfer Pricing

MEDEF feels somewhat perplex as § 45 states that “the issue of attribution of profits has focused on the determination of additional profits that would be allocated to the State of the PE as a result of the changes that could be made to the definition of PE” but strangely enough no indication is given in the draft on the method on which the allocation would be based.

Not giving any indication leaves the door open to more claims from States on the same taxable base.

For business, allocation must be based on substance, by focusing on functions, assets and risks assumed (TP analysis). Profit allocation must remain a separate and standalone analysis resulting from functional and economic analytical steps under the arm’s length principle. This should allow taxpayers as well as tax administrations to correctly assess compensation. It will correlative reduce the number of disputes as the key for the source country is that the local entity (whether subsidiary or former “non-PE”) receives arm’s length compensation. We wonder whether some options (i.e. E, F, G, H) are relevant as they create new PEs (with the difficulties we have mentioned) that do not create added value and generate poor, if any, taxable profit.

The fact that this draft artificially multiplies the number of “principals” strongly suggests that a formulary apportionment would be preferred, that is very likely to not reflect appropriately the contribution of such identified PEs in the whole value creation process.

As far as PEs are concerned, MEDEF does not support allocation based on criteria such as (residual) the profit split approach which is too subjective to ensure legal security. As mentioned in the § 2.114 of TP guidelines : “when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises’ other activities”.

We then wonder how the difficulty mentioned in the Guidelines would be overcome, what the key would be and if any consensus has been reached so far.
Organisation for Economic Cooperation and Development  
Centre for Tax Policy and Administration  
Attn. Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing, and Financial Transactions Division  
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Re: Comments on Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status  

Dear Ms. de Ruiter:  

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status, published October 31, 2014.  

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC’s Board of Directors is attached as an Appendix.  

This letter is divided into two parts. The first part provides general comments and observations regarding the main elements of the Discussion Draft. The second part addresses the options identified by the Discussion Draft with respect to four areas: (1) commissionnaire arrangements and similar strategies; (2) specific activity exemptions; (3) splitting-up of contracts; and (4) insurance. The options in the Discussion Draft in general represent a significant departure from longstanding tax treaty policy and could result in a proliferation of inadvertent permanent establishments. This proliferation would lead to uncertainty for companies engaged in international activities, as well as significant compliance and reporting burdens on such companies and potentially their employees, in contexts outside those identified by the Discussion Draft as abusive. The NFTC urges the OECD to consider these and other comments from business groups as it moves forward with this project.
**General Comments**

The NFTC supports the efforts of the OECD to maintain a Model Tax Convention that reflects international tax norms. Among those norms are reciprocal and mutually beneficial limitations on source country taxation designed to facilitate and promote international trade and investment. The permanent establishment standard is a critical element to this goal, by providing that a source country may not tax an enterprise of the other country on its business profits unless that enterprise meets a minimum threshold of business presence in the source country. To serve its purpose, the permanent establishment standard should require significant business presence by the foreign enterprise in the source country and should be relatively clear.

The consequences of a low or unclear permanent establishment standard are manifold. Foreign enterprises would face uncertainty over whether their operations give rise to a taxable presence in the source country, with attendant reporting and other obligations. Employees of foreign enterprises would face the risk of source country taxation of their wages, with attendant reporting and other obligations, to the extent such wages were borne by the permanent establishment and without regard to time spent in the source country. The changes inevitably would lead to a proliferation of actual or asserted permanent establishments, particularly in the initial years following the implementation of the changes. Tax authorities and businesses would be required to apply the rules for attributing business profits, which are complex and untested, to these marginal permanent establishments in novel contexts and without additional guidance. Tax disputes between countries would multiply, with no adequate mechanism to resolve them.

In general, the NFTC believes that the options proposed in the Discussion Draft overshoot the mark. The Discussion Draft proposes options to change the OECD Model that are much broader than required to address the concerns identified by the Discussion Draft. The NFTC urges the OECD to consider a more equitable approach that better balances the historical objectives of the permanent establishment standard with the concerns identified by the Discussion Draft. These points are discussed below in the context of specific options.

**Specific Comments**

**Commissionnaire Arrangements and Similar Strategies**

The Discussion Draft frames the BEPS concern arising from commissionnaire arrangements with an example illustrating the conversion of a local affiliate buy-sell distributor to a commissionnaire, resulting in a substantial reduction of profits of the local affiliate. ¶ 7. The Discussion Draft considers this result inappropriate because, “As a matter of policy, where the activities that an intermediary exercises in a country 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 unless the intermediary is performing these activities in the course of an independent business.” ¶ 10. This policy conclusion is not justified or defended by the draft. The profits of the intermediary, which are based on the functions of that intermediary in the source country, are subject to tax in the source country. This result is the same whether the intermediary is a dependent or independent agent, or whether the intermediary is an agent at all. The
A conceptual claim by the source country to some share of the profits of the foreign enterprise is not self-evident where the enterprise has no presence in that country. Indeed, a premise of the Discussion Draft is that the income of the foreign enterprise is not otherwise subject to tax. It is otherwise unclear why the home country of the enterprise should forego taxation of (or provide a foreign tax credit with respect to) profits that may be earned as a result of the home country activities of a resident taxpayer.

The Discussion Draft proposes four options for addressing the issue. Each option provides that an agent shall be considered a dependent agent if it acts exclusively or almost exclusively for associated enterprises. The options address the extent to which the activities of dependent agents can result in permanent establishments of the foreign principal, as follows:

(A) Replace language requiring the habitual exercise of authority to conclude contracts on behalf of the foreign enterprise with the habitual “engage[ment] with specific persons in a way that results in the conclusion of contracts’ in the name of the foreign enterprise or for the sale of goods or provision of services by the foreign enterprise;

(B) Replace language requiring the habitual exercise of authority to conclude contracts on behalf of the foreign enterprise with the habitual conclusion of contracts or “the negotiation of material elements of contracts” in the name of the foreign enterprise or for the sale of goods or provision of services by the foreign enterprise;

(C) Similar to Option A, but replaces the language describing contracts with “contracts which, by virtue of the relationship between that person and the enterprise, are on the account and risk of the enterprise”;

(D) Similar to Option B, but replaces the language describing contracts with “contracts which, by virtue of the relationship between that person and the enterprise, are on the account and risk of the enterprise.”

Each of these options is problematic. It is noteworthy that none of these options is limited to commissionaire arrangements, the arrangements cited in the Discussion Draft and the BEPS Action Plan. There is no evidence that the policy issue raised in ¶ 7 of the Discussion Draft has been a significant issue outside of the context of commissionaire arrangements. Indeed, to the extent commissionaire arrangements involve “low-function” principals, they may be adequately addressed by other parts of the BEPS project, in particular Actions 8 and 9. The OECD should consider a narrow option that is targeted specifically at commissionaire arrangements that have given rise to concerns.

Moreover, each option is ambiguous and therefore subject to differing interpretations. For example, Options A and C base a permanent establishment determination in part on whether a person engages with specific persons “in a way that results in the conclusion of contracts” by the foreign enterprise. The Discussion Draft suggests that the factual relationship must be a “direct causal relationship”, but does not provide guidance regarding the extent to which that relationship may be broken by activities of the foreign enterprise before the conclusion of the contract. The factual relationship necessary between the activities of the intermediary and the conclusion of contracts therefore is unclear. For example, would exploratory meetings
with potential customers meet this standard if the negotiation of material terms was done by the foreign enterprise outside the source country? Options B and D, on the other hand, hinge on whether a person “negotiates the material elements of contracts.” What elements are material in this context? What if some material elements are negotiated by the person in the source country, and other material elements are negotiated by the foreign enterprise outside the source country? What if the foreign enterprise develops standards for material terms it will accept, and negotiations in the local country involve persuading a potential customer to agree to such terms? Notwithstanding its perceived faults, the current dependent agent standard has the benefit of being relatively clear and is not as susceptible to such interpretive issues.

Finally, it is impossible to evaluate these options without additional guidance regarding the manner in which business profits would be attributable to a permanent establishment of a foreign enterprise resulting from the activities of (for example) a commissionnaire. The commissionnaire, of course, is already subject to tax on its profits. Would the business profits of such permanent establishment be limited to the difference between the profits of a local country limited risk distributor and the commissionnaire? Would the business profits of such permanent establishment depend on the extent to which material negotiating and selling activities were performed by the dependent agent in the source country as opposed to the foreign enterprise outside of the source country? The guidance to date under Article 7 is not adequate to deal with these issues.

Specific Activity Exemptions

The Discussion Draft provides options for addressing perceived weaknesses in the “specific activity exemptions,” the list of exceptions included in Article 5(4) of the OECD Model. There are two general approaches: (A) amend Article 5(4) so that each of its exemptions is subject to a “preparatory and auxiliary” condition, or (B) remove particular activities from the Article 5(4) list of exceptions, in particular the delivery of goods, the purchasing of goods, or the collection of information. In addition, the Discussion Draft proposes two alternative rules to address the fragmentation of activities among associated enterprises.

In general, the NFTC supports the retention of the specific activity exemptions to the greatest extent possible. In typical commercial contexts, the activities traditionally listed in Article 5(4) listed are far removed from the income generating activities of an enterprise and should not in and of themselves, or in combination, give rise to a permanent establishment. Even if these activities were deemed to constitute a permanent establishment, it is unlikely that the business profits that could be fairly attributable to such a permanent establishment would be material, especially considering the additional filing and reporting burdens and the inevitable disputes. Given the role of the permanent establishment standard, it is helpful to have a per se list of activities that do not give rise to permanent establishments.

The Discussion Draft does not articulate coherent rationales for removing the delivery of goods, the purchasing of goods, or the collection of information from the specific activity exemptions. With regard to the delivery of goods, the Discussion Draft simply asserts that “it is difficult to justify” the application of the current exemption where the enterprise has a large warehouse with many employees working to deliver goods that the enterprise sells online.
If the enterprise in such a context uses the warehouse to maintain a stock of its goods for purposes of delivery, then under current Article 5(4) this combination of activities would be tested to determine whether it is of a preparatory or auxiliary character. It is not clear that any change is needed in this context.

With regard to the purchasing of goods, the examples provided in paragraph 26 are better addressed in other ways. The first example posits a volume discount retained by a foreign enterprise’s purchasing function located in the same country as four manufacturing facilities. To the extent this example raises concerns, those concerns may be better addressed under the transfer pricing guidelines or perhaps under the CFC rules applicable to the foreign enterprise, rather than by deeming a permanent establishment in the source country. The second example posits a paradigm base company that purchases goods and makes sales outside of its home jurisdiction. To the extent this example raises concerns, those concerns may be better addressed under the CFC rules applicable to the foreign enterprise rather than by deeming a permanent establishment in the country of purchase.

With regard to the collection of information, it seems excessive to eliminate this specified activity exemption because of concerns that some enterprises essentially are in the business of collecting and providing information to third parties.

Finally, regarding the fragmentation of activities among associated enterprises in a manner that takes advantage of the specified activities exemptions, in general we would recommend that any proposal be limited to circumstances where specified activities have been artificially separated to minimize the profits attributable to a permanent establishment in the source country. In this regard, it is critical that the business activities carried on by the associated enterprises “constitute complementary functions that are part of the cohesive business operation,” as the Discussion Draft acknowledges. The first of the two alternative proposals, which requires at least one of the foreign enterprises to have a fixed place of business that constitutes a permanent establishment, seems more appropriately tailored to the concerns articulated by the Discussion Draft.

**Splitting-up of Contracts**

The Discussion Draft expresses concern with the splitting-up of contracts among different foreign enterprises to abuse the twelve month threshold of Article 5(3) or similar time thresholds in services-PE provisions. The Discussion Draft proposes two options to address these concerns: (A) an “automatic” rule that would aggregate the time periods that different enterprises carry on activities at a single building site or installation project, or (B) an application of a general treaty anti-abuse rule to the tax-motivated splitting up of contracts, as illustrated by an example in the OECD Model Commentary.

The NFTC believes that a narrower anti-abuse rule is more appropriate in this context. To the extent that there is a commercial rationale for the involvement of two enterprises in separate aspects of different projects, there is no abuse of the 12 month or other thresholds. For example, if different phases of a project requiring different skills and expertise (e.g., design/engineering, site preparation and construction) are put out to bid on a separate basis and independently awarded to two or more associated enterprises, each of which has the capacity to execute its phase of the project but not the others, then the time periods that each
is carrying on activities in the source state should not be aggregated. Countries should be permitted to adopt this approach even if they do not adopt a more general principle purpose test applicable to the treaty as a whole.

Sincerely,

Catherine G. Schultz  
Vice President for Tax Policy  
National Foreign Trade Council  
[Signature]

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Appendix to NFTC Comments on Discussion Draft on BEPS Action 7:
Preventing the Artificial Avoidance of PE Status

NFTC Board Member Companies:
McKenna Long & Aldridge LLP
ABB Incorporated
AbbVie Pharmaceuticals
Applied Materials
Baxter International Inc.
British American Tobacco
Caterpillar Incorporated
Chevron Corporation
Chrysler Corporation
CIGNA International
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Deloitte & Touche
DHL North America
eBay, Inc.
E.I., du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hercules Group
Hewlett-Packard Company
Johnson & Johnson
JPMorgan Chase & Co.
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Occidental Petroleum
Oracle Corporation
Pernod Ricard USA

Pfizer International Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Prudential Insurance
Ridgewood Group International, Ltd.
Siemens Corporation
Sullivan & Worcester LLP
TE Connectivity
Toyota
Tyco International
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.
Discussions Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Comments by NERA Economic Consulting

Dear Ms. De Ruiter,

NERA wishes to thank you for the opportunity to provide comments on the Discussion Draft issued under item 7 of the BEPS Action Plan. We understand that in order to fulfill the mandate of the BEPS Action 7, the Focus Group on the Artificial Avoidance of PE Status has had to propose changes to the definition of permanent establishment (“PE”) as currently worded in article 5 of the OECD Model Tax Convention (“MTC”) and, in addition, to address relevant profit attribution issues related to PE.

The concept of PE is, both in the identification of its existence and in respect of the attribution of profits, one of the most delicate concepts in the international taxation of corporate profits. The primary concept is that profits of an enterprise are “taxed only” in the residence state, and the exception to this rule is that profits attributable to business carried on through a PE in another state “may be taxed” in that other state. The PE profit attribution subject has received wide and nuanced attention over a number of years leading up to the introduction in 2010 of the Agreed OECD Approach (“AOA”), confirmed by a new text for article 7 of the OECD MTC, dealing with the taxation of business profits. The existence (or not) of PEs has received a lesser degree of concerted attention. The current Discussion Draft deals primarily with issues connected to the existence of a PE.

Paragraphs 3, 4 and 5 of article 5 deal with situations where, in spite of a fixed presence or representation of a foreign enterprise in a host country a PE is deemed to be absent. BEPS Action 7 targets situations where non-recognition of such potential PE in the host country is claimed based on these paragraphs, using various interpretations or tactics perceived as abusive.

As economists, we respectfully acknowledge the achievements of the Focus Group in developing alternative formulations of the MTC language that defines PE, and restrict ourselves to a limited number of comments. These are the following.
- As to Section A, we note that in option C referring to the “economic” relationship rather than to the legal relationship would improve its reach; the relevant relationship can only be established in a value chain analysis;

- As to Section B, we note that firm conclusions seem to be attached to certain words or terms (“auxiliary character”, “delivery”, “purchasing”) as if these have a defined categorical meaning. The relevant meaning of these terms however needs to be established explicitly in each specific case, by way of a value chain analysis. The examples given, unfortunately, fail to give meaningful guidance. Examples based on rudimentary, over-simplified fact sets, and leading to superficial (“it is clear that…”, “clearly…” ) conclusions are like kicking in an open door. The challenge in real-life cases is to establish the meaningful context of value creation in “a cohesive business operation”, as part of which the role of the potential PE activities and threshold levels of value-creating economic activity can be judged. That is what usually is not delivered by a traditional (compliance-inspired) functional analysis. Such analysis typically focuses either on a tested party or on parties to a specific transaction. Value chain analysis takes a holistic view as a starting point, and leads to the identification of the role of a relevant party or parties (whether subsidiaries or PEs) in terms of contribution to the joint value creation;

- As a more fundamental comment, we note that the Discussion Draft seems to conclude that dealing with the manipulative interpretation of the existing definition of PE (article 5 MTC), will not only resolve such perceived abuse, but also cover the impact of the “digital economy”. We think that the Discussion Draft tends to over-concentrate on addressing what is currently perceived as abuse and therewith risks missing certain challenges to article 5 posed by what is called the “digital economy”. The defining feature of the digital economy is that physical presences that used to be necessary for doing business in foreign jurisdictions are replaced by virtual presences in the modern business models. And business models will keep evolving. This can only be followed by way of functional analyses that include assessment of how value is created inside a business and what the relative involvement is of all parties concerned in the joint value creation in what the proposed texts for the new paragraph 4.1 call “a cohesive business operation”.

The Discussion Draft in its current state (see Section E) refrains from leveraging views developed in recent years in the context of amendments to the OECD Transfer Pricing Guidelines, in particular Chapter VI. The introduction of value creation as the decisive reference for judging what is acceptable or not in terms of the determination of arm’s length remunerations necessitates a deeper level of economic analysis. As we have noted here above, the role of value chain analysis needs to be recognized not only in that context, but also for purposes of identifying the existence or not of PE. Without applying a value chain analysis, not only to the PE profit attribution issue but also to the identification of PE, the effort to refine the MTC language may ultimately prove to be futile. We think that even though, historically,
determination of PE status relied heavily on the definitions contained in the MTC and bilateral tax treaties, refining the MTC formulations will not be sufficient to achieve the BEPS objectives. We respect the suggestions in the Discussion Draft as pertinent and relevant, but wish to point out that the possibilities for implementation in practice depend heavily on issues like the introduction of changed texts into individual treaties, and continuing disparity of interpretations between countries. What is of immediate relevance however is the AOA, arguably also in the application of article 7 MTC in its old wording. This is important because AOA implies the application of functional analysis, including value chain analysis.

We are pleased to note that the Focus Group so far has not identified any substantial changes that would have to be made to the existing rules on PE profit attribution, which implies its reaffirmed commitment to the AOA principles expressed in the 2008 and 2010 Reports.¹ We think that the most effective way to achieve the BEPS objectives related to PEs lies in a more active application of the analytical approaches articulated elsewhere in the BEPS Action Plan deliverables, such as identification of economic relations of the parties (rather focusing than transactions only) and complementing functional analysis with the value chain approach, to PE profit attribution as well as to the identification of PE.² Coordination of the work on both issues with the work on other aspects of BEPS plan will potentially improve the effectiveness of the Focus Group’s effort.

Sincerely yours,

Pim Fris

Sébastien Gonnet

Vladimir Starkov

Chicago/Paris, January 9, 2015


² See in this respect also “PEs and transfer pricing: the playing field in international taxation redefined” by Fris, Linares and Gonnet in BNA Tax Planning International Transfer Pricing, December 2008.
Public Discussion Draft on BEPS Action 7: Preventing the artificial avoidance of PE status: Nord Stream AG Comments

Introduction

In February 2013 the OECD issued a study commissioned by the G-20 with the title “Addressing Base Erosion and Profit Shifting (BEPS)”. Based on this report the OECD drew up an Action Plan which was published in July 2013. The Action Plan on Base Erosion and Profit Shifting identifies 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions.

Action 7 of the Action Plan deals with strategies that result in the artificial avoidance of permanent establishment status and that raise base erosion and profit shifting concerns. In the opinion of the Focus Group mandated to carry on the work on Action 7 the definition of permanent establishment (PE) must be updated to prevent abuses in particular by so called “commissionaire arrangements” and by artificial fragmentation of operations in order to qualify for the PE exceptions due to preparatory and auxiliary activities. Thus the goal of Action 7 is to develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on the issue should also address related profit attribution issues.

The comments provided below are prepared by the author as representative of Nord Stream AG.

Nord Stream AG is an international joint venture established for the planning, construction and subsequent operation of a new offshore gas pipeline through the Baltic Sea. Headquartered in Zug, Nord Stream was officially incorporated on 2 December 2005 at the Swiss Federal Commercial Registry Office as a limited corporation in Switzerland under its former name North European Gas Pipeline Company (NEGP). Nord Stream maintains a branch in Vyborg, Russia. Majority shareholder OAO Gazprom holds a 51 percent stake in the European-Russian pipeline project. Leading German energy companies BASF SE / Wintershall Holding GmbH and E.ON hold 15.5 percent each. The Dutch natural gas infrastructure company N.V. Nederlandse Gasunie acquired a 9 percent stake in 2008 and French GDF SUEZ acquired a stake of 9 percent in 2010.

General Comments

As a matter of fact, the OECD PE definition has an eventful past. Lately, in particular the Commentary to article 5 of the OECD Model Convention (MC) has been updated at numerous occasions. In our view this has not necessarily led to the desired clarity in all areas.
Therefore, we believe that the work related to Action 7 could in addition to the specific issues discussed in the draft on BEPS Action 7 be used to clarify – probably on a Commentary level – these uncertainties so that resources on both the tax authorities and taxpayers side are not wasted and double taxation or double non-taxation can be further eliminated.

It appears sensible that the lowering of the current PE threshold might be the only feasible measure to limit certain tax planning that has led to undesired tax avoidance in the past. However, it should still be differentiated between artificial structures and structures based on a sound business reason. It is undisputed that material activities of a multi-national entity (MNE) in a country should be taxed. Taxpayers should nevertheless be left the freedom to reduce activities in a particular country in order not to have to bear a disproportionate administrative burden (e.g. filing tax returns, complying with burdensome local regulations etc.) for relatively immaterial activities. It generally appears to us that tax authorities already have sufficient tools to fight against artificial tax structures. Thus, in our opinion, OECD should under BEPS Action 7 act carefully and reasonably in order not to destroy legitimate constructs and to limit any non-recognition of the MNE’s legal construct to clear cases of abuse.

At the same time, OECD could clarify the PE threshold in order to prevent both the undesired double taxation and unjustified double non-taxation of business profits. Since the PE concept is obviously not abandoned, we believe that the current threshold should basically be kept and possibly clarified, i.e. limited taxation in the source state besides the unlimited taxation in the state of residency should according to our view only incur if there is a sufficient socio-economic nexus between the non-resident taxpayer and the source state.

**Specific Activity Exemptions**

This topic refers to the list of exceptions in Article 5(4) MC according to which a PE is deemed NOT to exist where a place of business is used solely for activities that are listed there. The proposed actions target mainly warehouses, purchasing offices, and offices used for the gathering of information. In fact the proposal seeks to modernize the exemptions for activities, such as warehousing, that would have been considered preparatory or auxiliary when the MC provisions were originally negotiated. However, today’s ways of doing business, e.g. internet sales, transformed warehouses into sophisticated logistics centres which often became a key part of the business’ value chain.

In its current version §26.1 of the Commentary to Article 5(4) MC notes that an enterprise which owns and operates a cable or pipeline solely for transporting its own property and such transport is merely incidental to the business of that enterprise, then Article 5(4)(a) would apply. On the other hand, a cable or pipeline operator who uses the same facilities to transport property of a 3rd person would not qualify for any of the activity exemptions.
The Discussion Draft discusses possible alternative amendments to Article 5(4) MC. One of them is a catch-all requirement that for the exemptions to apply each specific activity (or the combination of activities) must be of a preparatory or auxiliary character.

In our opinion the adding of an explicit preparatory and auxiliary test (option E) to transport and storage activities would create a high degree of uncertainty in the energy sector. Therefore, it would be very useful to keep the current wording of § 26.1 in the Commentary and even make it insofar firmer as, provided the owner of the transported good (e.g. gas or oil) is also the operator of the pipeline, the transportation is per se preparatory and auxiliary and can therefore not constitute a PE for that enterprise in the other (source) state. Even in case options F-H would be implemented, we believe it would add clarity to amend the wording of § 26.1 of the Commentary in the above mentioned way.

According to our opinion, in case of a fully-fledged supply chain in the gas or oil industry with several activities from up-, mid- and/or downstream operations combined within one entity (or group of entities) it would seem un-reasonable and un-proportionate to characterize the mere transportation of the natural resource as a main activity. It is clearly an auxiliary activity that should irrespective of any changes to Article 5(4) MC continue to qualify for specific activity exemptions.

In addition, we propose to eliminate the somewhat unfortunate reference to immovable property in § 26.1 since it is not necessary.

Profit attribution to PEs and interaction with Action Points on Transfer Pricing

This point is treated only very briefly in the Discussion Draft although in our opinion it is a key issue. Even when the overall business is making profit, it does not automatically mean that profit should be attributed to each PE of the enterprise. Thus, lowering the PE threshold and at the same time leaving the allocation rules open for amendments would lead to more uncertainty on both the taxpayers’ and the authorities’ side that could end up in more disputes not only about the existence of a PE but also regarding profit allocation.

In the case of pipeline operators (in particular the ones that transporting 3rd party goods) the plan to generally extend source taxation could lead to additional, taxable presence in the countries where the pipeline is crossing instead of the country where the business is based, i.e. the control center is located or alternatively the control center plus a section of the pipeline. Probably the overall tax burden would also increase due to the fact that on the one hand the country of residence has a moderate tax rate, and on the other hand merely passive installations in the (source) countries where the pipeline is simply crossing could be (a) taxed and (b) on a profit that might be out of scale, potentially even at a high tax rate. This would cause uncertainty in the energy sector as financial planning (i.e. effective tax rate) could become more difficult and additionally it would raise the policy question how much taxes can
be paid for the transportation of natural resources since higher taxes would lead to an increase of transportation costs lowering the margins in the energy sector with generally very high investment risks and price sensitive buyers. This could ultimately endanger the energy security.

In order to prevent that the lowering of the PE threshold leads to great uncertainty (i.e. with respect to the taxable presence and the amount of tax expense), the qualitative assessment regarding the existence of a PE (in essence Article 5 MC) should as far as feasible already include some indications or rules regarding the necessity that the classic TP factors like functions, risks and assets are (at least partly) given in order that a PE is deemed to exist.

For the sake of illustration, let’s assume a transit section of a pipeline within the territorial waters of Country S is deemed to constitute a PE according to local tax law of country S and the DTT between country S and country R (resident state of the pipeline operator) does not prevent country S to tax this PE, then it should already be possible to deduce from Art. 5 MC that, since in country S there is only transit and no employees, so a mere passive presence, i.e. not all TP factors are given, the attributable profit should be close to zero (if not even zero).

The idea is to include the classic TP factors not only in order to calculate the attributable profit, i.e. as a measurement in the quantitative assessment according to the Authorized OECD Approach (Article 7 MC), but already on the qualitative level, i.e. in determining whether a PE exists in the first place, giving a clear indication regarding the scale of attributable profit.

This should ideally be determined at the point of decision as to whether a PE exists or not, so basically under Action Point 7 it would result in a pre-qualification of a PE’s profit potential. This would determine whether the PE is a huge value driver, probably involving all three TP factors, i.e. functions, risks and assets or rather a low value driver, e.g. only consisting of an asset (but with no functions and risks).

These comments have been prepared by:

Patrick Trafelet
Nord Stream AG

1 It is the author’s distinct opinion that a mere transit section of a pipeline in a specific country without own personnel present in this country nor any kind of automatic equipment within the limits of this country cannot constitute a PE since it does not fulfill the requirements of the basic PE rule in Article 5(1) MC.
Marlies de Ruiter,
Head, Tax Treaties,
Transfer Pricing and Financial Transactions Division,
OECD/CTPA
Sent via email to taxtreaties@oecd.org

January 5, 2015

Comments on the OECD Discussion Draft on Preventing the Artificial Avoidance of PE Status 31 October 2014

Dear Madame:

This letter is in response to the OECD’s request for comments on its most recent Discussion Draft on Preventing the Artificial Avoidance of PE status issued October 31, 2014, hereinafter referred to as the “Discussion Draft.”

We appreciate the efforts the OECD is taking in addressing the BEPS Action Plan. As an in-house tax practitioner, we understand how BEPS can undermine the fairness and integrity of our tax system. With regards to the Discussion Draft, we are concerned with the proposals regarding artificial avoidance of PE status through the specific activity exemptions. Tax treaties are meant to facilitate trade, but the proposals in this draft seems to be overdoing some aspects, especially Option F which in our view, will affect trading to a large extent.

The purpose of this letter is to highlight from a business perspective, specific examples of unintended effects that might result from option F as proposed in the Discussion Draft.

Artificial avoidance of PE status through the specific activity exemptions

We understand how the current Article 5(4) of the OECD Model Tax Convention lists the exceptions whereby a PE is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph. We also understand that there are concerns that this article does not clearly cover only preparatory and auxiliary activities.

The Discussion Draft proposes two options – option E and option F. Option E proposes amending Article 5(4) so that all its subparagraphs are subject to a 'preparatory and auxiliary' condition. Option F proposes removing the reference to “delivery” from subparagraphs (a) and (b).

We would like to raise the concerns we see from a business perspective of option F. Removing the reference to “delivery” from subparagraphs (a) and (b) would mean that the use of facilities for the “delivery of goods/ merchandise”, or “maintenance of a stock of goods/ merchandise solely for the purpose of delivery” would give rise to a PE of an enterprise in that country.
This would lead to PE issues for most multi-national companies where the following arrangements are common:

1. Maintenance of stock points in each region
2. Consignment arrangements

The first arrangement is common for many multinationals in order to facilitate trade. In today’s fast paced economy, customers are always pushing for faster deliveries. Hence, it is crucial to maintain stock points in each region to facilitate distribution of goods to customers in each region.

Consignment arrangements - where an enterprise’s stocks are physically maintained at a location as designated by the customer (for delivery to customer), are also increasingly requested by customers so that they can access the stocks in a quicker manner.

In addition, we would also like to point out that the concept of PE varies quite significantly between the EU and Asia. For example, the understanding of PE in the EU is sophisticated and tax authorities are able to clearly differentiate this from a Value Added Tax (VAT) discussion. PEs are recognised in the EU without the need for VAT registration, conversely an enterprise can register for VAT without necessarily creating a PE in that country.

However, this is not the case in the Asian region where the concept of PE is not so clearly defined. We have seen cases whereby having a PE in a particular country would also mean that one has to be registered for VAT purpose, conversely an enterprise may not be able to register for VAT without creating a PE in that country.

In summary, we foresee that the proposed option F would impact many multinational companies who maintain stock points for delivery and/or have consignment arrangements with their customers – which would result in a PE arising in those locations. This might also have tremendous effects in the area of VAT where companies may find themselves with VAT registration/ reporting consequences.

In view of the above, we urge the OECD to consider option E to address the artificial avoidance of PE through the specific activity exemptions.

Please feel free to contact me if you have any clarifications.

All the best,

[Signature]

Erik Fredriks
Head of Group Taxation, SVP
NXP Semiconductors
**Petrofac Group Representations**

**Public Discussion Draft on BEPS Action 7 Preventing the Artificial Avoidance of PE Status**

In response to the paper issued on 3rd November 2014 requesting comments from Business and Industry to the proposals on preventing the artificial avoidance of PE Status (PE), Petrofac Group (Petrofac) would like to make the following comments.

**Petrofac Group Background**

Petrofac is a FTSE 250 oilfield services company which operates in 29 countries across the globe. Its primary corporate and operational offices are in UAE, India, Malaysia and the UK; project sites are located in a number of countries where we:

- design and build new oil and gas facilities,
- manage and maintain existing facilities,
- enhance the performance of more mature or marginal facilities, and
- develop and train our customers’ staff to work more effectively and safely.

We operate onshore and offshore, and any of our service lines can be delivered on a standalone basis or they can be integrated together, under a range of commercial models. Our workforce numbers over 18,000 employees around the world.

**Petrofac Position Summary**

Petrofac understands that the measures set out in the Public Discussion Draft are intended as targeted anti abuse provisions which address some key concerns of member states, where it is perceived that multinationals artificially divert local source income offshore by attributing the activity to a non-resident entity with no local taxable presence. While Petrofac agrees with the principles we are concerned that adoption of some of the measures as drafted could inadvertently impact business which is not structured for avoidance purposes and may result in material additional costs to business in defending PE allegations resulting from normal activities carried out in the course of ordinary business.

**Commissionaire arrangements and similar strategies**

Petrofac does not utilise Commissionaire structures, but some of the proposed amendments to Article 5 could have unintended consequences more generally for business.

Alternative A- Replacing “conclude contracts” with “engages with specific persons in a way that results in the conclusion of contracts”. This is too broad, and could prejudice normal business interactions which do not result in a diversion of profits from the country of activity. For example for most MNE’s it is accepted that senior executives will engage in customer and Government relations, which could ultimately be linked to the conclusion of a contract for one of the Group Companies. Their involvement in providing arbitration in negotiations is also not uncommon. Typically these activities are provided as a corporate service which would be remunerated on an arm’s length basis. In effect many MNE’s senior executives are mandated to act in this capacity by all Group companies, and will have interaction with specific persons in key jurisdictions. These activities would almost
certainly take place in the client or Government locations, so could have the appearance of a fixed location.

While Alternate A is our preferred option we believe that further qualification either in the wording or commentary is necessary in order to prevent inadvertent consequences or an overly aggressive interpretation by tax authorities.

Alternative B- replaces “conclude contracts” with “concludes contracts or negotiates the material elements of contracts”. This goes too far in associating the negotiation of a contract with a PE of the enterprise that enters the contract. At a minimum the negotiation should be habitual, but even this does not qualify the activity sufficiently.

If an MNE has a business presence in a jurisdiction (Country X) and has the ability to broker (using employees in that country to negotiate) the use of an affiliate company (in Country Y) in the provision of an ancillary service for example training to be conducted in Country Y by a local entity for workers of a third party based in Country X, the employee’s activities could in this context be deemed to create a PE of the Country Y entity in Country X. The Country X entity would charge a service fee for the provision of the brokerage service, so there is no loss of revenue to the tax authorities as long as the transfer pricing is appropriate, but the PE compliance and administrative cost, and mutual agreement procedure involved in settling attribution of the training revenues between the two jurisdictions is disproportionate.

Arguably if the training service involved assessment activity (site visit of one week to determine content) in Country X and actual training over the course of a year in Country Y, the site visit, which may not be remunerated at all, would constitute a PE.

Alternative C- replacing “contracts in the name of the enterprise” with “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise” (in addition to the language in Alternative A). The points raised in Alternative A are exacerbated here by explicitly including employees, which means that any Group employee that has a role of business development or Government relations could be deemed to create a PE of any affiliate company whose contracts he has been deemed to have influenced the conclusion of.

Alternative D - combines the language in Alternative B (negotiates contracts) and C (on the account and risk of the enterprise). This encompasses all of the points raised above, and being the broadest and most subjective, is the least likely to result in a clear and consistent interpretation.

**Specific Activity Exemptions**

Alternative E- The proposal to amend Article 5(4) such that all the listed activities are qualified as to their nature being preparatory and auxiliary is not problematic in itself, but if adopted will require a significant amount of additional definition around what constitutes preparatory and auxiliary.

We have no objection to the amendment in E per se as long as a uniform and consistent interpretation is applied. The alternative given in F is more problematic since delivery of goods is part of the Petrofac standard service offering and the need to store goods for delivery in jurisdictions where no other Petrofac PE exists or will be deemed to exist, is we believe, essential to the effective management of our business.
For example, if we were to undertake a procurement project, it may become necessary to store the procured goods in preparation for assembly or installation, or post assembly, ready for delivery to a client site. Procurement is a Petrofac core service offering, but storage is not. We would utilise a third party’s storage space, and pay an appropriate fee for that service. The delivery could be contingent on a number of factors, over which Petrofac have little control, the title to the goods could be with Petrofac until delivered to site.

We believe that the preparatory and auxiliary qualification in subsection 4 would allow the storage of goods in the above scenario to be an exempt activity, whereas the amendment suggested at Alternative F would not. The consequences of PE creation by virtue of storage of goods for delivery would adversely impact Petrofac as a result of arbitrary profit allocation, mutual agreement delays and unnecessary compliance costs. At a minimum there should be an exemption where the storage facilities are not owned by the enterprise storing the goods, or an affiliate of that enterprise.

The amendments suggested at G and H appear excessive. Maintaining a fixed place of business for the purpose of purchasing goods or collecting information are we believe necessary exemptions for MNE’s with complex global supply chains. MNE employees may visit client/ vendor offices on a very regular basis throughout a given project life, when aggregated the presence could be potentially deemed a fixed place of business, but the sole purpose of the meetings/ visits is the collecting of data or is in connection with the purchasing of goods. They are not a remunerated activity, but facilitate the delivery of the wider project, more often than not in a third location. To suggest that such visits and meetings could, when taken together constitute a PE would lead to protracted negotiation in respect of profit attribution and unrealistic and unnecessary compliance and administrative costs.

**Fragmentation of activities between related parties**

It is not always possible given the licensing, local content and ownership requirements we face in the oil and gas sector to limit activity to one in country entity. The sector also has issues around the financing of projects and the ring fencing of project risk. To suggest that one entity can fulfil all activities in one jurisdiction is an oversimplification and there can be compelling commercial reasons to fragment a project, some of which will be undertaken entirely outside a jurisdiction, and others within that jurisdiction.

Further to suggest that all activities in a Group can and should be seen as part of a cohesive operating business, which necessarily links all activities in a jurisdiction, is naive. Petrofac provides several distinct offerings which can be complementary, or standalone products. EPC contracts are quite often handed to an affiliate for Operations and Maintenance (O&M) support, and then a local workforce trained to replace the Petrofac O&M team. Training is clearly a separate offering to EPC or O&M, and more often than not takes place at dedicated sites, or in a classroom, or even online. The proposals suggest that, for example, if an EPC contract is undertaken at a site (say 10 miles offshore) spanning six to seven months, and immediately that contract is concluded safety training is undertaken in the client’s offices for one month, a PE of both entities would be created.

Administering a PE for the training contract would be onerous and disproportionate, coupled with non-compliance penalties which could arise where one company in one division is unaware of the full details of work performed by another in a different division.
Clearly the further condition which requires neither of the affiliates to meet the PE threshold individually, but when in country presence is aggregated could meet the threshold test is even more challenging, and assumes a complete knowledge in all parts of a business of all activities at all times, which whilst ideal does not reflect commercial reality. MNE’s encounter many situations where services are requested on relatively short notice, and for very short periods of time and quite often in the same territories. Complete oversight in real time is challenging, which would make compliance obligations incurred by a PE difficult to assure. This type of work is usually taxed on a withholding basis, and we believe this is the more appropriate treatment, reducing administrative process for both the Company and the Tax authorities. Any perceived abuse of a treaty in this context can be addressed elsewhere in the BEPS actions.

**Splitting up of Contracts**

There are many reasons why different contracts are undertaken by different affiliates, and this can mean that a number of affiliates operate in one jurisdiction. One of the principle reasons is that in our business sector entities often have to prequalify for contracts, and a specific track record may be required. There are also licensing constraints, and local content regulations that need to be taken into account. These considerations may for example mean that engineering can only be undertaken by a company with local directors and shareholders who are themselves engineers, which will mean that this subset of an EPC contract will have to be undertaken with a locally incorporated and licensed company. At the same time construction could be subcontracted to meet local content regulation, whilst procurement could require some expediting in country but be principally undertaken offshore in specialist procurement centres. Similarly installation and commissioning may be undertaken in the same country, at the same site, by affiliates which are specifically qualified, licensed and experienced to undertake such activities. In this example all of the affiliates could be argued to have a PE in country if all of the activities aggregate 12 months. It is not clear how the PE would actually be deemed, would each affiliate have a PE which would need to be registered and administered as such, or would one entity report the attributed revenue and associated costs of each of the affiliates?

Both the exemptions in K. have their own challenges. Petrofac would question whether the 31 days of activity justifies the administration that a PE requires, and how the days of activity would be measured? Client meetings and inspections which are not remunerated activity under contracts, particularly in the case of dispute resolution, (which cannot be anticipated in pricing) should not be included? A PPT test would add too much subjectivity where certainty is required to price a three year plus fixed price contract.

Petrofac prefers the narrative solution suggested in L as this addresses the perceived abuse more directly and is likely to lead to a more consistent treatment. However the presence of joint and several liabilities should not be expressed as a critical factor. For the reasons set out above it may be necessary to have this attribute in a contract, but this should not imply mischief but should be assessed in light of the commercial requirements of the client who will often insist on joint and several liability for legal reasons. In terms of matching economic activity with physical presence this one feature of a contract is not indicative, and could even be argued to attribute more value offshore where there could be an implied performance guarantee from the parent company.
Dear Sir

We are writing to you in response to the OECD Base Erosion and Profit Shifting (“BEPS”) Report on Action 6 (“Prevent the granting of treaty benefits in inappropriate circumstances”) issued September 2014 and the related follow up work discussion document published on 21 November 2014, as we are concerned about the implications for Phonographic Performance Limited (“PPL”) and the wider music industry. We trust the comments which follow will be taken into account in your further consideration of the model provisions and related Commentary, as invited in the discussion draft.

Established in 1934, PPL exists to ensure that those people who invest their time, talent and money to make music are fairly paid for their work. PPL licenses recorded music played in public or broadcast on the radio or TV, as well as certain uses on the internet, and then distributes the fees to its performer and record company members. Through agreements with over nearly 70 music licensing companies around the world, PPL also collects royalties for its members globally. PPL is one of many collective management organisations (CMOs) in the UK and globally, which license different types of material protected by copyright and related rights.

While we support the general principles behind BEPS, we are concerned that some of the proposed actions could have unintended adverse consequences for PPL, the wider music industry and the collective rights management industry in general. In particular the proposed actions could lead to over 20,000 sole traders and small businesses suffering double taxation on small payments, leading to such small businesses being placed at a competitive disadvantage against larger businesses. The proposed actions could also potentially deter a significant number of medium sized businesses from utilising collective management of copyright and related rights, leading to significant avoidable inefficiencies in the music licensing market.

We have set out our concerns below, together with some background to PPL and the music industry.

We understand that further work is likely to be undertaken with respect to issues related to the treaty entitlement of Collective Investment Vehicles (CIVs) and non-CIV funds. We would welcome the opportunity to discuss the issued faced by PPL and the wider music and collective rights management
industry in a similar manner to the separate discussions that are being held with the funds industry.

**Background**

*The music industry and collective rights management*

The global recorded music industry is worth around $15 billion per year\(^1\) and the market is changing rapidly. In 2013, digital revenues accounted for 39% of total revenues and revenues from subscription streams have more than tripled to $1.1 billion in the last three years.\(^2\) In particular, over 28 million people paid for music subscription services in 2013, which was up 40% on 2012\(^3\).

Revenue from performance rights for owners of copyright in recordings topped $1.1 billion globally for the first time in 2013, increasing by an estimated 19% in 2013\(^4\), more than double the growth rate in 2012, and accounting for 7.3 per cent of total record industry revenue\(^5\). If income for performers was included this revenue would be closer to $2 billion.

Music CMOs like PPL play a major role in the collection of revenues on behalf of rightsholders. CMOs grant licences to commercial users (TV channels, radio stations, online music service providers), collect royalties and make distributions to rightsholders. CMOs make it possible for commercial users to clear rights for a large number of music tracks or other works, where individual negotiations – such as with individual record companies and performers, in the case of sound recordings – would be impractical. Music CMOs also exist to help level the playing field within the industry by enabling holders of rights in fewer works to collect income efficiently and so encouraging more grass roots music.

Public performance of music is by its nature localised and most broadcasting of music is organised on a country by country basis. CMOs generally reflect a national model, with a different CMO utilising knowledge of local laws and markets and a local presence to license users of music in the domestic market. The revenue collected is distributed to the owners of rights in the music that has been used, according to detailed usage information gathered by each CMO from its licensees, and each CMO’s published distribution policy.

However, the music used within any given country may have originated in any country. While large record and music publishing companies may have the international infrastructure to operate in each country and join each local society directly, smaller businesses and individual writers and performers will normally rely on their chosen CMO to enter into agreements with CMOs in each country where their music is used in order to collect revenue due to them as a result. In summary, cash travels cross-border in many different transactions as local earnings as passed on to other societies to reach the artist.

Collective management organisations collect around €6 billion in the EU alone every year.\(^6\) For a number of years, the European Commission has been encouraging the music industry to adapt to the changing market, to enable multi-territorial licensing and to facilitate cross border payments for the use of music. The Directive on collective management of copyright and related rights and multi-territorial licensing,

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\(^1\) IFPI *Recording Industry in Numbers* 2013
\(^2\) IFPI *Recording Industry in Numbers* 2013
\(^3\) IFPI *Digital Music Report* 2014
\(^4\) IFPI *Digital Music Report* 2014
\(^5\) IFPI *Digital Music Report* 2014
\(^6\) European Commission - MEMO/14/79 04/02/2014
which was adopted by member states in February 2014, requires improvements to standards of transparency and data accuracy by CMOs to allow effective multi-territorial licensing.

There is concern that BEPS could disrupt the progress made so far, and work against the European Commission’s principles. The BEPS action points could adversely affect the music industry’s efforts to enable multi-territorial licensing and to facilitate cross border payments by increasing withholding taxes (“WHT”) on cross border payments and, at best, increasing the administrative burden of obtaining double taxation relief for WHT suffered.

**Phonographic Performance Limited (PPL)**

PPL collects and distributes UK and international income for broadcasting and public performance of sound recordings on behalf of its members and performer members. As explained above companies such as PPL exist because for members or artists trying to collect royalties individually would be inefficient, if not impossible. CMOs leverage economies of scale to maximise the return to members.

PPL is established as a company limited by guarantee. In 2013, PPL had 79,000 performer members and 11,500 recording right holder members, and membership continues to grow as over 250 new recording rightsholder and over 300 new performer members are registered each month. PPL’s governance structure ensures a fair and balanced representation of the interests of its members and representatives of featured performers, session performers, major and independent record companies all have a place on the PPL Board which meets ten times a year. In addition, separate committees, each with a similar representative make-up review distribution policy, executive remuneration, the company’s finances and the annual audit.

License fee income for 2013 was £176.9m which represented growth of 4% on the previous year, and distributable income grew by 4% to 148.4m. The international income within the license fee turnover was £34.4m, constituting over 19% of the total. Societies in many countries across the world also collect internationally for their local members. The PPL figures demonstrate the large aggregate amounts that these companies are collecting and distributing. However, the aggregate amounts are made up of millions of individual transactions.

PPL has entered into agreements with nearly 70 music licensing companies in 34 countries around the world in order to collect global income in respect of the rights it manages. Some of the major CMOs PPL has reciprocal agreements with include SoundExchange in the United States, Adami in France and Sena in the Netherlands.

In 2013, PPL collected £34.4 million from overseas CMOs. Over the next 5 years these collections are expected to increase as PPL signs additional bilateral agreements with CMOs in new territories. During 2013, over 23,000 performer and rightholder members received an allocation of international revenue. The median payment of international income to a member was £102 and over 89% of members received less than £1,000 in total during the year across all territories. On average PPL’s members received payments from 11 different territories.

7 PPL website – [www.ppluk.com](http://www.ppluk.com)
8 PPL annual review 2013
9 PPL annual review 2013
10 PPL annual review 2013
The sheer volume of money flows presents real challenges in respect of taxation, particularly in relation to cross border payments. This volume is an unavoidable result of many licensees in many countries paying licence fees in respect of the use of music created by many artists and performers in many countries. At the present time there is real concern that these challenges will be made worse as a result of the proposed BEPS action points.

Challenges arising from the international tax system

Current challenges

PPL and other CMOs already face challenges within the international tax system when collecting international revenues. The application of WHT can lead to double taxation of income and the compliance burden associated with claiming double taxation relief increases the cost of collection and reduces the income received by rights holders.

CMOs currently have to deal with inconsistency of approach by tax authorities. The compliance burden is lowest where tax authorities treat the CMO as the beneficial owner of its income allowing a single claim for double tax relief by the society. Other tax authorities allow the society to claim double tax relief but require the society to collect and provide information on the residence of its members in order to support the claim such as, for example, the UK’s Block Exemption Scheme. In order to prevent double taxation on collections from the United States, PPL has become a Qualified Intermediary and has to spend significant time and resources on an ongoing basis, including 3 additional full time staff, to maintain this status.

If a tax authority does not allow double tax relief claims to be made by the society then the compliance burden is such that only the highest earning rightsholders will be able to claim the relief that they are entitled to. For the nearly 90% of PPL members receiving less than £1,000 of international revenue, the cost of obtaining relief is likely to exceed the WHT suffered leading to double taxation of income. As rights protection becomes more prevalent in developing countries, the cost of double taxation and the administrative burden of claiming relief under double tax treaties will only increase.

Implications of BEPS

The BEPS initiative is aimed at addressing flaws in double taxation treaties and domestic tax systems that lead to base erosion and profit shifting by multinational groups. When developing its action plan, we feel the OECD has not taken into account the particular challenges faced by the collective rights management industry. There is a very high risk therefore that PPL, and the wider music industry, will be caught in the cross fire of the BEPS action points. In particular, we are concerned about the implications of the following action points:

- Action 1: Digital economy
- Action 6: Prevent treaty abuse
- Action 7: Permanent Establishment

As set out above, digital revenues are an increasingly important source of income for the music industry and the music industry is becoming more reliant on businesses operating in the digital economy for its revenues. The music industry is continuing to expand into new markets and international revenues are growing.
The public discussion paper on BEPS Action 1: Addressing the tax challenges of the digital economy broadly suggests that the challenges of the digital economy may be best addressed through changes to permanent establishment rules and, possibly, if needed by withholding taxes.

The proposed changes set out in the discussion paper on BEPS Action 6: Prevention of Treaty Abuse and in the subsequent Report issued in September 2014 could result in fundamental changes to the taxation of CMOs such as PPL and, more significantly, their members. Should CMOs no longer be able to claim the benefits of double taxation treaties then withholding tax could be suffered by members on income collected by the society as well as the income distributed to the member. Many countries impose withholding tax on royalty payments meaning that this would not be an isolated problem.

As explained above, PPL distributed international revenue to over 23,000 members in 2013, from an average of 11 different territories each, with a median payment aggregated across all territories of £102. If all of PPL’s individual members were required to file separate claims for relief in each territory they received income from, this would represent more than 100,000 possible claims for treaty relief for 2013 alone. Such a large volume of claims would represent a significant administrative burden to the overseas tax authorities as well as to PPL’s members and could become a reality if the proposals in the treaty abuse paper are adopted as drafted.

Details of proposed changes to the permanent establishment rules in the model tax convention have not yet been published as this is a 2015 action. However, we are concerned that changes could lead to an increase in the number of overseas permanent establishments for PPL and other CMOs in the music sector, and for users of music.

We have set out below our concerns on some of the specific BEPS proposals.

**Implication of specific BEPS proposals**

*Limitation of benefits clause proposed in the discussion paper on Preventing Treaty Abuse*

The proposed limitation of benefits (LOB) clause limits treaty benefits to ‘qualified persons’ or other persons specified in the treaty. If PPL were not to meet the definition of ‘qualified person’ or other specified persons then its members would potentially suffer double taxation. Our key concerns on the proposals are as follows:

- As noted above, PPL is a company limited by guarantee and therefore has members rather than shareholders. Unlike the LOB clause in the UK-US double tax treaty, it is not clear in the proposed LOB clause whether PPL’s members would qualify as ‘shareholders’ for the purpose of the ownership tests.

- Even if PPL’s members are treated as shareholders, the 50% ownership test in the definition proposed in 2(cc)(ii) would not apply to PPL regardless of the residence of its members due to the requirement for the test to be met by 5 or fewer shareholders. As noted above, PPL has many thousands of members.

- In order to determine whether PPL would meet the 50% ownership and 50% gross income test proposed in 2(e), PPL would need to collect and analyse a large amount of information from its more than 80,000 members. As the proposed LOB clause is an annual test, PPL would incur a
significant annual compliance burden in ensuring that the ownership and gross income tests are met each year.

- PPL employs over 280 people and carries out significant activities in order to manage its rights and collect income so we would expect it to meet the proposed active trade or business test. However, any inconsistency in application of this test by tax authorities would lead to uncertainty for PPL and its members. Clear guidance on this test and how it will apply to the management and exploitation of intellectual property will be essential.

- If PPL is unable to meet the definition of a qualified person or qualify for treaty benefits under the active trade or business test, it should qualify under the proposed competent authority test in paragraph 5 as obtaining treaty benefits is not one of the principle purposes of PPL’s existence and operations. However, obtaining competent authority approval in respect of agreements with more than 50 music licensing companies is likely to be a lengthy and burdensome process.

- The ‘derivative benefits’ clause as drafted at paragraph 4 could not apply to PPL as drafted in the Report issued in September 2014 due to the requirement for the ownership test to be met by 7 or fewer equivalent beneficiaries. As noted above, PPL has many thousands of members.

Where PPL and other music industry CMOs do not meet the conditions in the proposed LOB clause, they will be unable to claim double tax relief for WHT suffered on the payments they receive from overseas CMOs and overseas users of music. This will lead to double taxation for rightsholders regardless of whether the country of residence has a double tax treaty in place with the country in which the income arises.

In this situation, WHT would be likely to be levied therefore on almost all of the payments made to/from music CMOs such as PPL. This includes rates as high as 33.33% in France and 30% in the US. As a result, it is likely that multinational licensing will become uneconomical and high-earning rightsholders will be more likely to register with a CMO in numerous territories. As noted above, nearly 90% of PPL members receive less than £1,000 in international revenues with a median payment of international income of £102. With members receiving payments relating to an average of 11 different territories, this is unlikely to be a feasible option for many members and they will either miss out on income or suffer double taxation. This outcome is directly opposed to the objectives of the European Commission.

In some cases, depending on the nature of agreements, in may be possible for rightsholders to claim double tax relief in their own right. However, given the large volume of rightsholders, this will result in a large number of low value claims and will result in significant compliance burden for both tax authorities and rightsholders. As noted above, in 2013, over 23,000 members received an allocation of international revenue relating to an average of 11 different territories, which would represent over 100,000 potential double tax relief claims for 2013 alone.

**Permanent Establishment**

Though no detail has yet been released on the Permanent Establishment action point, it is possible that the proposals could result in an increase in the number of Permanent Establishments for PPL and others in the music industry. For example if PPL carries out activities overseas in order to collect overseas revenue for UK resident members/artists, this could potentially result in a Permanent Establishment under
a revised model convention. This could potentially lead to double taxation and an increased tax compliance burden.

In addition, commercial users of music may see an increase in the number of Permanent Establishments, particularly in relation to digital revenue streams. This could result in more than one application of WHT on the same income, increasing the incidence of double taxation and the compliance burden for obtaining treaty relief.

Comparison with the funds industry

The music and wider collective rights management industries face similar issues to the operation of Collective Investment Vehicles (“CIVs”) in the funds industry due to the large number of shareholders and volume of transactions.

Furthermore, the 2010 OECD report on the granting of treaty benefits to CIVs notes that CIVs may face difficulties accessing treaty benefits if they are not considered to be the beneficial owner of their income. The report recommends that the model treaty and commentary are updated to include a number of options to address the issues faced by CIVs, which should be considered by states when negotiating bilateral treaties.

The favoured option would treat a CIV as a resident of a Contracting State and the beneficial owner of its income, rather than adopting a full look-through approach and the proposed Commentary includes alternative provisions that adopt different approaches with respect to the treatment of treaty-eligible residents of third countries. The proposed Commentary also includes an alternative provision that would adopt a full look-through approach, allowing the CIV to make double tax relief claims on behalf of its investors rather than in its own name.

Although this report is not directly relevant to music CMOs, the commercial drivers and the issues with claiming treaty benefits are similar. The proposed options to address the issues faced by CIVs could be extended to address some of the issues faced by music CMOs. While the favoured option would be preferable, the proposed alternative provision allowing the CIV to make treaty claims on behalf of its investors is similar to the UK Block Exemption Scheme that HMRC currently provides to overseas CMOs.

We are aware that the OECD is holding separate discussions with the funds industry on the BEPS proposals due to the nature of the challenges they face, and we would be very grateful for the opportunity to take the same approach for the music industry / collective rights management industry.

Potential solutions

We have provided suggestions below which we believe would help ease the taxation challenges faced by PPL and the wider music industry. These suggestions seek to relieve the risk of double taxation whilst maintaining the integrity ambitions of the BEPS action points. As well as potential solutions that could be achieved within the BEPS process, we have identified solutions that could potentially be achieved through the European Union. Over 60% of PPL’s international income is collected in the EU. An EU based solution, together with the Qualified Intermediary status PPL already has in place to manage double taxation on US sourced income, would mean that double taxation could be prevented on over 90% of PPL’s current international collections.
Solutions that could be achieved through the BEPS process

1. Similar to the approach being suggested to deal with CIVs, include explicit provision in bilateral treaties and the proposed multilateral instrument to allow CMOs to claim treaty benefits in their own right, relieving the administrative burden for CMOs, members and tax authorities. Appropriate conditions on ownership could be included to maintain the integrity of the BEPS actions.

2. Explicitly exclude music royalties from the proposed LOB clause in the model convention. Music rights are not the type of intangible assets that are used by multinational enterprises to shift profits between different jurisdictions and are therefore not the intended target of the BEPS actions.

3. Adopting a block exemption scheme – similar to that which is currently applicable in the UK – which would allow music CMOs to claim treaty relief on behalf of rights holders on a look through basis. This would carry a compliance burden for PPL but would reduce the burden for individual members and tax authorities by avoiding many thousands of individual claims. PPL already has qualified intermediary (QI) status for US tax purposes and therefore has systems in place to collect the relevant information that would be required to implement this solution.

Solutions that could be achieved within the European Union

1. Amending the interest and royalties directive to eliminate WHT on royalty payments between third parties as well as connected parties. The current interest and royalties directive discriminates against smaller businesses that are unable to establish their own operations in other Member States and have to do business with third parties. In the music industry in particular, the major record companies have the resources to establish subsidiaries in other member states and can therefore benefit from the WHT exemption on cross-border royalty payments. Music CMOs and smaller record companies do not have subsidiaries in every Member State in which their rights are exploited and need to enter into agreements with third party businesses in those Member States in order to collect the revenues that they are entitled to.

Conclusion

The purpose of this letter is to draw your attention to the issues arising from the BEPS action that will potentially affect music CMOs such as PPL. We have set out our key concerns in relation to the current BEPS proposals and identified possible solutions to the issues which aim to avoid double taxation and ensure that income that is rightfully due to artists is not unjustly reduced, while maintaining the integrity of the BEPS proposals.

We would welcome the opportunity to discuss the issues faced by PPL and the wider music and collective rights management industry in a similar manner to the separate discussions that are being held with the funds industry.

Yours faithfully,

Chris Barton, Finance Director
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8 January 2015

Dear Marlies,

BEPs Discussion Draft: Preventing the Artificial Avoidance of PE Status

1. General comments on the Discussion Draft

The response in the pages that follow reflects the views of the PwC network of firms, and we offer our observations on several key aspects of the Discussion Draft.

Our general response to the Discussion Draft is based on the observations that (1) the OECD has stated in the BEPS Action Plan that BEPS is not about changing the balance between source- and residence-based taxation and (2) Action 7 is concerned with artificial avoidance of the PE rules. However, the proposals contained in the Discussion Draft do not seem primarily focused on addressing questions of artificial avoidance of PEs. Rather, they suggest a conscious attempt to lower the PE threshold. The result is that, while some of the proposals will counter artificial avoidance of PEs, most of them will also apply to situations where there has been no such attempt at artificial avoidance.

We assume this approach has been taken because the Working Group has worked on the assumption that artificial avoidance of PEs comes from the threshold being too high. In our view, a better approach to deliver the objectives of Action Point 7 would have been to:

• assume (in the absence of evidence to the contrary) that the decades-old threshold is right
• identify how certain structures artificially sidestep the threshold; and
• devise ways of preventing them from doing so.

Simply lowering the threshold is in our view an arbitrary (and inefficient) way of addressing the identified problem which will result in many more inter-fisc disputes (for no great gain to any of them) and also in an arbitrary shift in the current residence/source balance.

It follows from the comments made above that some of the more important proposals included in the Discussion Draft are not supported by any meaningful explanation of the rationale behind the specific proposal made. Given the inevitable change in long-standing standards that is proposed (and the likelihood of unintended consequences that will arise) we consider it essential for the proposals to be...
considered from the perspective of whether and how they further the BEPS agenda, thereby giving stakeholders a basis for commentary on the merits of the proposals made.

In our view, a major omission from the Discussion Draft is any significant discussion about the related PE profit attribution issues. The issue is of critical importance because in many cases the measure of profit attributable to a PE (under Article 7 of the OECD Model) will (due to the absence of "significant people functions" — "SPFs" — or "key entrepreneurial risk taking functions" — "KERTs") be the same as what may be referred to as the corresponding transfer pricing analysis under Article 9 of the OECD Model (i.e. where an agent is taxed in its right on the income it receives for the services it provides). To avoid the proliferation of a multitude of PEs where there is no gain to any tax authority, we would recommend consideration be given to a rule which would avoid the need to recognise a PE in such a situation.

The Discussion Draft notes that the proposals it contains are not based on any consensus of the CFA or its subsidiary bodies. In relation to the PE rules in particular (because of their significance and the link to the PE attribution rules which we discuss below), we believe it important that a consensus position is developed. In our view failure to achieve a consensus position will be counterproductive, leading to very significant increases in dispute levels and double taxation.

Given the points made above, we consider it of the utmost importance for the OECD to deliver materially improved dispute resolution mechanisms if it proceeds with the measures contained in the Discussion Draft.

2. **Commissionaire arrangements and similar strategies**

Of the four options suggested for the amendment of the Art 5(5) rule, we consider option B to be the least problematic. This is on the basis it is closest to the current rule (given the existence of the reference in paragraph 33 of the Commentary to negotiating "all elements and details of a contract") and therefore it is likely to be the option which will be best understood (and therefore best applied) in practice. In this case, however, it would obviously be essential to develop clear and workable guidance on what is meant by "material elements" of a contract.

Notwithstanding the comments above, we consider that all of the four options proposed will pose real difficulties as regards the clarity of the standard intended and the uniformity of application in practice. As indicated earlier in this letter, we consider that a more targeted approach would have been preferable as the proposals in the Discussion Draft introduce a broad and subjective standard that could potentially apply in a very wide range of instances. The original focus was on commissionaire arrangements but the proposals are not restricted to commissionaires putting all distributor arrangements at risk and significantly raising the potential for unintended consequences and greater controversy. We suggest that the proposals be limited to commissionaire arrangements and arbitrage arrangements akin to commissionaire arrangements.

With regard to the proposal for strengthening the independent agent test, we are concerned that a consequence of the proposals will almost certainly be that more SPV agents (both affiliated and unaffiliated) are treated as dependent agents and therefore as PEs of their principals, leading to a material shift in taxing rights from residence to source states. In our view, the rule is intended to identify agents whose business is independent of the principal’s business such that:

- the source state may tax a foreign principal in the name of a domestic agent where the agent is, in essence, carrying on the principal’s business; but
can only tax the domestic agent in its own name where the agent is, in essence, carrying on their own business.

This means that while the number of principals an agent represents might be a factor in determining whether its business is independent of the principal’s business, it is not, nor should be regarded as, a determinative one. For similar reasons, we do not support the proposed exclusion of “related party” independence. Excluding related party agencies has the disruptive effect of protecting a principal from PE status if the principal uses an unrelated party but creating a PE if the agent performing the identical functions is related. In our view, that makes no sense and disregards the time-honoured principle of respecting transactions between related parties as long as they transact business at arm’s length and respecting the separateness of corporations, as reflected in paragraph 7 of the PE article.

We believe it would greatly assist the interpretation of the rules discussed above if certain existing difficulties in the Commentary were also addressed – e.g. by an improved explanation of what is required to be regarded as economically independent. It would also be helpful if it could be clarified that references to concluding contracts, etc. is intended to refer to substantive functions and acts, not merely formal ones (e.g. as in power of attorney arrangements or an agent communicating and explaining terms and conditions set by the principal).

In the absence of material amendment to the proposals, we envisage widespread collateral damage will result from the proposals. For example, it may be expected that a potentially very wide range of agents (such as agents conveying standard “list prices”, whether with discretion to vary the terms within limited ranges or not, agents providing client relationship services, marketing agents, etc.) will all fall within the scope of the amended rules proposed. Further, in the banking sector affiliates are used widely to perform origination and brokerage functions in the case of suitably-capitalised regional risk trading vehicles. A wide spectrum of agency roles will similarly be impacted. In the funds sector also, local country fund managers/advisers are used extensively by regional or global fund vehicles and this sector is also likely to be materially impacted the PE proposals.

The changes proposed for Art 5(5) and (6) are directed at “commissionaire arrangements and similar strategies”. Whilst the scope of commissionaire arrangements is clear, the scope of “similar strategies” is not. If the suggestion we make above on limiting the proposals is not accepted, it would be helpful to understand more clearly the scope of the arrangements which the OECD wishes to target. For example, we assume it is not the intention of the proposals to impact buy-sell or back to back contracting arrangements, though the drafting of the proposals does not deal clearly with this point. We would recommend that the matter is clarified.

3. Specific activity exemptions and fragmentation

(1) Specific activity exemptions

We are sympathetic with the OECD Proposal, reflected in option E, to constrain the application of Art 5 (4) to broadly non-core activities, though this proposal will clearly require improved guidance on the meaning of the phrase “preparatory or auxiliary” and its application as the existing guidance (see paragraph 24 of the Commentary) is brief. We would recommend an expanded explanation and the use of examples in the Commentary in the event option E is followed.

We see no basis in policy terms for the exclusion of the specific activity exemptions as in option F, G and H and consider that the justification given for option H is in any event very weak, providing no substantive explanation for its inclusion.
(2) Fragmentation

We have strong doubts as to the wisdom of extending the anti-fragmentation rule across entities as is proposed at option I. At a policy level, deeming the services of an affiliate as creating a PE may inappropriately penalise enterprises for offering services via affiliates (as opposed to the business going to a competitor). Further, we consider any possible improvements that might be claimed from such a change to the rule (though we are sceptical of the materiality of any such improvements) would clearly be more than offset by the deep difficulties in practice of identifying "complementary functions" and a "cohesive business operation". Further, and again as a practical matter, we consider that the vagaries of the terms of this proposal would in practice mean that tax authorities would seek to apply the rule far beyond the circumstances for which it is presumably intended.

Option J avoids using the problematic words referred to in the paragraph above but in our view does not sidestep the practical difficulties of identifying the circumstances in which the proposed rule is intended to operate.

For the above reasons we think the anti-fragmentation proposals should be dropped from the package.

4. Splitting up of contracts

At a policy level, we recognise the objectives of seeking to prevent abuse of the Art 5 (3) rule which are reflected in option K. However, we are concerned about the imprecision of the rule which is proposed, especially in relation to its potential for unintended collateral damage without further amendment. To avoid this result we would suggest tightening up the reference to "activities" in the proposed paragraph (b) in option K so that the requirement is for the same type of activities as are referred to in paragraph (a) of option K. The explanation of the provision would also be assisted by the inclusion of examples. We also favour the proposal in the Discussion Draft for the addition of an exception "unless it is established that obtaining the benefit of paragraph 3 is not one of the principal purposes for carrying on these activities through different enterprises".

We believe it preferable to deal with all of the PE provisions in Art 5 itself and accordingly we do not support option L.

5. Insurance

We see no basis for singling out the insurance sector for special treatment (nor is any rationale for the singular treatment proposed contained in the Discussion Draft). We therefore do not support option M. Option N would avoid this discriminatory treatment and put insurance business on the same footing as other businesses and in our view is therefore clearly preferable.

6. Profit attribution to PEs and interaction with action points on transfer pricing

The Discussion Draft itself recognises the importance of profit attribution issues to any decisions to be made on rule changes in Art 5; yet there is no significant discussion of profit attribution issues in the Discussion Draft. Rather, the Discussion Draft seems to proceed on the basis of an assumption that: there are greater profits to be attributed to PEs than would be the case with a corresponding transfer pricing result (for instance, this assumption seems to be reflected in the example in paragraph 7 of the Discussion Draft). However, very often this will not be the case (due to the absence of SPFIs or
KERTs). Our concern is that, without a great deal more clarification, needless PE attacks by the tax authorities will be encouraged in practice by the proposals in the Discussion Draft on the basis that tax inspectors will automatically assume that the PE changes must lead to greater profits attributable to a PE since why else would the OECD wish to sponsor the change?

We also have more fundamental concerns with the consequence of a sharply increased use of the profit attribution rules. Based on our experience of dealing with these rules around the world (and including especially in the financial sector for which these rules were initially developed) we consider that the highly complex rules simply cannot bear the materially increased weight which would follow from a lowered PE threshold in a multitude of specific cases. The attribution rules are too vague and subjective to support their application in the very large number of cases which would arise in practice as a consequence of the proposals in the Discussion Draft. We consider this is a further compelling reason to limit the proliferation of PEs to instances where there are sound policy reasons to require the recognition of a PE.

Yours sincerely

Richard Collier
Partner
PricewaterhouseCoopers LLP, London

cc Stef van Weeghel, Global Tax Policy Leader

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Dear Ms. de Ruiter,

**BEPS Discussion Draft: Preventing the Artificial Avoidance of PE Status - Possible Impact on the Aircraft Leasing Sector**

We welcome the opportunity to comment on the above document, issued on 31 October 2014, and in particular on the likelihood of it unintentionally impacting the strategically important aircraft leasing sector.

1. **Aircraft Leasing - Global Operating Model**

   In tandem with the current surge in demand for commercial aircraft, which is expected to continue strongly over the medium to long term with the growth in passenger numbers globally, the aircraft leasing industry is expected to continue to expand its international reach.

   This is a cross border industry with a global operating model and aircraft lessors must comply with the tax rules and legislation of multiple jurisdictions. Aircraft lessors are very cognisant that relevant thresholds or conducts cannot be breached if they are to avoid / minimise triggering tax liabilities or filing requirements in the lessee’s country of residence. For instance aircraft leasing companies typically have marketing personnel travelling to local countries engaging with airline customers. They would not normally possess the authority to conclude contracts. This is not necessarily tax driven. Given the nature of such negotiations, which involve a relatively small number of very high value transactions, the approval process for a deal will go through an extremely rigorous procedure involving senior personnel based outside that local country.

   As detailed below, fundamental changes to the PE rules, or the introduction of a lack of clarity surrounding same, may result in the consequence of creating a taxable presence for aircraft lessors in multiple jurisdictions where they do business but do not have any physical presence. We would assume that was not the intended outcome of the Action Point 7 Discussion Draft.
2. **Section A – Artificial avoidance of PE status through commissionaire arrangements and similar strategies**

We are aware that commissionaire arrangements have been a concern to a number of tax authorities for a number of years and are now a target of the BEPS project. Such structures are not used in the aircraft leasing industry and although the Discussion Draft does not seek to directly target the sector, the paper will, nevertheless, be of material relevance to aircraft leasing operators and will introduce real risks of collateral impact via its proposed changes to the rules surrounding the PE status of an entity.

As noted earlier aircraft lessors typically limit the work of personnel engaging with airline customers in local countries to merely discussing broad contractual terms in principle. The ultimate decision to approve and conclude a contract with customers is usually taken elsewhere. We are concerned that a consequence of the proposals will almost certainly be that more employees fulfilling marketing roles, will be treated as PEs of their principals, leading to a material shift in taxing rights from residence to source states.

The current OECD commentary on the conclusion of contracts and the generation of a PE states that the mere fact that a person has participated in negotiations in a State between an enterprise and a client should not be sufficient to determine that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The Discussion Draft is therefore a large departure from the OECDs own previous commentary on the authority to conclude contracts on behalf of an enterprise.

For the aircraft leasing industry, this additional focus and attention on the conclusion of contracts raises unwelcome, and probably unintended, consequences with the risk that the current operational approach of airline lessors may result in the triggering of PE’s in multiple jurisdictions. The proposed alternatives in the Discussion Draft present different approaches to dealing with the perceived problems with the current drafting of PE rule. Although, the current rule is open to interpretation depending on the particular circumstances, the proposed amendments to the wording do not appear to provide more clarity.

The overall approach of lowering the threshold below the “concluding contracts” test is likely to widen the scope of the rule and introduce greater subjectivity when determining whether a PE exists in a particular scenario. The current drafting seems to go far beyond the “commissionaire” model and potentially impact a wide range of business models that make direct sales or provide sales support. In the absence of material amendment, we envisage collateral impact will result from the proposals. For example, it may be expected that a potentially very wide range of sales or support staff (such as those conveying standard “list prices”, providing client relationship services, marketing agents, etc.) will all fall within the scope of the amended rules proposed.

We would expect significant uncertainty will be created if the proposed changes are adopted as currently worded. For all of the proposed options there is a significant lack of any guidance on interpretation of changes with an absolute need for detailed examples and guidance to be agreed before any changes are decided on.
We believe it would be helpful if detail on those activities, which would not be regarded as meeting the “conclusion of contracts” threshold, were listed in Article 5 of the model tax convention. In relation to dependent agents acting in country on behalf of an aircraft lessor, activities such as:

- provision of marketing materials;
- provision of price list information;
- discussion of various specification options available;
- solution proposals based on customer requirements;
- tailoring options to customer requirements and providing costings of same;
- explanation of the method of payment, frequency and the set finance costs;
- responding to potential customers requests for information;

should not meet the threshold of the definition of “concluding contracts”. Therefore we would request that such detail (although it is not exhaustive) be included in Article 5 to clarify those activities which would not be regarded as meeting that definition. Absent this the result of the suggested change is that the PE threshold will become very low and thus will lead to a significant increase of compliance expenses. The purpose of a tax treaty is to facilitate and encourage the trade between states and this change is counterproductive from that perspective. Such compliance expenses may outweigh the benefits of current business models.

3. **Section B – Artificial avoidance of PE status through the specific activity exemptions**

**Section B.4 – Fragmentation of activities between related parties**

The anti-fragmentation rules proposed in the Discussion Draft raise a number of concerns. The lack of clarity surrounding the explanation of the terms could firstly result in tax authorities seeking to implement the rule far beyond the scenarios we assume it is intended.

Many aircraft leasing companies conduct their operations in jurisdictions where they may also have local “affiliate” group entities. These companies provide support services to the leasing operations, with no involvement in the negotiation or conclusion of the lease contract itself.

The changes as proposed in the discussion draft would penalise leasing companies who operate in this manner. The current operating structure has real commercial basis, as it avoids the business requiring the services of a 3rd party or competitor and the potential commercial sensitivities that such a scenario could produce.

For the above reasons we think the anti-fragmentation proposals should be excluded from the Action Point.

4. **Section E - Profit attribution to PEs and interaction with Action Points on Transfer Pricing**

It is encouraging that the Discussion Draft highlights the importance of profit attribution issues to any changes in Art 5. However, there is a notable lack of discussion on the point of profit attribution within the paper.
The Draft assumes that greater profits would be attributed to PEs as opposed to the outcome of an appropriate transfer pricing assessment, which clearly is not always the case. Without further clarification, tax authorities may be encouraged to argue for the existence of a PE on the grounds that this would lead to greater taxable profits being attributed to that jurisdiction than would otherwise be the case. We would therefore see a risk of misguided increased scrutiny in the area, resulting in increased uncertainty with significantly more disputes among tax authorities, who are already struggling to deal with the huge increase in MAP cases in recent years. The outcome will be to create extra PEs with very little (if any) profits attributable to them. In many cases there may be minimal additional tax being paid in the country where the new PE is located. In some cases a tax burden may simply shift from a related party in the same country. Additional administrative and compliance obligations will be created for businesses as a result of these extra PEs with potentially significant risk management issues for businesses due to the uncertainty around whether PEs exist.

Please feel free to contact me (at 00 353 1 7926359 or enda.faughnan@ie.pwc.com) if you would like to discuss this submission further or if you would like us to provide you with any clarifications or elaborations.

Yours sincerely

Enda Faughnan
Partner
PricewaterhouseCoopers Ireland
Comments on the Public Discussion Draft
BEPS Action 7:
Preventing the Artificial Avoidance of PE Status

January 8, 2015

Mrs. Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
By email: taxtreaties@oecd.org

Madam,

With the Holiday spirit still among us, we are pleased to briefly comment on public discussion draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status (the paper) through the consultation taking place from October 31, 2014 to January 9, 2015.

This document may be posted on the OECD website. Full credit goes to Robert Robillard, RBRT Transfer Pricing. ¹

1. General comments

1.1. Contrary to the assertion in paragraph 10 of the paper, our professional practice, both in the public and private sectors, demonstrates that commissionnaire structures and similar arrangements may in fact be warranted by various commercial situations and circumstances.

1.2. In that light, like any other controlled transaction or arrangement, these structures should be considered with regard to the comparability analysis as per Chapter I of the OECD Transfer Pricing Guidelines, that is, the functional analysis.

1.3. Special attention should be given to the economic circumstances surrounding the transaction or arrangement which include, among other things, the regulatory environment.

1.4. Commissionnaire structures and similar arrangements help minimize in numerous cases the amount of investments required to penetrate a new market.

¹ Robert Robillard, CPA, CGA, MBA, M.Sc. Economics, is the Transfer Pricing Chief Economist at RBRT Transfer Pricing (RBRT Inc.) and also Professor at Université du Québec à Montréal; 514-742-8086; robert.robillard@rbrt.ca. He is a former Competent Authority Economist and Audit Case Manager at the Canada Revenue Agency.
1. In other cases, they enable a significant lowering of the cost of capital of the firm.

2. General comments on options A-D

2.1. Options A to D in the paper (ref.: A. Artificial avoidance of PE status through commissionnaire arrangements and similar strategies) would not lead to an efficient resolution of the purported problem.

2.2. The design and implementation of business contracts are complex fields where commercial considerations must meet with legal and regulatory requirements.

2.3. As such, we fail to see how the suggested language changes in Article 5 of the OECD Model Tax Convention would enable any meaningful modifications in the reasoning of any domestic tax court.

3. Specific comments on option E

3.1. Option E in the paper (ref.: B. Artificial avoidance of PE status through the specific activity exemptions) proposes a set of welcomed modifications.

3.2. There is indeed little doubt that the activities listed in Article 5(4) should be reviewed in light of the digital economy.

3.3. Activities which comprise the digital economy are much more than ancillary in nature for numerous businesses. For more than 20 years already, they have allowed small, medium and large businesses alike invaluable commercial opportunities.

3.4. However, the Authorised OECD Approach (AOA) included in the Report on Attribution of Profits to Permanent Establishments should also be updated. 2

3.5. This would help create greater certainty and consistency on the matter.

4. Conclusion

4.1. Apart from the proposed changes in the paper, let it be written that as long as countries will tax commercial transactions differently under their transfer pricing and customs regimes, a significant part of the alleged problem will remain in place.

4.2. Canada like most of the industrialized countries is a proud member of the “twin taxation club” as it pertains to transfer pricing and customs purposes.

4.3. The transfer pricing legislative provisions are, for the most part, included in section 247 of the Canadian Income Tax Act. But sections 44 to 56 of the Customs Act throw the proverbial wrench in any possible converging approach with its own “methods” and “rules” to determine the “transactional value”.

4.4. In the end, for the sake of taxpayers of all sizes and shapes, would it be too much to ask for rule-clarity and rule-cohesiveness before the implementation of “enhanced” rules?

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January 8, 2015
Dear Mrs. de Ruiter,

Please find below the comments of RBS RoeverBroennerSusat GmbH & Co. KG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft ("RBS RoeverBroennerSusat") on the public discussion draft regarding "BEPS Action 7: Preventing the artificial avoidance of PE status" issued on 31 October 2014 ("OECD Discussion Draft"). RBS RoeverBroennerSusat acts as tax advisor and auditor of small and medium sized entities ("SME") as part of the German mid cap market (Mittelstand). Thus, the focus of these comments is set on the impact of the OECD Discussion Draft for SMEs. Consequently, we did not comment on every single aspect of the OECD Discussion Draft.

A. Commissionaire Arrangements and Similar Strategies

The working hypothesis held by the OECD, namely that commissionaire arrangements and similar arrangements were often put in place primarily to erode the taxable base of the State were sales took place, should be further substantiated. It has not been established to what extent these strategies contribute to BEPS – please refer to our respective comments on BEPS Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it.

While the suggested amendments generally appear suitable to prevent the artificial avoidance of PE status – see comments below – more consideration should be given to the fact that the bulk of commissionaire arrangements will generally be in line with the relevant economic circumstances. Particularly for SMEs, commissionaire agreements often constitute a sensible strategy to expand their business and to enter new markets. The alternative wording of Art. 5 Para. 5 and 6 OECD-MT outlined in the

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OECD Discussion Draft (letters A to D) amounts to a significant widening of the PE definition.

Additionally, some provisions seem rather vague

- It will be hard to establish a clear delineation of the extent to which a person may interact with customers before the actions are deemed to result in the conclusion of contracts. For SMEs, the alternative formulations increase the risk of establishing a PE as an unintended consequence of cross border activities.
  
  o It should be specified what economic functions are included in the term “engaging with” (Para. 5, Option A). Here Option B generally appears preferable as “concluding” or “negotiating” are less ambiguous.
  
  o Similarly the term “specific persons” should be specified, e.g. persons with the authority to conclude contracts (Para. 5, Option A).
  
  o It should also be clarified what elements of a contract are considered to be “material” (Para. 5, Option B).

- A clear definition of “transfer of ownership” should be integrated. It should further be clarified that economic considerations take precedence over respective legal formalities. Further, it should be clarified that ordinary legal structures, for instance, an agreement of title retention (so-called “Eigentumsvorbehalt”){1}, which usually parties agree on to deal with insolvency risks of intermediaries do not establish a PE.

- The notion of “acting exclusively or almost exclusively” (Para. 6) should be further substantiated. This concretization seems to be of high importance because all proposed options have in common that the requirement of “independence” should be strengthened. Based on our experience in German social security law with an ongoing discussion regarding the determination of terms like “independence” and “exclusive or almost exclusive acting”{2}, we recommend the implementation of clear and well-defined requirements. Otherwise we see the risk that the application of the OECD-MT takes place in an inconsistent way which could even contravene German constitutional law.

- The concept of “associated enterprise” (Para. 6) is not consistently defined in double tax treaties and may potentially widen the scope for applying PE regulations; please find detailed comments below in the context of the fragmentation of activities between related parties.

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1 For additional information about the German concept of title retention see Westermann, MüKoBGB, BGB, Sec. 449, Nr. 1 et seq. and Nr. 80-96.

2 Under German social security law it is controversially discussed whether a person is subject to social security contributions (i.e. pension insurance, health insurance and unemployment insurance) if this person works to a material extent for one client, even though this person acts as unemployed freelancer pursuant to German labor law. This discussion shows the necessity of unambiguous terms with respect to the definition of the “exclusively or almost exclusively acting on behalf of one enterprise”. As reference to the so-called phenomenon of “Scheinselbstständigkeit” see Köhler, GWR 2014, 28 et seq. with further references.
When widening the definition of the term PE, the OECD should thus duly consider possible adverse effects on SMEs, including an increase in administrative burdens as well as an increase of legal uncertainty. The OECD should further devote additional attention to outlining general guidance in respect to documentation and related requirements. In this context, it should be evaluated whether so-called safe harbor clauses or de minimis provision could be adopted in order to minimize additional compliance burdens. For SMEs such provisions are highly relevant, as the lack of corresponding thresholds translates to additional documentation requirements when establishing a PE opposed to establishing a legal entity.

Considering the widening of the term PE, one measure to strengthen the tax payer’s position might be the shift of the burden of proof to the tax administration within Art. 5 Para. 6 OECD-MT with regard to the application of the “ordinary course”-clause.

B. Artificial Avoidance of PE Status through the Specific Activity Exemptions

In the following we are pleased to provide a brief overview of the different approaches discussed within the OECD Discussion Draft (see 1.). Subsequently, we will comment the various approaches (2.). Finally, we will try to conclude on the preferable alternative (3.).

1. In general

The OECD Discussion Draft outlines different approaches to combat artificial avoidance of PE status with regard to activity exemptions set by Art. 5 Para. 4 OECD-MT. Below we will discuss these approaches, namely

a) the application of “preparatory or auxiliary character” to all subparagraphs;

b) the deletion of the “delivery”-alternative provided by subparagraph a) and b), the deletion of “purchasing goods or merchandise” provided by subparagraph d) or, alternatively, the deletion of subparagraph d) in total;

c) the reference to and implementation of an amending paragraph 4.1 combating so-called “fragmentation of activities”

2. Focus on the individual approaches

a) Application of “preparatory or auxiliary character” to all subparagraphs

Art. 5 Para. 4 OECD-MT deals with preparatory and auxiliary services not constituting any PE in the understanding of Art. 5 OECD-MT. The background of the exemption of preparatory and auxiliary services is that (i.) mainly profit generating functions executed in a respective jurisdiction should be taxed and (ii.) the determination of the profit to be aligned with the respective services is rather difficult. The German Federal Tax Court classified Art. 5 Para. 4 OECD-MT

Vogel/Lehner, Commentary on DTT, 6. Version, Art. 5, Nr. 85.

OECD-Commentary, Art. 5, Nr. 23.
as superior to the general determination of a PE (*lex specialis*). Thus, based on this ruling it seems fair to argue that the performance of preparatory and auxiliary services should by intent not constitute any PE.

The current definition of preparatory and auxiliary services comprises two elements:

(i) the character of the services executed have to be of a preparatory and auxiliary character,

and

(ii) the services should only be performed for the use of the enterprise.

The performance of the services for the benefit of third parties (not for the head office) would result in the reclassification of the services into the main activity of the PE and not solely of preparatory and auxiliary character. Consequently, the exemption of Art. 5 Para. 4 OECD-MT would not apply and a PE would be constituted.

However, with regard to the current definition of preparatory and auxiliary services discussed above it seems to be unclear whether those services shall be solely defined by the kind of activities performed or also by the volume of the activities. Following the OECD-Commentary it is decisive "...whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole." Consequently, it could be argued that activities classifying as an essential part of an enterprise’s business could not be seen as preparatory and auxiliary services independent from the kind of services performed if their volume exceed a certain quantitative extent (see also above). However, such a view is not free from doubt.

In case of the total adoption of Option E (Amend Art. 5(4) so that all its subparagraphs are subject to a “preparatory and auxiliary” condition), the definition of “preparatory and auxiliary services would apply to Art. 5 Para. 4 OECD-MT in full. Hence, in such case every service performed for the benefit of a third party will constitute a PE irrespective of the kind and the volume of the services performed.

Thus, to proceed we propose in a first step the clarification of the character of preparatory and auxiliary services in a way free from any doubt, in particular, whether solely the kind of services is the decisive item or also the volume.

Moreover, if the volume of the services should not be relevant for every single activity of a certain character will constitute a PE with the respective tax compliance obligations. Therefore,

5 BFH, 23.01.1985, I R 292/81, BStBl. II 1985, 417.
6 OECD-Commentary, Art. 5, Nr. 26.1; Vogel/Lehner, Commentary on DTT, 6. Version, Art. 5, Nr. 94.
8 OECD-Commentary, Art. 5, Nr. 24; see also German Federal Ministry of Finance, 24.12.1999, BStBl. I P. 1076, Nr. 1.2.1.1.
with the aim to promote cross border business activities this provision has definitely to be extended by a de minimis clause (amount still to be determined) to avoid that cross border activities will be reduced due to the relating tax compliance costs.

b) Deletion of the “delivery” provided by subparagraph a) and b), deletion of “purchasing goods or merchandise” provided by subparagraph d) and deletion of subparagraph d)

In deviation to Option E, which focuses on Art. 5 Para. 4 OECD-MT in toto, the Options F- H deal with several BEPS concerns. While Option E provides for a sound approach, the Options F - H seem to be an unsystematic punctual repair considering BEPS concerns as solely certain aspects are corrected.

Further, with respect to subparagraph b) of Art. 5 Para. 4 it could even be argued that the maintenance of a stock of goods or merchandise does per se not fulfill the preconditions of a PE itself.\(^\text{10}\) The stock itself does not create the fixed place of business as necessary element for the creation of a PE.\(^\text{11}\) Therefore, a deletion of the word “delivery” in this subparagraph may not help as a PE would not be created anyhow.

The political intention that a large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online qualifies as PE is understood.\(^\text{12}\) However, for SMEs as part of the German mid cap market it is decisive that the volume of the services performed is considered and a de minimis provision (amount to be determined) is implemented.

c) Fragmentation of activities between related parties

We appreciate the proposed amendment of Art. 5 Para. 4 OECD-MT addressing the fragmentation of activities. In contrast to the approach already proposed by the OECD Commentary, the OECD Discussion Draft goes further and promotes a mechanism which also covers the fragmentation of activities between related parties. The OECD Transfer Pricing Guidelines\(^\text{13}\) contain wording referring to Art. 9 OECD-MT, which could be seen as borderlines for the definition of “associated enterprises”.\(^\text{14}\)

In a case, where the respective double tax treaty does not comprise any clear guidance the general rule – laid down in Art. 3 Para. 2 OECD-MT – applies. This provision rules that any term

\(^{10}\) Vogel/Lehner, Commentary on DTT, 6. Version, Art. 5, Nr. 88.

\(^{11}\) Wassermeyer, Commentary on DTT, OECD-MT, Art. 5, Nr. 163.

\(^{12}\) OECD Discussion Draft Nr. 18.

\(^{13}\) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. 22.07.2010.

\(^{14}\) For purposes of the OECD Transfer Pricing Guidelines, an “associated enterprise” is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if “the same persons participate directly or indirectly in the management, control, or capital” of both enterprises (i.e. if both enterprises are under common control).
not defined in the respective double tax treaty shall, unless the context requires otherwise, have the meaning that it has according to the tax law of that state.

For German tax purposes the definition of a related party (which could be seen as similar to associated enterprise) is laid down in Sec. 1 Para. 2 AStG (Foreign Tax Law – Außensteuergesetz)\(^{15}\), stating that a party is related to a taxpayer where

i) the party holds a direct or indirect ownership interest in the taxpayer of one fourth or more (a substantial ownership interest) or is able to exert direct or indirect control over the taxpayer, or conversely, the taxpayer holds a substantial ownership interest in the party in question or is able to exert direct or indirect control over this party, (Sec. 1 Para. 2 Nr. 1 AStG) or

ii) a third party holds a substantial ownership interest in both the party in question and the taxpayer or is able to exert direct or indirect control over both, (Sec. 1 Para. 2 Nr. 2 AStG) or

iii) when agreeing on the terms and conditions of a business relationship, the party in question, or the taxpayer, is able to exert influence extraneous to the business relationship on the taxpayer, or on the party in question; or either of them has an interest of its own in the generation of income by the other (Sec. 1 Para. 2 Nr. 3 AStG). The German professional tax literature also comprises parties which could be economically influenced as related party in this sense.\(^{16}\)

Groups are more and more structured in a way that the individual functions (e.g. production, sales and purchase) are separated into different entities due to business or legal considerations.\(^{17}\)

In the event the current proposals will be implemented in the OECD-MT, SMEs as members of the German mid cap market might not be able to initiate business activity in another jurisdiction by engaging or co-operating with a contractor without risking the establishment of a PE if this contractor already has implemented a business of economically importance.

Thus, we strongly advise to shape the Options I - J in a way that the collateral damage due to the excessive scope of these Options will be restricted.

3. Conclusion

A regulation solely exempting the activities indicated in Art. 5 Para. 4 OECD-MT if these services inherent a preparatory and auxiliary character seems the most systematic approach. But this proposal has to be completed by a pragmatic *de minimis* provision (amount to be determined) avoiding the risk that every single activity could create a PE in a foreign jurisdiction.

\(^{15}\) Translation see KPMG, German International Taxation.

\(^{16}\) Blümich, AStG, Sec. 1, Nr. 69.

\(^{17}\) See also on this topic Ropohl, DB 2014, P. 2673.
Moreover, in addition a grandfathering rule for PEs already implemented to allow the respective entrepreneur to reshape their business model to the new wording of the tax law has to be added to avoid immediate harmful consequences for SMEs as part of the German mid cap market.

C. Splitting-Up of Contracts

We understand that the intended splitting-up of contracts between different entities to avoid the creation of a PE has to be tackled.

However, Option K again contains the not clearly defined expression “associated enterprise”. Thus, with respect to this topic we would like to refer to our comments above.

Further, the intended implementation of a de minimis provision in this Option is definitely a good move for SMEs as members of the German mid cap market. The negative impact of such alternative would be that also circumstances triggered by the business model of the respective group would be covered by this alternative due to the wide coverage of this provision.

In contrast to this, Option L solely covers tax-motivated circumstances while excluding situations with a legitimate business purpose.\(^\text{18}\) Thus, from our perspective the adoption of Option L is preferable.

E. Profit Attribution to PEs and Interaction with Action Points on Transfer Pricing

As pointed out above, commissionaire arrangements that are in line with the relevant economic circumstances do not give rise to transfer pricing issues. Thus allocating limited profits to a group member that performs the functions and bears the risks typically associated with a commissionaire will generally reflect an arm’s length remuneration.

The work on other BEPS Actions facilitates a closer alignment between profit allocation and value creation. Hence, we concur with the preliminary finding presented by the OECD, namely that no substantial changes are required to specifically address guidance on profit allocation to PEs. In this context, a distinct prioritization should be devoted to provide further guidance on the implementation of the AOA instead.

\(^\text{18}\) OECD Discussion Draft, P. 23.
We remain at your disposal for any further discussion of these issues.

Yours sincerely,

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Dear Marlies,

Public Discussion Draft on BEPS Action 7: Preventing the artificial avoidance of PE status

We are writing in response to the OECD’s request for comments in relation to the Public Discussion Draft on BEPS Action 7: Preventing the artificial avoidance of PE status.

We wish to highlight some areas where there is a higher likelihood of unintended effects, as requested in the Executive Summary, with particular reference to some examples from the digital economy.

Reed Elsevier

Reed Elsevier is a world leading provider of professional information solutions. We operate across several professional market segments through five business divisions comprising of Elsevier, LexisNexis Legal and Professional, LexisNexis Risk Solutions, Reed Exhibitions and Reed Business Information. Reed Elsevier operates from more than 30 countries and employs approximately 28,500 people worldwide. Reed Elsevier is the world’s fourth largest provider of paid-for digital content and has customers in almost every country in the world.

Allocation of taxing rights

The preamble notes that the Action Plan stresses the need to update the treaty definition of permanent establishment in order to prevent abuses of the current threshold. This is clearly appropriate but, to the extent that the proposals result in wider reconsideration of the allocation of taxing rights between source and residence states, there is an increased risk of
double taxation in non-abusive circumstances unless there is a very clear consensus as to the precise detail of the new approach.

We appreciate that the Action Plan has stipulated that it is not intended that there should be a wider discussion of the allocation of taxing rights but the Introduction notes that “it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country via the internet, without having a taxable presence therein… questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits ….”. We raise a concern here because, in common with other digital businesses, we have customers in almost every country in the world and the very high risk of an increased incidence of double taxation will need to be addressed as well as the practicality of dealing with more than 180 tax administrations. We suggest that any expansion of the definition of permanent establishment should be carefully targeted at abusive cases so as to leave commercial arrangements outside the scope, particularly where the amount of profit that would be allocated is either indeterminable or very small. Tax administrations would be equally concerned about the disproportionate resources required to deal with such cases and consequential cross border disputes.

The Discussion Draft notes that there are particular features of the digital economy which expose the current definition to abuse. Our concern is that these same features, the ability to transact business in very large numbers of jurisdictions via the internet, with relatively little or no local activity, could result in the application of some of the proposals being subject to severe practical difficulties in non-abusive cases.

**Intermediaries**

There is a wide spectrum of cases between those where a simple service is delivered over the internet without much interaction with the customer and those where the scope, nature or choices available might be highly complex and require the provision of information to, and perhaps from, a potential customer. Sophisticated choices may need to be made as to precisely which content, services or functionality might be required. In the more complex cases, a digital service provider would need the support of a local representative to provide and collect information. In cases where the local representative is not authorized to conclude or negotiate material elements of the contract and where the limited services provided are appropriately remunerated, we suggest that there should be no permanent establishment. Again, this is a question of practicality and the facilitation of cross-border business in the digital economy. If the mere provision of information gives rise to a permanent establishment, the provider of a more complex service will be unable to serve customers anywhere without intractable questions arising as to the allocation of profit.
Example: a digital content provider enters into contracts with customers throughout the world, operating only from its residence country. Representatives visit potential and actual customers in the source country to provide information which will enable the customer to decide which particular items of content are required and with which frequency. The representative can show the customers examples by calling up web-pages and explain how the data is organized. The representatives do not have the authority to enter into or negotiate contracts or to do anything other than provide information. They should not be regarded as carrying on anything other than preparatory or auxiliary activities. The local representative should, of course, be appropriately remunerated.

This is essentially a practical concern in that to treat each case as giving rise to a permanent establishment would result in a taxable presence in almost every country in the world. It would be extremely difficult to calculate the amount of profit to be allocated to each jurisdiction and insurmountably difficult to avoid disputes and the consequential double taxation. We attach a copy of our letter of 14th April 2014 in which we set out the practical aspects of revenue and cost allocation for a global digital information provider.

In conclusion, we support those proposals which refer to the conclusion of contracts or the negotiation of material elements but not to those which would treat a permanent establishment as arising just on the basis of engaging with specific persons in a way that results in the conclusion of contracts (by the principal) unless there is a clear and specific exclusion for non-abusive cases.

**Collection of information**

It is proposed in paragraph 28 that the exception for the maintenance of a fixed place of business for the purpose of collecting information be removed to address concerns arising from abusive cases. Once again, a distinction needs to be made between cases where the collection of information is a core function of the enterprise, when it may be appropriate to regard the activity as more than preparatory or auxiliary and, on the other hand, cases where the collection of information really is of a preparatory or auxiliary nature. A functional analysis may be required but the exception should not be wholly removed because this would greatly increase the risk of disputes and double taxation. Instead it would be more appropriate to qualify it by reference to the “preparatory or auxiliary” test.

In our view, a key distinction is between a case where an enterprise is actually remunerated by its customers for collecting *particular and specified* information (e.g. a market research company) where the collection of information would be a core activity and, on the other
hand, a case where an enterprise collects information in order to put itself in a position to carry out its core activity (e.g. the publisher of an international catalogue of works of art collecting information about art works held around the world). In this latter example it would be wholly impractical to allocate profit to the collection of information about art works and, indeed, that information has little or no value until it has been consolidated and prepared for publication.

In some cases, information may be provided gratuitously to an enterprise. It is even more impractical to seek to attribute profit to a permanent establishment represented by third parties who are providing information gratuitously and in some cases even spontaneously.

Example: an enterprise publishes a widget manufacturing database which is used by widget industry customers throughout the world. Subscription agreements are entered into by the enterprise only in the residence country. It collects information from businesses throughout the world. There are no local representatives. Companies provide their information free of charge because they know that the databases would not be useful unless they were comprehensive. It is not possible to specifically value particular items of data. Because companies volunteer their information the enterprise has no control or foreknowledge of how much data will be provided or where the data will come from or, in particular, how valuable a particular item of data might be. It carries out quality control and other functions only in the residence country.

There is no practical way of attributing value to the provision of particular information from the various “source” countries. If the gratuitous provision of information in each jurisdiction is regarded as giving rise to a permanent establishment there will be insurmountable difficulties in revenue, cost and profit allocation and in many cases the amount allocated would, in any case, be trivial.

**Associated enterprises**

The Discussion Draft addresses cases where fragmentation results in activities which should constitute a permanent establishment being treated as preparatory or auxiliary. In cases where the fragmentation reflects a genuine commercial arrangement, where, for example, activities have been divided between legal entities in order to focus the business or to manage risk from a commercial perspective, it would not be appropriate to act in a way which, essentially, pierces the corporate veil.
Example: Most multi-national enterprises operate as divisions, each carrying on a discrete business or part of the business. We are no exception, each division operating a separate business, under separate management and with a separate operating structure. If one division has a local operating company in a particular jurisdiction it would be entirely inappropriate to treat the activities of another division as constituting a permanent establishment solely because the two companies are members of the same multinational group.

This is a particular concern for digital businesses where, again, one division might have a substantial local presence while another might remotely enter into contracts with local customers for the provision of digital services but not have a local presence, or, as described above, have local representatives which provide information but no more. To link the preparatory or auxiliary activity with the other, locally established, division simply because the businesses are associated would discourage even a modest level of activity such as that required to serve digital customers and thereby act as an impediment to the development of cross border trade.

Thank you for the opportunity to comment on these matters. We appreciate the work of the OECD in undertaking this analysis in what is clearly a complex area.

Kind regards,

Paul Morton
Head of Group Tax
Reed Elsevier Group plc
RE: Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy

We are writing in response to the OECD’s request for comments in relation to the Public Discussion Draft on the tax challenges of the Digital Economy.

Reed Elsevier is a world leading provider of professional information solutions. We operate across several professional market segments through five business divisions comprising of Elsevier, LexisNexis Legal and Professional, LexisNexis Risk Solutions, Reed Exhibitions and Reed Business Information. Reed Elsevier operates in more than 30 countries and employs approximately 28,500 people worldwide. Reed Elsevier is the world’s fourth largest provider of paid-for digital content.

We appreciate the serious efforts which have been made in the Public Discussion Draft to enquire into the underlying characteristics of the digital economy which cause difficulties in a tax context and to explore options for further consideration. We have focused our representations on the key practical issues for our businesses.

1. Challenges for international taxation
We agree, as noted in paragraph 2 of the Public Discussion Draft, that “the spread of the digital economy also poses challenges for international taxation.” Quite apart from concerns regarding BEPS, it is necessary and timely for the OECD to develop further guidance on the treatment of digital business models under double tax treaties and for transfer pricing purposes. There are difficult issues to be addressed but we believe that these can all be dealt with in the course of the on-going project on the chapter of the Transfer Pricing Guidelines on intangibles, as well as some revision of the chapter on cost contribution arrangements, and under the other BEPS action items. We feel that the key objectives, in addition to addressing the BEPS concerns, should be to provide clarity, to avoid uncertainty and to minimise the risk of double taxation.

2. BEPS concerns

Paragraph 122 of the Public Discussion Draft describes certain strategies associated with BEPS including minimization of taxation in the market country by avoiding a taxable presence, low or no withholding tax and low or no taxation at the level of the recipient. While these features may be associated with BEPS, there are clearly cases where there may be no local presence, no withholding tax or no taxation at the level of the recipient where BEPS is not a relevant consideration. It is essential to consider the full facts and circumstances.

Example: A digital information provider based in a European jurisdiction with a tax rate of 25% provides data to hospitals throughout the world. The company will have no presence in any country other than its home country, is providing a business service on which there should be no withholding tax (under OECD principles) and there is no taxation at the level of the recipient because these are mostly non-taxable publicly funded bodies.

The Public Discussion Draft identifies BEPS opportunities in relation to VAT in the case of remote digital supplies to exempt businesses. Importantly, however, this is only half of the issue. Where a business provides digital services to entities which are not subject to VAT it is very important that mechanisms exist whereby the recipient can claim appropriate treatment.

Example: In country X digital services are not currently subject to indirect taxation. A new indirect tax is introduced to ensure that the consumption of digital services is appropriately taxed and foreign suppliers are required to register. Hospitals have fixed budgets and are not able to recover all of their input tax because their outputs are partially exempt. They would now have to either pay the indirect tax to the foreign supplier, who registers and collects the tax,
or have to apply the reverse charge and account for the tax. Either way, they will have a reduced budget available for the actual services which they require. The solution is to provide a mechanism whereby the hospitals (and other publicly funded bodies e.g. Universities, Charities) are relieved from applying the reverse charge or the supplier is relieved from charging the indirect tax.

It is important to deal with this issue in a balanced manner so that as well as the BEPS concerns, the treatment of publicly funded bodies, where indirect tax on digital services is a real cost to their budgets, can be addressed. It is also important not to create distortion between the treatment for VAT purposes of physical goods and digital services e.g. print medical journal containing papers of the latest research into cancer treatment compared to an electronic equivalent.

3. **Tackling BEPS in the digital economy**

We agree that the other actions of the BEPS Action Plan will address BEPS in the context of the digital economy and we agree that this is a better approach than devising special measures for digital businesses. We comment in the following paragraphs on the options discussed in Section VII of the Public Discussion Draft. We consider that most of the options are likely to be unworkable in practice. However, recognising that solutions have to be found to the problem areas we then suggest an approach to applying existing international tax principles to complex digital business models.

We comment first on the option to recognise a permanent establishment where a digital business maintains a “significant digital presence” but conventional rules would indicate that it has no permanent establishment in the territory in question.

**Example:** A digital information provider, the taxpayer, based in a European jurisdiction with a tax rate of 25%, provides data to hospitals throughout the world. It meets the criteria set out in paragraph 213. A significant number of hospitals in a foreign jurisdiction subscribe for data services. The customers submit a signed contract to the European home office where they are signed by the taxpayer. As a matter of contract law the contracts are regarded as made in the European home jurisdiction. Substantial payments are made for use of the services.

If a digital permanent establishment is considered to exist two questions arise. How is revenue to be attributed to the permanent establishment and how are
costs to be allocated? Revenue could be allocated according to the country of origin. In other words revenues received in the European home country from customers in the foreign jurisdiction would be the starting point for the tax base in the foreign jurisdiction. The foreign jurisdiction would also need to be assured that revenues received by other legal entities within the multinational enterprise, but of a similar nature, were included in the calculation in order to avoid artificial splitting of revenue streams. This means that every taxing jurisdiction would need to have a full analysis of all revenues received by every entity in the enterprise. As a practical matter it would be quite challenging to agree on the segregation of revenues into relevant categories and then the allocation between jurisdictions.

In order to allocate costs it would be necessary to identify which categories of cost related to which categories of revenue, to identify appropriate allocation keys for each category of cost and to provide every tax authorities with a complete breakdown of costs so that they could satisfy themselves that the allocation was appropriate. The allocation key is likely to at least include the local proportion of global revenues. This would mean that the foreign jurisdiction would need to know the amount of revenues received from every country in the world, in this case there being nearly two hundred countries in which hospitals subscribe for data. Again, it seems extremely challenging to agree on the cost allocations without a great deal of difficulty. This presupposes that it has been possible as a practical matter to provide the potentially enormous quantity of information to every tax authority and that once received it has been possible for them to process the data.

Other difficulties arise. For example it may be possible for a hospital to purchase certain data directly from the supplier or, in the alternative, from intermediaries or agents in other countries. Would revenues earned from an independent agent in a third country be allocated to that country in taxing the digital enterprise or to the country in which the ultimate purchaser, the hospital, was based? If the answer is the country of the agent, the taxation of the revenue in that country rather than that of the hospital would clearly be a distortion. If the answer is the country in which the hospital is located, the compliance process would be even more tortuous.
This example is just one illustration of the extreme complexity, uncertainty and administrative difficulty which could arise from the recognition of a significant digital presence as a permanent establishment.

Other difficulties arise in relation to “virtual fixed place of business PEs” where, for example, a server is located. Leaving aside the difficulties of identifying which particular server carries out a particular function in the era of cloud computing, there would be scope for abuse or distortion, for example where traffic might be directed to servers in particular jurisdictions for non-business reasons.

Withholding taxes would create a number of difficulties. Withholding taxes cannot be calibrated to the profitability of a particular line of business so low margin businesses are likely to suffer significant disadvantages while high margin businesses might be insufficiently taxed. One consequence may be that contracts typically include “gross-up” clauses whereby the withholding tax is, in effect, borne by the consumer so that these become merely additional taxes on consumption rather than taxes on the profits of business activities through which the services are provided.

4. **VAT and indirect taxation**

There are difficult theoretical questions as to the appropriate balance between direct and indirect taxation which need to be carefully considered. At this point, we would simply suggest that the solution to BEPS is not to substitute additional taxes on consumption in place of taxes on business profits which have not been collected. It would be a reasonable presumption that, in any particular jurisdiction, consumption is already being taxed at a level which is felt to be appropriate.

5. **Application of the existing international tax principles to the digital economy**

We believe that the sound application of existing principles will provide a framework for the digital economy once further guidance has been developed to deal with difficult cases. We agree that value chain analysis and profit methods can be effective as indicated in paragraph 166 of the Public Consultation Document. Techniques that may be helpful include:

- Developing a model of a digital business by analogy with traditional businesses
- Functional analysis which recognises the relative contribution of small numbers of individuals who are responsible for key IP creation
- Accepting that where there is no physical presence in a jurisdiction, profits are not earned there for tax purposes.

Example: A company collects data on widget manufacturing and distribution and sells this data to manufacturers, distributors and consumers of widgets throughout the world. A manufacturer in Norway provides data free of charge to the company in the UK where the head of global widget research is based. He incorporates the data in his global database which is held on a server in the US. The software was designed by a team in the affiliated company in France and written by software engineers in the affiliated company in India. The data is sifted and tagged in the production centre in the affiliated company in the Philippines. The sales contracts are negotiated with global customers and entered into by the affiliated company in the Netherlands. There is a sales office in Tokyo which provides support to a customer in Australia which contracts directly with the Dutch subsidiary. The customer’s global head of widgets is on holiday in China when he downloads the latest data. Although he is on holiday he sees an immediate opportunity and telephones his head office and secures a valuable contract.

The tax treatment of the various activities can be ascertained by reference to the equivalent traditional business activities and a value chain analysis.

Norway: Although certain data originates in Norway the taxpayer has no activity in Norway and should not be taxed there. In the traditional environment the data might have been posted or faxed by what is clearly a third party. The collection of data in Norway is clearly valuable for the taxpayer but entirely outside his control.

UK: The head of global widget research is located here. This is where a large part of the value is created and should be taxed.

US: The servers are located here but this is a routine service for which a routine return is appropriate.

France: The software was designed here. A value chain analysis is required to determine how much value is attributed to the software and how much to the data.
India: Coding is a routine service and a routine return is appropriate. (If higher value functions take place here the transfer pricing analysis should reflect that).

Philippines: Tagging is a routine service and a routine return is appropriate.

Netherlands: The appropriate return will reflect the degree to which risk is assumed by the Dutch company and the functions carried on there.

Japan: The return will be appropriate to a sales support function.

Australia: The taxpayer has no activity in Australia and should not be taxed there.

China: Although the data was downloaded in China the taxpayer has no activity in China and should not be taxed there. It may not be apparent that the data was downloaded in China if the individual used his company’s VPN which would route the request for the data through the Australian customer’s servers.

The key principles that might be applied are:

- to identify in each jurisdiction the analogous non-digital business, taking into consideration the functions, assets and risks;
- to recognise, where relevant, that very small numbers of individuals might represent the heart of the value creation in a particular business (in this example, in the UK);
- not to apply a “force of attraction” principle to attribute additional value to routine or secondary activities where these are, in substance, routine or secondary in nature.

6. Specific comments

Is it possible to ring fence the digital economy?

No because every digital business is at least to some extent traditional and every traditional business is at least to some extent digital. It is not possible to identify a clear boundary.

Are there other key features?

In the digital economy, technology platforms are increasingly costly and are likely to be jointly developed by members of a multinational enterprise. Work is urgently needed to
update the Transfer Pricing Guidelines for cost sharing arrangements involving the joint
development of intangibles such as technology platforms. One area which requires
particular attention is that of assets which are developed over a long period of time where
the allocation of costs to a jurisdiction in which the asset is brought into use may take place
long after the original costs were incurred. There may be no mechanism for adjusting the
cost allocation once periods of assessment in the original jurisdiction are closed. Other
areas of difficulty include the identification of appropriate allocation keys where the
reasonably anticipated benefit is highly uncertain and the treatment of changes in ownership
interests or cost shares of cost-shared assets like technology platforms.

Are the Ottawa taxation framework principles still appropriate?

Yes.

Are there more compliance cost efficient alternatives?

Despite the difficulties in applying the arm's length standard in the digital economy, we
strongly agree with the OECD that the alternative of formulary apportionment would result in
a much higher degree of uncertainty and a risk of multiple double taxation. While it is difficult
to apply the conventional approaches to the digital economy it is even more difficult to devise
a satisfactory basis on which to allocate revenue and costs to all relevant jurisdictions on the
basis of formulary apportionment. This problem will be exacerbated by the way in which the
digital economy facilitates trade with larger numbers of jurisdictions than was possible in the
past. The traditional allocation keys of revenues, employees and physical assets are
extremely hard to apply in businesses where the revenues cannot easily be allocated to
jurisdictions, employees are highly mobile and there are no physical assets. Although it may
be difficult for tax authorities to agree the allocation of profits according to conventional
methodologies, it will be far more difficult for large numbers of jurisdictions to agree to the
outcome of formulary apportionment.

Paul Morton
Head of Group Tax
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COMMENTS ON THE OECD PUBLIC DISCUSSION DRAFT ENTITLED “BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS”  31 October 2014 – 9 January 2015

First of all, Repsol wants to thank the opportunity to comment on this Discussion Draft, released on 31 October 2014, which deals with preventing the artificial avoidance of PE Status. This Action 7 addresses the following issues:

1. Artificial avoidance of PE status through commissionaire arrangements and similar strategies
2. Artificial avoidance of PE status through the specific activity exemptions
3. Splitting-up of contracts
4. Insurance
5. Issues related to attribution of profits to PEs and interaction with Action Points on Transfer Pricing

REPSOL, a Spanish multinational company involved in the Oil and Gas sector, would like to comment some of the proposed changes to paragraphs 4 to 6 of Article 5 of the OECD Model, i.e. especially we are going to comment on “commissionaire arrangements”, “specific activity exemptions” and “splitting-up of contracts”. In this respect, the following facts shall be taken into account:
**Introduction:**

As it is well known, oil is a non-renewable natural source and will remain the primary source of energy worldwide for decades to come.

The whole value-chain of this business covers: (i) upstream for hydrocarbons exploration, development and production activities (ii) midstream/downstream for transportation of crude oil, refining and marketing activities, (iii) manufacturing and marketing of petrochemicals and liquid petroleum gas.

Vertically integrated oil companies are those that are involved in the whole value-chain activities we described before.

Repsol is an energy company, integrated and global, with a vast experience in the area, that carries out upstream (oil and gas exploration and production) and
midstream/downstream (transportation, refining, chemicals, marketing and liquid petroleum gas) activities. As an energy company, we are also exploring renewable sources.

i) UPSTREAM: Exploration and Production

Exploration and Production of hydrocarbons is characterized as highly intensive in capital investment with a low level of success in locating raw materials and therefore, with a high level of risk. The diagram below shows visually this reality.

This high risk / intensive investment profile needs to be managed through two main diversification policies: the constant analysis of a large portfolio of opportunities (to allow the incorporation of reserves which can be produced in the future) and the association with other industry competitors via Joint Venture Agreements for the operation of projects. Therefore, an Oil & Gas Company would typically develop its upstream activity together with other publics or privates, which become partners in risks, loses and profits.

The above, together with the fact that in the vast majority of the cases, Upstream projects are ruled by virtue of public contracts signed with the source state, leads to a basic contractual structure that is twofold:
First, Oil contracts are agreements concluded with the States where the investments are made and which enables the joint venture to operate; and

Joint Operating Agreements. Agreements concluded with companies (private or public).

From another perspective, in view of its different temporal phases, E&P activity can be divided in 4 different periods:

After the exploration process is completed (successfully), the facilities and evacuation systems are commissioned and a certain number of development surveys are completed, the production phase of the field of oil and/or gas starts. Contractually, this phase usually lasts between fifteen and twenty-five years, provided that the economic limit of the field has not been reached earlier. Throughout this time, new and/or improved assisted recovery techniques are applied to increase to the maximum the level of production and the final reserves recovered.

From the point of view of location of activities, it should be point out that, unlike other industries, oil & gas is a locus industry as these products are where they are. That means that we cannot choose where to operate and the activity has a strong nexus (i.e. connection) with the taxing State and, in particular, with the specific place or location where such activity is carried on. Besides, countries where natural resources are located decide which company - or companies - is going to develop the activity and in which area (known as block) the activity is going to be developed normally through an international bid round for one or more blocks or direct negotiation.

As a consequence of these specialties, companies normally operate in another country through multiple places of business within a country, performing similar activities. In this respect, each contractual block is deemed to be considered a separate PE form each other as long as there is no commercial or geographical coherence between them. That is, if they are at least separated from each other, they should be regarded as separate single “places of business”.
In this respect, petroleum contracts are signed with the State that enables the oil & gas enterprise to carry out its activities within a delimited area (block). Under this contract, the company has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities. The area is clearly geographically delimited and at the disposal of the enterprise. Therefore, each block is regarded as a separate PE, as many countries already recognize under its domestic legislation. It would be desirable that this statement is somehow recognized in the commentaries to the definition of PE. Anyhow, when a State characterizes a block as a PE, this characterization should be respected.

When we analyze the structure of companies involved in Oil and Gas business, it is very common that a joint venture agreement (JOA) is concluded with other companies to carry on activities in a block. Under this agreement one of the partners is designated the operator. The operator is responsible of contracting all needed resources to carry out the exploration and production (E&P) activities, while the other partners make cash contributions in proportion to their working interest in the joint venture and audit operator’s activities. When acting as an operator (and sometimes non operator), the company establishes an unincorporated coordination centre that provides support to various exploration and production blocks within the same jurisdiction. Typically, the main functions to be undertaken by the coordination centre include corporate functions, i.e. accounting, administration, finance, human resources, treasury, information and communication, technical support, and supervision activities.

Finally, sometimes, Oil & Gas companies also establish a representative office to search for new opportunities within the country or outside the country of operations.

ii) MIDSTREAM/DOWNSTREAM

The so-called midstream activities involve trading and transportation (by pipeline, rail, barge, oil tanker or truck), storage, and wholesale marketing of crude or refined petroleum products. Pipelines and other transport systems can be used to move crude oil from production sites to refineries and deliver the various refined products to downstream distributors. The main goal of Supply & Trading (S&T) undertakings in a vertically integrated oil and gas company is the purchasing and selling of products in international market because often oil companies do not refine their own products. Sometimes they do not distribute their own productions either. These mismatches are reduced by purchasing and/or selling crude oil, intermediate or end products in international markets.
Another aspect that is important to take into account is that crude oil-importing and producing countries are located in different geographical areas; therefore transportation is a key factor in this business.

a. **THE PETROCHEMICAL INDUSTRY**

The petrochemical industry works on obtaining chemical derivatives from petroleum and associated gases that, subsequently, are used by fertilizer, plastics, food, pharmaceutical, chemical and textile industries, among others.

The petrochemical products demand’s growth is mainly due to the replacement of traditional raw material by the new synthetic materials:

- **Textile industry**: Synthetic fibres to replace wool, cotton and new dyes which offer bigger possibilities than previously known pigments.

- **Rubber industry**: New products with the same properties and, sometimes, above the natural rubber ones.
Containers and packaging industry: Polyethylene, as an alternative to glass and cellophane in the production of plastics for the construction, due to its high corrosion resistance and inclement weather conditions and due to its light weight and flexibility.

Construction industry: Isolation, water distribution inside and outside the home, electrical cables, furniture and decoration are areas where polymers like polyethylene and polypropylene as well as materials such as polyurethane foams, both flexible and rigid, have an important role to play and have replaced traditional materials like wood, steel or concrete.

In a nutshell, the petrochemical business process is the following:

b. OTHER PRODUCTS.

Lubricants:

A lubricant is a product used between two mobile surfaces with the aim of reducing the friction between them and so improving the efficiency of mechanical process reducing its erosion. The lubricants are composed with a mix of lubricants base oils, minerals or synthetic, and additives that, depending on the final use, imply more or less technological complexes.
The most common application of lubricants is related to the protection of combustion motors in vehicles and industrial machines. This kind of lubricants contain between 80% - 90% of base oils and 10% - 20% of additives.

Additives reduce the friction and erosion of mechanical processes, provides better level of viscosity and improve the resistance against the corrosion.

The global market of the lubricants is a mature market with stable and continuous demand during the last 15 years. The main elements of the market during said period are the non-increasing of the demand, the drastic changes of the consumption, the aggressive competition between the suppliers and the pressure to drive the price down.

Nowadays, the worldwide demand is estimated on 39 millions of tons a year (10.4 millions of tons in European Union).

**Asphalts:**

The asphalt (technically, bitumen) is a hydrocarbon product derived from petroleum that is used to build roads.

As asphalt is mainly used to build roads, the developing of this market is directly related to regional business cycles. Therefore the demand increases during the expansive cycle and decreases during recessions. In this sense, data shows that the European market has fallen sharply during the last years.

**Specialties:**

The main specialty produced is sulphur which is obtained from the refinery process. Sulphur is intended for producing sulphur acid which is used to produce fertilizers.

Other specialties are the production of aromatics hydrocarbons and solvents.
**General remarks:**

The structure described implies that BEPS Action 7 may have an impact on the manner Oil & Gas companies have been performing its operations in foreign countries until now. A summary of REPSOL main concerns is described below:

We think that it is laudable that OECD makes efforts to tackle certain abusive schemes but it seems excessive to amend the Article in the manner proposed by the draft. Especially when:

- Despite the measures are aimed to specific cases, the measures proposed may affect a wide spread of taxpayers leading to unintended and collateral consequences that go beyond what can be currently anticipated.

- Action 6 already deals with treaty abuse issues and the specific issues identified by the OECD could better be covered by such Action rather than modifying Article 5 which may affect honest business structures already put in place since long time ago.

- The measures proposed will surely have as a consequence an increase of the number of PE that under the current rules have not been considered as such without any relevant problem. This will imply a higher level of burdensome compliance without a cost-benefit analysis about the increase of collection of taxes that derived therein. That is, it is uncertain if the overall costs of complying – a burden carried by taxpayers– will exceed the additional tax that countries would ever collect taking into consideration the type of activities under the scope.

- Also, unintended new double taxation issues will arise. No countermeasures are proposed in respect of the attribution of profits to PE or in respect of the Head Office. The proposal does not specifically address the attribution of profits to PE which in our opinion should have priority over other issues discussed under the OECD draft. Without having a clear view of how profits should be attributed to PE under the proposed amendments it is not really possible to address the real impact of such proposals.

- The aim of Action 7 seems to be taxing the creation of value wherever it occurs, but forgets that many of the preparatory and auxiliary activities are
recurring loss making activities and, therefore, it will create inconsistencies as value does not always corresponds with profits generated.

- As Oil & Gas project agreements are regarded as administrative contracts, national laws and regulations of the State concerned should be respected. Taxpayers involved in the Upstream industry lack any capacity to artificially split of fragment their activity since they are limited by the source state rules and public contracts.

- The introduction of subjective elements creates room for controversial interpretations over structures already being used, thus spreading uncertainty for taxpayer’s investments.

More detailed commentaries are summarized below in respect of each of the proposals:

1. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

OECD and countries should fight against fraud; and Repsol supports it. But it seems that Action 7 considers prima facie that in many cases commissionaire structures were put in place primarily to erode the taxable base of the State where sales took place. We believe that this assumption proves wrong in a majority of cases. Commissionaires structures and arrangements are legitimate ways of organizing a business.

Unlike previous OECD papers, different alternative options, sometimes very similar, are proposed in the draft. In respect of this subject, the OECD focuses on the wording of two concepts or tests: “concludes contracts” and “contracts in the name of the enterprise”.

- The point at stake is how to interpret the binding relationship between the agent and the principal in a commissionaire agreement. We think that there are differences between the common law and the civil law perspective. High courts in France (Zimmer), Norway (Dell) and Italy (Boston Scientific) have held that a commissionaire, who acts in his own name and under the applicable general law of a State that does not legally bind the principal, does not
constitute a PE\(^1\). Such decisions do not fit well under common law practice. It seems that the law ruling the contract shall be relevant in this respect.

- Binding relationship is considered to be the essential characteristic of the agency PE but the OECD seems to be willing to focus not on who is bound by the contract, but on what the object of the contract is. If the interactions with specific persons result in the conclusion of contracts, preventing situations with respect to associated enterprises, the negotiation of the material elements of contracts, if such contracts are on the account and risk of the enterprise, etc.

- As mentioned, Oil & Gas companies usually form joint ventures (JV) with other partners to share the risks of E&P activities. An operator is designed to be in charge of negotiating all contracts with the providers. However, there is scarcely a reference to this type of business alliances in the OECD Model. These strategic business alliances are complex and, probably, diverse in nature depending on the sector of activity.

- The fact that the operator of the JV concludes contracts in its own name, but might be consider that they have collateral effects on the non-operator’s parties as the risk of the project is shared between them, may lead to different interpretations as to what extend the operator is a dependent agent of the non-operators parties by virtue of the relationship created by the Joint Venture agreements.

\(^1\) In Spain, it is worth mentioning the Spanish Supreme Court decision on 12 January 2012, in the Roche case (Appeal number 1626/2008). In this case a Spanish affiliate (Roche Vitaminas, S.A. – RV -), which performed manufacturing and promotional activities at the request of a Swiss company (Roche Vitamins Europe Ltd. – RVE-), was deemed to be a permanent establishment (PE) of RVE. The Court held that, however RVE had not a fixed place of business in Spain as it only had at its disposal a warehouse rented by RV, from which RVE made sales of the products purchased to RV, RVE had a permanent establishment in Spain due to the manufacturing and promotional contracts signed with RV. In this respect, the Supreme Court stated that the manufacturing activity carried on by RV implied the developing of all the necessary means to market RVE’s products. Even though the manufacturing activity demonstrated that RV had no capacity to conclude contracts, the OECD Model and its Commentaries consider that the existence of a permanent establishment is also possible where other activities not involving “signing contracts” are performed. In this respect, the Supreme Court concluded that RV acted as a dependent agent of RVE, as the activity of RV: (i) was limited to the manufacture of products for its principal; (ii) following its orders (i.e. products to be manufactured, quantity, deadlines, price, etc.); and (iii) assuming the sole risk of not applying the quality parameters instructed by RVE.
Based on the above we consider that more explanation and examples in the commentaries, rather than modifying the article of the OECD Model should be provided.

In this respect, more than providing comments on the four alternatives proposed, we express our disappointment that the OECD has not provided clearer tax criteria about the widespread multinational use of joint ventures. Oil & Gas specialties should be taken into account when proposing to modify article 5 of Model Convention, as it is reflected in many bilateral treaties.

Furthermore, we strongly suggest the elimination of the proposal for paragraph 5.6. This proposal can have very bad unintended consequences. For example: it could be very important for a start-up business to achieve an exclusive or almost exclusive agreement with a MNE for the distribution of the multinational products. The adding of the wording “exclusively or almost exclusively” can take companies to look for existing operators in other countries instead of giving opportunities to new ones.

Another issue to bear in mind is that for business reasons it could be strategically convenience to have an independent agent acting exclusively or almost exclusively, for example if the agent is the best or one of the best in his field or if you are a vertically integrated company.

Anyhow, it is important to point out that the proposals do not change coherence and geographical interpretation of the article to consider a place as a PE. This observation could imply that a highly increase of the number of PE in a country.

2. Artificial avoidance of PE status through the specific activity exemptions

The draft examines four aspects of the Article 5.4 of the OECD Model, according to which a PE is deemed to exist where a place of business is used solely for activities listed in that paragraph:

A. First option: Make all of the activities currently listed as subject to the requirement of being “preparatory or auxiliary”,
B. Alternatively,
   1. Delete the “delivery” activity from the exemption in subparagraphs a) and b):
      a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

2. In respect of the exemption related to subparagraph d)\(^2\) it proposes two options:
   a) retain the exemption for collecting information but delete the exemption for purchasing goods or merchandise;
   b) remove the entire provision,

C. The final option, with is not really related to the above mentioned ones, is to introduce a preamble regarding the fragmentation between related parties.

With respect to Option A, we think that is already included in the commentaries and, therefore, would be unnecessary to modify the Article. In Spain some authors already consider the preparatory and auxiliary character applies to all the subparagraphs.

Regarding the delivery issue of B.1, it clearly is intended to narrow the scope of the use of warehouses. Something that is vital in the Oil & Gas industry that keeps oil stocks in many places. We think that deleting the word delivery is not a good solution if no definition of this concept can be found in the treaty. It seems difficult to imagine a warehouse without delivery of goods.

We think that this proposal could be better addressed if instead of deleting the delivery activity, a definition of the scope of this concept is provided by the commentaries to the OCDE Model.

In respect of the exemption related to option B.2 (subparagraph d of Art. 5.4), we consider that the Oil & Gas industry may rely on such exemption to collect information (market research) in other countries through what is called Representative Offices (Rep Offices).

As already mentioned Oil & Gas companies place people in Rep Offices in other countries. The purpose is to study the feasibility of entering into new Oil & Gas blocks or in other related new businesses. In some cases, they purchase data or goods to perform this activity. Sometimes the information gathered is not only related to the country where the Rep Office is established but also the region.

\(^2\) “d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise”. 
Many jurisdictions recognize the existence of these Rep Office that normally are exempted from certain mercantile or tax filing obligations as an ordinary permanent establishment may have to comply with. This is due to the fact that they consider that the activities performed does not created enough nexus to be considered as a permanent establishment and because of the restricted activities that Rep Offices are allowed to perform. It is note mentioning that no profit would derive from this Rep Offices taking into account the activities they carry out, but only losses.

**Therefore, we consider that this exception should be entirely retained as currently established.**

Regarding the final option C, fragmentation of activities between related parties, we are of the opinion as also it is mentioned in the OECD proposed draft, that the OECD already addresses this fact in paragraph 27.1 of the Commentaries.

However, the OECD seems to widen the fragmentation limitations. In this respect, the OECD draft explains that the anti-fragmentation rule would deny the application of the exceptions where (i) complementary business activities are carried on by associated enterprises at the same location, or (ii) by the same enterprise or by associated enterprises at different locations.

In respect of the first option, it mentions that a group of associated enterprises must have at least one fixed place of business that satisfies the PE threshold in a contracting state and the activities concerned must be “complementary functions that are part of a cohesive business operation”.

The second option is quite similar, but extends its application where none of the places to which it refers constitutes a PE but the combination of the activities at the same place or at different places goes beyond what is preparatory or auxiliary.

We consider that these options introduce a “force of attraction” that is contrary to the aim of the same OECD Model (a limited force of attraction could be found in the UN Model). The same paragraph 27.1 of the commentaries states that each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists.

Moreover, paragraph 5.1 of the commentaries to paragraph 1 of article 5 establishes the “coherent whole commercially and geographically” concept in respect of considering if more than one permanent establishment exist. This concept seems to be
overridden by the new and wider scope given to the “cohesive business operation” under the proposal introducing complexity to the application of the provision.

Oil & Gas companies normally operates in another country through multiple places of business performing similar activities or acting as service centres for the other places of business. We have considered that each of these places shall be independent permanent establishments for tax purposes (ring-fenced). The consequences of the proposal could modify this approach without undetermined effects.

Accordingly, we are of the opinion that the proposal should be not retained as it creates controversy and leads to unintended and collateral undetermined consequences.

3. Splitting-up of contracts

We consider that both the “automatic rule” and the “anti-avoidance rule” proposed are already covered under the Commentaries to the OECD Model. In any case, in our opinion the proposed “anti-avoidance rule” should be eliminated because of the uncertainty it provides. In relation with the anti-fragmentation proposal, as mentioned, is clearly in the Commentary. Paragraph 27.1 of the Commentary on Article 5 confines a taxpayer’s ability to fragment activities, providing that “[a]n enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.” Currently this statement applies only to multiple places of business of a single enterprise and only if the places are not “separated organisationally.” The Commentary notes, however, that “[p]laces of business are not ‘separated organisationally’ where they each perform in a Contracting State complementary function such as receiving and storing goods in one place, for example.

Nevertheless, the proposed anti-fragmentation rules would give tax authorities an unlimited power to re-characterise and combine legal entities (based in- or out-of-country) for purposes of attracting PE status to in-country activities. This would be the case even where such entities have been set up for valid business purposes.

Repsol fully agrees that splitting-up what in substance is a single contract into two or more contracts solely for purposes of avoiding the 12 month time threshold of paragraph 3 should be avoided. However, a rule that “automatically” combines activities of associated enterprises that take place at the same construction or installation site could ignore legitimate business reasons for conducting activity at the same site through separate entities. The limitation of the ability of tax authorities to
aggregate contracts only to cases where the splitting-up of contracts is tax-motivated, as is the case with Option L, would be preferable to aggregating any contracts that satisfy the conditions of Option K, whether tax motivated or not.

Anyhow, whenever the fragmentation of contracts is something that has been promoted by the State due to its own internal policy —for example when there are different blocks in different periods and in different bid rounds taken into account—, or when there are circumstances where entering into separate contracts is not under the sole control of the enterprise or is required by the nature of the work —the “automatic” rule of Option K, should be excluded.
Subject: Comments on the OECD Discussion Draft on BEPS Action 7: Preventing the artificial avoidance of PE status (October 31st, 2014)

Dear Mrs. de Ruiter,

On October 31st, 2014, the OECD published a public discussion draft on BEPS Action 7: Preventing the artificial avoidance of PE status and ask for comments.

We would like to take advantage of the invitation addressed to stakeholders and keep working on this project by submitting our comments on this draft.

Based on the above, we would like to thank you very much for your efforts and for the ongoing interest with which the OECD is working on this topic, as well as on the more general and ambitious BEPS Action Plan. We also truly appreciate having again the opportunity to participate in the future developments by providing you with our comments.

Please do not hesitate to contact us should you require any clarification on the following comments that are sent on behalf of Rödl & Partner.

Best regards,

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A. Preface

According to the Action Plan on Base Erosion and Profit Shifting “The definition of permanent establishment (PE) must be updated to prevent abuses. In many countries, the interpretation of the treaty rules on agency-permanent establishment allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by “commissionaire arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to permanent establishment status for preparatory and ancillary activities.”

According to the Public Discussion Draft on BEPS Action 7: Preventing the artificial avoidance of PE Status, page 11 (“the Discussion Draft”), marginal number 10 it “is clear that in many cases commissionaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place”.

We believe that the intended changes would exceed the objective of the BEPS action plan. In most cases the implementation of a commission or sales agent model has not tax reasons. The intended changes in the definition of a permanent establishment will lead to high administration burdens and bears the risk of disputes, how to determine the profit of a permanent establishment created by the implementation of a commission agent or sales agent structure. In the following we want to highlight the main aspects of this opinion and provide some thoughts on alternative solutions.

B. Commission agent and sales agent structures as general means for eroding the tax basis?

It is doubtful whether commission agent structures and sales agent structure are actually just put in place to erode the basis of tax assessment. Especially in cases, where the principal itself is not resident in a low tax jurisdiction, this accusation is not durable.

I. The new wording would include third party transactions

From our perspective an abuse is hardly possible, if it is performed by third party transactions (other than trusteeships, etc.). Therefore, it is not clear why the new permanent establishment definition shall also include third party transactions. In cases where sales activities are actually performed by people (e.g. via an independent entity) and not only by digital means the profit to be allocated to that activity should already reflect an appropriate share. Due to the sales function of (independent) third parties, the nexus for taxation should be at the level of that third party. It is not clear what additional functions (as basis for the determination of the permanent establishment profit) shall be allocated to the deemed permanent establishment as all sales functions in the respective country where performed by the third
party (as long as there is no additional personnel of the principal in the country present, in which the sale took place).
II. Economic reasons

Economic reasons for commission agent or sales agent structures are inter alia:

a) We observe that commissionaire structures were not implemented to erode taxable bases but to reduce the burdens of administration expenses mainly with respect to transfer pricing. In the opposite of distributor structures in which there is the need to establish and document transfer prices at least for each product an affiliated commissionaire would only have to determine and document an arm’s-length remuneration for a commission. Especially in cases of groups selling a lot of different products in a country (and the single products maybe are just sold irregularly) this approach decreases the extent of transfer pricing administration tremendously.

b) The local market is too small to be served by a fully-fledged sales organization. Therefore, third parties or affiliated entities cover small markets with just low volumes of sales. The erection of a fully-fledged distribution structure makes no economic sense respectively would in such a case lead to inefficiencies and thus would make the local market unattractive.

c) Customers want to contract with the parent company. Especially in investment goods economy with high prices of goods sold customers want to contract with the parent directly to reduce financial risks. Thus, sales agent structures are implemented due to customer reasons.

d) Unstable sales volumes (e.g. in project businesses) lead to high uncertainties for sales entities. Due to the fact that group entities will often just sale own group products (and not competitor’s products also) this exclusiveness would lead to a high volatility of profits (high losses in years of no new projects and high profits in years of new projects). Commission models granting a remuneration for the exclusiveness would decrease the volatility.

C. Determining the Permanent Establishment Profit and Administrative Burdens

Generally, the Report on Attributions of Profits to Permanent Establishments mainly uses the so called “Significant People Functions Approach”, which means that the profit of a permanent establishment will be determined by the functions performed by people of a permanent establishment. It is questionable whether there are additional functions to be allocated to the country in which the sales take place (country of the commission agent or sales agent) respectively how these functions could be identified, due to the fact that the local sales activities are rendered by the local commission agent or sale agent. Assuming arm’s-length conditions for the commission or sales agent’s remuneration, the profit of the permanent establishment should be zero (all local activities were already remunerated appropriately). It is therefore a question, if in case of business relations within a group of companies, whether the remuneration of the sales functions actually considered all functions and risks of the sales entity. Therefore, it should not be asked whether non-remunerated functions of the commission agent or the sales agents should lead to a permanent establishment and consequently to a permanent establishment profit rather than if the commission agent or sale agent was remunerated at arm’s-length (considering all functions performed and risks born by the commission agent or sales agent).
From our understanding, arm’s-length remunerations of a commission agent or sales agent will presumably lead to no or low profits of a deemed permanent establishment. The administration of a permanent establishment (i.e. allocation of profits, tax declarations, etc.) from our perspective will be disproportionate to the profits to be taxed.

As commissionaires or sales agents acting companies which are part of a group of companies in most cases are active as on an exclusive basis, i.e. such entities do not perform sales activities for competitors or independent principals. In all of this cases – irrespectively whether the commission agent or sales agent structure led to an erosion of profits – will create a permanent establishment. Although the profit of the permanent establishment will be low, there might be a high additional administrative burden for those entities, which have structured their business using commission agent or sales agent relation.

D. Conclusion

We believe, that the overwhelming majority introduced the commissionaire or sales agent structure not for tax but for economic reasons. Additionally, in many cases the principal is not seated in a low tax jurisdiction and the group of company is not doing aggressive tax planning.

The new definition of the permanent establishment would increase the administrative burdens to a high extent, because most of the commission and sales agent structures would lead to permanent establishments.

Arm’s-length remunerations for affiliated commission agents or sales agent or third party relations assumed, the profit of the permanent establishment should be zero at least be very low. The administration expenses to comply with the local tax procedures (determining the permanent establishment profit, tax declarations and returns, uncertainties towards double taxation due to different approaches to determine permanent establishment profits) will be disproportionate to the additional profits to be taxed. Especially in cases where the reason of implementation of a sales agent or commission agent structure was owed to the size of the market or the low individual sales volume the administration expenses will consume the profit achieved by the local business. Therefore, broadening the permanent establishment definition could have a big impact on the global distribution and competition and might threaten international activities especially of smaller and medium sized groups of entities. Taking into account the inefficiencies of authorities in developing countries, this might lead to a disadvantage for entities of developing countries doing business abroad.

E. Alternative Approaches to Reach the Aim of Action 7

From our perspective in many cases the main value creating function of the sales activity is the acquisition of new customers and the conclusion of contracts. From our experience, the most easiest and used way to artificially avoiding a permanent establishment is to avoid the right of a sales agent to conclude contracts in the name of the principal. Therefore, we agree to replace “conclude contracts” by
“engages specific persons in a way that results in the conclusion of contracts”. However, we refuse to additionally strengthen the requirement of “independence”. Instead, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD Guidelines”) should be concretized with respect to sales functions.

The existing rules and mainly the existing OECD-Guidelines already provide some means to prevent the shift of profits. It might be differentiated into following aspects. Firstly, the restructuring of existing distribution entities towards commissions agents or sales agents itself and secondly, the arm’s-length remuneration for the sales activities of a commission agent or sales agent. Finally, it could be asked if the actual function and risk allocation would have been agreed similarly between third parties in the situation to be assessed.
I. Restructuring

The restructuring of sales relations between third parties from full-fledged distributors toward a commission agent or sales agent just takes place if noteworthy economic reasons do require such a change. A third party distributor will not give up the future profit potential of its sales function. Only, if the new sales structure will provide him with a higher profit or if the principal offers him a compensation for the loss in future profits a third party distributor might agree to change the sales structure. Very often this compensation is justified by the transfer of customer base. In both mentioned cases there would be no erosion of tax basis.

Besides the exemplary comment there are additional possibilities to adjust the tax bases with respect to the restructuring itself.

II. Arm’s-length-remuneration

We agree that the commission agent structure is very often close to a full-fledged distribution structure. This is even more the case where a restructuring of the sales function (down-stripping of a distributor to a commission agent) took place. Thus, the profitability factors of the commission agent should not be based on costs (like in relation to a merely service provider) but on sales success comparable to that of distributors. Thus, it should be clarified that the functions performed and risks born by a commission agent are similar to that of a distributor and hence the profits should also be similar. The profitability of a commission agent should therefore be based on the external sales achieved (for his principal), like the profitability measure of a distributor. Alternatively, a commission payment could be closely be determined like a gross profit margin of a distributor. This would also lead to an avoidance of eroding the tax base, because the profit of the commission agent will not decrease to that extent as it would often be the case when using a merely cost plus mark up.

III. Re-characterization

There are cases in which the change of the kind of sales character from a distributor to a commission agent or sales agent does actually have no real impact on the functions performed by the entity responsible for the sales. Additionally, there are cases in which the allocation of risks is artificial. To avoid an erosion of profits by such artificial means, the existing rules of re-characterization of business relations of the OECD Transfer Pricing Guidelines could be concretized, i.e. the kind of doing business should be in line with the actual function and risk profile. An artificial splitting up of functions or an agreement to provide fully-fledged distribution activities as merely low risk services is generally not accepted between third parties and thus might not be accepted for determining arm’s-length conditions.

This has a lower impact in cases where the commission agent already receives a remuneration which is closely to that of a distributor. In cases where functions where artificially split up and performed by different entities of a group this aspect gets more importance. Especially, in structures where a principal is resident in a low tax jurisdiction having no noteworthy personnel it might be doubtful whether the allocation of functions and risk would have be agreed similar between third parties. This approach would focus on those structures which were actually put in place to erode profits or do aggressive tax planning and would spare those entities which implement the commission agent or sales agent structure for economic reasons and spending much effort to determine arm’s-length conditions.
F. SUMMARY

We believe that the intended new definition of the permanent establishment goes far behind the aim to avoid base erosion and profit shifting for the following reasons.

Third party relations will be included although it is in most cases not a case of profit shifting.

The overwhelming majority use commission agent and sales agent structures due to economic reasons; additionally the principal is in most cases not resident in low tax jurisdictions. Thus, the structure is in most cases not implemented for tax reasons.

The result of the new definition will be the creation of very high administrational burdens because the majority of sales activities, except via distributors will lead to a permanent establishment. Besides this, it is not clear how to determine the permanent establishment profits, what will cause a lot of conflicts with authorities and the need of arbitration procedures.

The aim of action 7 could also be reached by adjusting the OECD Guidelines towards business restructuring, profitability measures of a commission agent and the rules of re-characterization of business relations.

We would be ready and grateful if we could explain our thoughts during the public consultation meeting on 21 January 2015.

Nuremberg, January 8th, 2015
9 January 2015

Dear Ms Ruiter,

SABMiller plc response to the OECD Discussion Draft on BEPS Action 7: Preventing the Artificial avoidance of PE Status

The SABMiller Group is one of the world’s leading brewers, involved in the manufacture, distribution and sale of beverages across six continents. Listed on the London Stock Exchange it is ranked as one of the top 20 companies on the FTSE. It has some 70,000 employees, with over 200 branded beverages sold in over 75 countries, including a number of market-leading local brands. As a large multinational group, transfer pricing is clearly an important issue that affects our operations.

Executive summary

This discussion draft clearly focuses on the specific situation where a company markets products and services in a host country without a meaningful physical presence. In our view the options proposed regarding commissionaire arrangements may have the unintended consequence of being interpreted and applied beyond this type of commercial structure. It is commonplace for a global group to have ‘centres of excellence’ comprising of deep subject matter experts which deal with customers and suppliers and this activity can involve discussing and negotiating contracts, this activity is not in a commissionaire structure and the current proposals may be incorrectly applied. We provide specific details on this below.

We would also anticipate an increase in tax compliance resource and costs during dispute discussions with tax authorities as both parties seek to agree on what ‘material’ and ‘engagement’ mean.

A: Artificial avoidance of PE status through commissionaire arrangements and similar strategies

The options presented at paragraph 11 introduce language regarding the involvement of principal companies in contracts; ‘engages with specific persons that results in the conclusion of contracts; contracts’, ‘negotiates material elements of the contracts’. We believe that this wording has the
potential to be taken out of context and applied to other commercial situations due to a misunderstanding between tax authorities and taxpayers.

For example, today’s commercial environment includes increasingly global customers and global suppliers. With this trend, groups need to respond and are required to form ‘centres of excellence’ with deep subject matter experts who are essential to achieve optimum commercial outcomes for their related companies. The use of such specialists can, and does, include involvement of central teams in global contract negotiation. Where this occurs, provided there is correct remuneration, and appropriate positioning of where the activity takes place, this should not give rise to PE concerns. These arrangements are commercially necessary and are in no way an avoidance of permanent establishments.

To mitigate this potential unintended consequence, we suggest more detailed guidance, including examples on the commercial situations to which the PE proposals do not apply, how engagement is measured, and what is meant by material elements of a contract.

In the current Article 5, the concluding contracts test creates a simple benchmark and as such companies are able to provide group-wide direction on approaching working in different countries.

E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing

We agree that the OECD should wait for further discussion on Action 4 (Limit base erosion via interest deductions and other financial payments), Action 8 (Intangibles) and Action 9 (Risks and capital) to enable guidance to be issued on PE profit attribution for ‘new’ PEs that arise from the proposals. This guidance will improve interpretation for all parties and the format of multiple examples in the Intangibles paper would, we suggest, appear to be the most obvious way to achieve this.

Conclusion

The proposals for PEs require further articulation and provision of examples to limit ambiguity and to ensure application is only to the targeted commercial situations.

We trust that our comments are useful to the OECD’s further consideration. If you would like to contact us directly in relation to any of the above issues we would be more than happy to discuss in more detail.

Yours sincerely,

Graham Holford

Director: Group Tax, SABMiller plc
January 8, 2015

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Comments on Action 7 Discussion Draft

Dear Ms. de Ruiter,

We are pleased to have the opportunity to provide comments on the Action 7 Discussion Draft (“DD”) issued on October 31, 2014. We understand that the DD is not a consensus document at this point. We appreciate the opportunity to provide comments at this stage, and hope that our comments will be useful to the OECD/G20 delegates as they engage in the further work to revise and focus the proposals.

We are submitting these comments on behalf of the Software Coalition. The Software Coalition is the leading software industry group dealing with US domestic and international tax policy matters. The Coalition was formed in 1990 and now comprises 24 companies which operate in the software and e-commerce sectors. Software Coalition members account for approximately $400 billion per year in total gross revenue and $50 billion per year in total R&D spend. Member companies employ over 1.1 million individuals around the globe.¹

From its inception, the Coalition has provided analysis and support to its members, national tax administrations and international organizations on matters of international tax policy of importance to the software and e-commerce industries. The Coalition has

been involved over the years in providing comments to the OECD on various international tax issues of importance to the software industry.

Coalition members have extensive experience with commissionnaire commercial structures. Many software companies, both members and nonmembers of the Coalition, have organized their distribution structures through this commercial relationship for many years. We hope that the experience of our members in operating such structures will lend appropriate significance to our comments.

I. Executive Summary

The relationship of commissionnaire is one of several commercial relationships which suppliers of goods or services may enter into with other parties, and has been a feature of civil law in various jurisdictions for many years. Unrelated parties have used this commercial arrangement in various sectors. Accordingly, Coalition members do not believe that simply selecting a commissionnaire arrangement constitutes an “artificial avoidance of PE status”.

The primary policy justifications stated in the Action Plan and DD to support treating commissionnaire structures as creating deemed PEs are actually transfer pricing concerns. As such, Coalition members observe that recent revisions to the Transfer Pricing Guidelines ("TPG") and the revisions anticipated to be adopted as a result of Actions 8-10 of the BEPS project should address these concerns completely.

Coalition members agree that any new rules arising from Action 7 should be drafted to avoid unintended effects. If it is determined that Art. 5(5) should be amended to cause commissionaire arrangements to create deemed PEs, the best way to avoid unintended effects is to define the activity which creates the PE by a direct reference to the statutory definition of commissionnaires.

Of the options put forth in the DD, Option B is the most precise alternative. Contract negotiation normally is an identifiable and economically significant event in the sales process. That said, further clarifications are needed to avoid possible unintended effects. In particular, it should be confirmed that reseller arrangements are not covered by this rule. The other options are much less precise and should not be further developed.

With respect to Art. 5(6), if a per se rule is to be adopted, it should be limited to persons which act exclusively for related persons.

If the first proposal with respect to Art. 5(4) is adopted, new Commentary language should be added to provide guidance on how these subjective assessments should be made.

The proposed anti-abuse rule relating to splitting up contracts to avoid the Art. 5(3) threshold should be limited to the building site provisions of Art. 5(3).
Additional guidance, including examples, is needed as to how profits would be attributed to notional PEs arising from the application of Art. 5(5) or any constriction of preparatory or auxiliary protection under Art. 5(4). Such guidance is necessary to give taxpayers and tax administrations reasonable certainty regarding the consequences of the changes to the PE standards.

A simplified filing regime should be available for notional PE returns, as well as procedures for advance determinations of the profits attributable to notional PEs.

II. Commercial background to choice of using commissionnaire structures

As an introductory matter, we would like to describe some of the commercial considerations which groups address when deciding whether to adopt a commissionnaire structure to regulate the intercompany relationships in their distribution chain. We fully understand that the purpose of the changes proposed in the DD is to create deemed PEs of the nonresident supplier for groups which continue to operate a commissionnaire structure. We respectfully disagree, however, with the assertion in the DD that the mere selection of a commissionnaire arrangement constitutes an “artificial avoidance of PE status”. OECD/G20 member states certainly are free to exercise their legislative and executive authority to cause notional PEs to arise in the case of commissionnaire structures, but we believe that such changes should be pursued under a policy justification that supports changes to the PE threshold in order to create a different balance of taxation rights allocated between source and residence states, and not on the assertion that groups adopting commissionnaire arrangements have created abusive structures.

It is universally the case among Coalition members that they choose to operate through locally incorporated entities in most of the jurisdictions in which the group does business. Separate entity incorporation provides multiple business benefits for managing the group’s commercial liability, employment law obligations, and the like.

Once it has been decided to operate in a jurisdiction through a separately incorporated entity, it is then necessary for the group to determine what commercial arrangements will govern the relationship between that entity and the other group members with which the entity transacts. The respective rights and responsibilities of the entities are determined by the contracts entered into between them, as well as by applicable commercial law. In all major commercial jurisdictions, the commercial law defines the rights and obligations that may exist between contracting parties, both related and unrelated, which choose to operate under various commercial relationships. Those relationships include agents with the power of representation of their principal, sales representatives without such power, distributors or resellers which acquire products for resale, and service providers which oblige themselves to provide services to their principal. For example, in Germany, the civil code and commercial code have distinguished buy-sell distributors, commission

\[2\] For convenience, we use the term “reseller” in this letter to refer to all entities that sell in their own name for their own account, including distributors.
agents and commissionnaires since those laws came into effect over 100 years ago in 1900.³

In many civil law jurisdictions, the commercial law defines the rights and responsibilities of parties operating under the commercial relationship of “commissionnaire”. In broad terms, this commercial relationship is a subset of the general law of mandate, under which a supplier may authorize a party to take certain actions on the supplier’s behalf, subject to the contractual or statutory limits of the mandate.

Unrelated parties in many sectors frequently operate under commissionnaire contracts. For example, commissionnaire agreements are commonly entered into by unrelated parties engaged in international trade.⁴ Other more specialized sectors which commonly use commissionnaire arrangements include art and antique dealers, book publishers, concert / event operators, and film rental companies. In general, this commercial arrangement is used in situations where a reseller wants to sell in its own name to customers but minimize its commercial risks of sale.

Applicable commercial law in most civil law jurisdictions defines the commercial relationships between commissionnaires and their principals in specific ways. One is that title to the property sold by the commissionnaire is never owned by the entity operating under the commissionnaire contract. Second, the receipts collected by the commissionnaire are held solely for the benefit of the principal, although the commissionnaire in most cases would be able to assert a claim for its commission against amounts due to the principal.

Those elements in particular create many commercial efficiencies for groups operating through commissionnaire structures. First, inventory is owned solely by the principal. This creates business efficiencies in managing centralized accounts receivable, foreign exchange hedging, inventory financing, insurance coverage, and cash management. Since there is no sale of property between the principal and the sales entity acting as commissionnaire, there is no need for commercial invoices to be issued by the principal to the sales entity. This creates significant administrative savings for groups with numerous transactions between entities. As all inventory is owned by a central entity, the enterprise may transfer inventory between warehouses in multiple locations, and transfer other assets such as spare parts or demonstration equipment between locations, with greater efficiency and reduced costs due to the absence of the need to transfer ownership of such property between legal entities.

Both large and small groups use commissionnaire arrangements. In fact, smaller companies which are establishing their first sales operations outside their home jurisdiction frequently are particularly attracted to the business efficiencies of this commercial relationship. Accordingly, many enterprises have always operated through

³ Buergerliches Gesetzbuch, BGB, Handelsgesetzbuch, RGBl. 1897 S. 219.
⁴ See the German language business law treatise at http://wirtschaftslexikon.gabler.de/Definition/kommissionsgeschaeft.html
commissionnaire arrangements from the moment they establish their first civil law jurisdiction sales affiliate.

In all cases, a sales and marketing entity operating under a commissionnaire commercial agreement is subject to the tax laws of its country of operation. In all cases, the commission payable to the entity by the related party principal is subject to review and adjustment under applicable transfer pricing principles. In all cases, jurisdictions which follow the OECD’s Transfer Pricing Guidelines (“TPG”) will review whether the commission paid is arm’s length based on a functional analysis of the activities performed by the sales entity.

III. Interpretative background to Art. 5(5) as applied to common law agents and commissionnaires

It is well known that the interpretative issues arising from the application of Art. 5(5) to commissionnaire structures has created much controversy. Some of the interpretative challenges arose due to the blend of civil law and common law concepts which were incorporated in Arts. 5(5) and 5(6) of the Model Tax Convention (“MTC”) from the earliest years. By 1992, it became apparent that the application of Art. 5(5) to common law agents and civil law commissionnaires was different. In 1992, the UK entered an Observation to the Art. 5 Commentary to the effect that under the UK common law system, a dependent person with authority to conclude contracts on behalf of the principal created a PE regardless of whether the person was acting as a disclosed or an undisclosed agent. The UK Observation was removed in 1994, when paragraph 32.1 of the Art. 5 Commentary was revised to take its current form.

The application of Art. 5(5) to civil law commissionnaires was addressed in three recent cases. In each case, the highest national court of France, Norway and Italy concluded that a commissionnaire arrangement does not create an Art. 5(5) PE.

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6 The 1992 UK Observation read as follows at then paragraph 45: “The United Kingdom considers that an agent who is not an agent of independent status within paragraph 6 of this Article and who has the characteristics described in paragraphs 32 and 33 above will represent a permanent establishment of an enterprise if he has the authority to conclude contracts on behalf of that enterprise.”
7 In 1994, paragraph 32.1 was part of paragraph 32 of the Commentary. Paragraph 32.1 was added in 2003. Based on a review of the history of the Commentary and the UK Observation, the Public Reporter in the Zimmer case concluded that the UK Observation was only intended to address situations involving common law agents and not commissionnaires. See CE 31 mars 2010 n°304715 et 308525, 10° et 9° s.-s., Sté Zimmer Ltd., conclusions Julie Burguburu, BDCF n° 6/2010.
8 CE 31 mars 2010 n°304715 et 308525, 10° et 9° s.-s., Sté Zimmer Ltd.; Boston Scientific. Italian Supreme Court, Tax Section, n. 3769 of Mar. 9, 2012; Borgarting Lagmannsrett, dated 2 March 2011, Dell Products vs. Skatt Øst, ref 10-032855ASD-BORG/03. The contemporaneous Roche case in Spain, DSM Nutritional Products Europe Ltd. (formerly Roche Vitamins Europe Ltd.) vs. General State Administration, No. 1626/2008 (Jan. 11, 2012), which did find a PE of the nonresident supplier, did not deal with a commissionnaire structure.
Accordingly, prevailing European legal precedent establishes that a commissionnaire arrangement does not create a PE under current Art. 5(5). Therefore, in order to cause the use of a commissionnaire structure to create a PE, it will be necessary to amend the relevant treaties to cause that result. It is worth noting that in none of the three cases, did the tax authorities argue that a commissionnaire commercial structure is an “artificial” arrangement.

IV. The policy justifications as expressed in the Action Plan and the DD are transfer pricing issues

Software Coalition members note that the main policy justifications given in the Action Plan itself and elaborated in the DD to support treating commissionnaire arrangements as creating deemed PEs are transfer pricing concerns. If that indeed is the justification, we suggest that the appropriate response to the concerns underlying Action 7 is to closely review how the TPG, as enhanced in recent years including the changes anticipated from Actions 8-10 of the BEPS project, should apply to determine the arm’s length remuneration of a sales and marketing entity operating under a commissionnaire contract.

The Action Plan and the DD express these transfer pricing concerns in several places. First, the Action Plan itself provides the following statement to justify examining commissionnaire arrangements:

In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by “commissionnaire arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country.

The transfer pricing concerns are elaborated in the DD. The example given in paragraph 7 of the DD refers to a case in which an enterprise transferred certain of its productive assets to an affiliate outside the state, and thereafter earned “substantially reduced” profits. Further, paragraph 43 of the DD notes that the principal BEPS concern around the PE rules (outside the digital economy issues) relates to situations where a taxable member of a group is allocated limited profits because of its limited risk assumption, while another group member which is not subject to local tax is allocated a “large share” of the relevant group income by virtue of its assuming business risk, holding valuable assets, etc.

These concerns relate to (i) business restructurings, and (ii) the application of the TPG to limited risk entities.
The example described in paragraph 7 of the DD is addressed directly and in detail in TPG Ch. IX dealing with business restructurings. The consequence described in the DD example that an enterprise which divests itself of valuable assets thereafter does not earn a return on those assets is clearly correct. The DD example does not address, however, the main focus of Ch. IX, which is to determine whether the business restructuring involves the disposition of a valuable asset which requires compensation at arm’s length. Ch. IX provides a comprehensive treatment of the tax issues arising from a business restructuring. There is nothing in Ch IX that suggests that the appropriate policy response to the transfer of assets in a business restructuring is to create a PE.

Many Coalition members have used commissionaire arrangements from the day they first established sales operations in the jurisdiction. Accordingly, the policy justification expressed in the DD example is not germane in those cases.

With respect to the ongoing profits which should be earned by a sales and marketing entity, the point made in the DD at paragraph 43 is clearly correct that under the TPG, entities which bear low risk and do not hold valuable assets do not generate returns on risks or assets borne or held by other members of the group. The issue identified in paragraph 43 is one of result not of principle; one entity earns “limited” profits and the other earns a “large share”. Accordingly, the principal concern with commissionaire arrangements would seem to relate to the proper application of the TPG in such cases.

In the case described in the DD example, the main profit elements which could be shifted by the business restructuring are those related to the assets and risks which were in fact transferred, not those related to functions which remain the same. The Action Plan describes the problem as a reduction of profits “without a substantive change in the functions performed in that country”. To the extent that the functions performed in the country in fact are the same before and after the restructuring, Coalition members believe that a proper FAR analysis performed under the TPG should fully recognize and reward those functions.

If the goal is indeed to ensure that sales and marketing entities operating under a commissionaire contract earn an arm’s length remuneration, the BEPS work on transfer pricing will achieve the desired outcome. In particular, the work under Actions 8-10 dealing with intangibles, risk, and use of profit splits in the context of global value chains all will apply to groups using commissionaire structures. These enhancements to the TPG all will assist taxpayers and tax administrations to determine returns for sales and marketing entities which comport with the arm’s length principle, including those which operate under commissionaire contracts.

V. Proposal to avoid unintended effects: identify commissionaire arrangements by specific statutory reference

Coalition members appreciate the desire expressed in the DD that any new rules should avoid unintended effects. If the policy goal is to cause nonresident suppliers to have PEs
if local market entities are structured as commissionnaires, then the best way to avoid unintended effects is to define the activity which creates the PE by a direct reference to the statutory definition of commissionnaire. Contracting States which wish to cause commissionnaires to create PEs could simply refer to the applicable statute in their treaties. Accompanying Commentary could explain that sales relationships which are not expressly documented as subject to the commissionnaire statute of the state, but which as a matter of local law would be governed by the commissionnaire statute regardless of the absence of specific mention in the contract, would be given the same treatment for purposes of the tax treaty. Reseller relationships in which the sales intermediary takes title to the goods sold would be excluded.

This proposal would be a precise response to the desired policy goal.

VI. Comments on proposed revisions to Art. 5(5)

A. Reflections on the current rule

Before providing comments on the four proposed options, we would like to offer some observations on features of the current rule which have provided concrete guidance to taxpayers and tax administrations over the many decades which that rule has been part of the international treaty network. Coalition members acknowledge that there have been interpretive controversies over the current standard. Nevertheless, the current rule based on the habitual exercise of the authority to conclude a contract in the name of the nonresident is a well-designed rule as a matter of treaty drafting. The question of whether a dependent person in fact has and habitually exercises the authority to conclude a contract is relatively precise. Businesspersons and lawyers in most cases can identify with precision the commercial act which binds an enterprise to perform. This precision is important to taxpayers, and we hope useful to tax administrations. Precision certainly is an essential attribute of treaty language, as treaties need to serve as a bridge between two states with different domestic law regimes.

The contract conclusion rule also connects well to the policy justification for creating tax nexus of an entity not actually operating in the jurisdiction. The Commentary explains that cases which create a deemed PE are “to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned.”9 The contract conclusion standard connects well to that policy justification because the conclusion of a sales contract is the critical culminating event in the sales cycle. Accordingly, the current standard connects to business reality by establishing as the test the performance of a critical business activity.

We respectfully suggest that evaluations of any proposed new Art. 5(5) standard be considered with a view towards defining a rule which refers to business activity which is

9 Art. 5 Commentary, para. 32.
clearly identifiable and which, in this context of creating tax nexus for a nonresident, constitutes a critical business function as it may be performed in the source state.

We also note that language must be chosen which minimizes the chances that the terms might be interpreted differently by the contracting states. Absent a definition of the term in the treaty itself, domestic law interpretations of a treaty term may be relevant pursuant to Art. 3(2). Recourse to domestic law interpretations will be particularly problematic when the term to be interpreted, such as “habitually engages” has no specific commercial law meaning.

B. Assessment of options

We observe that the four options are created through the combination of two proposed clauses which describe the activity of the dependent person, and two clauses which describe the effect of that person’s activity on the performance obligations of the nonresident. Of the four options, we believe that Option B is the more precise. We also believe various clarifications to Option B are necessary to avoid unintended effects. Accordingly, we first provide our comments on Option B, and then provide comments on the other options.

C. Option B

Coalition members assume that the intent of the DD is to reduce the level of business activity in the source state required to create a deemed PE of the nonresident. If that indeed is the policy goal, Coalition members do not believe that there is a better definition for a new rule than one focused on contract negotiation, subject to the clarifications discussed below. The reason we prefer the “negotiation” standard is because the act of negotiating a contract of sale is identifiable and reflects an important part of the sales process for many companies. That said, the proposed standard is less precise than a test based on exercising the authority to conclude contracts, so clarifications including the following are needed.

Most importantly, it needs to be clear that no activity is covered other than direct negotiation with customers over material terms of contracts to sell or rent goods or to provide services. Software companies engage in many market-facing activities towards current and prospective customers, so it is essential to provide clarity that those activities are not described in the new rule. Examples include sales solicitation, marketing, customer support, education, training, receiving orders, and receiving payments.

In many cases, enterprises make their goods or services available through standard contracts. In those cases, sales personnel are not engaged in negotiation of material terms of those contracts. It should be clarified that in cases of sales under standard contracts, the new rule does not create a PE, even if the sales personnel engage in substantial customer-facing promotion or sales solicitation.
In some cases, sales personnel may be given the right to communicate to customers certain pre-authorized modifications (e.g., volume discounts). These cases also should not be regarded as “negotiations”, as the modifications to standard terms have been pre-authorized.

We note that the proposed text departs in an important way from the current description of the authority given to the dependent person to conclude contracts. Current Art. 5(5) refers to a dependent person which “has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise” (emphasis added). The Option B proposal does not refer to a grant or exercise of “authority”; instead, the proposed text carries over the contract conclusion element of current Art, 5(5) but refers only to the mere conclusion of contracts as sufficient to create a PE and deletes the reference to "authority".

In our view, the description of the dependent person as one who has been granted an “authority” is an important element of the current rule. It describes persons who hold and exercise discretion to exercise business judgment on behalf of the nonresident. It is through the delegation of that authority to exercise business judgment, that the nonresident has become sufficiently involved in the business activities of the source state to warrant extraterritorial taxation. The Commentary makes that point expressly, by referring to those dependent persons which create a PE as those “who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned.”

The deletion of the reference to a grant of authority is a significant change. Coalition Members believe that a PE should be created only if the dependent person has indeed been given an authority to exercise business discretion on behalf of the nonresident. For example, under the proposed standard, personnel employed in call centers could be considered as creating a PE, as call center personnel routinely conclude contracts with prospective customers. In general, however, call center personnel are required to follow a script, and do not have authority to vary any terms. Those activities which do not allow the exercise of business judgment by the personnel involved over contract terms should not give rise to PEs.

Similarly, sales solicitation personnel may be authorized to discuss rate card pricing, including preapproved discounts with customers, but would not have authority to negotiate outside the parameters of the rate card. If the sales personnel do not have authority to conclude the contract, that solicitation activity does not create a PE under the current rules. If the test is changed to cause a PE potentially to arise due to negotiation of material terms, then the concept that the dependent person must be given some authority to exercise business judgment would suggest that discussions over a preapproved rate card should not be regarded as “negotiation” within the new rule.

10 Art. 5 Commentary para. 32.
The proposed rule would create a deemed PE of the nonresident only if the dependent person is given the authority to negotiate “material” terms of the contract. A materiality threshold is appropriate, in order to limit the nexus-creating activity to business activity which is an important part of the sales process. Coalition members appreciate that what terms may be “material” will differ based on the business and the circumstances. That said, it still would be useful to have some guidance as to what constitutes a material term, presumably through new Commentary language. The new Commentary language should be drafted concurrently with the new treaty language, in order to ensure that the Commentary reflects the contemporaneous intent of the Model Convention draft persons.

The second operative element of Option B refers to the conclusion of contracts, or the negotiation of material elements of contracts, “for the transfer of ownership of, or for the granting of the right to use, property owned by the enterprise…[or] … for the provision of services by that enterprise”. Of the two alternative references to the nonresident, this statement is more precise than the alternative in Options C & D. The principal concern of Software Coalition members regarding this text is that it be made clear that this language could not be interpreted to create a PE of a nonresident supplier through the sales activity of an in-country reseller, which sells in its own name. A local reseller of software products or services will typically enter into contracts in its own name, but the user agreement regulating the use of the software copy in many cases will be granted by the nonresident or by the ultimate IP owner (typically the parent company of the group). Especially in the case of digital deliveries, the nonresident supplier typically will have the commercial obligation to deliver a copy of the software program even though the sale has been completed by the in-country reseller. The same commercial situation typically exists in the case of an in-country reseller of Software as a Service (“SaaS”) services, as the actual performance of the SaaS service typically would be by the nonresident.

The same ambiguity exists in the case of unrelated resellers. The commercial activity of unrelated resellers is not excluded by Art. 5(6), as they are not “agents” under commercial law.

Accordingly, Coalition members request clarification that the rule in Option B is not intended to describe any negotiation or contract conclusion activity of a reseller, when the reseller enters into contracts in its own name. Coalition members consider that any commercial relationship where the sales intermediary takes title to the goods sold should be regarded as a reseller for this purpose. Since in many reseller transactions involving software there is no physical "good" to be sold, the principal indication that the sales intermediary is a reseller is that the sales revenue is recognized on the books of the intermediary along with a cost of goods sold reflecting the price paid to the supplier.

D. Other options

The other options are much less precise, and for that reason should not be further considered in subsequent discussion drafts. The proposed description of the in-country activities of a person who “habitually engages with specific persons in a way that results
in the conclusion of contracts…” is extremely imprecise. For it to have any utility as a nexus standard, there will need to be very precise descriptions of the business activities which are considered to constitute “habitual engagement…”.

Similarly, the proposed standard that a PE could be created if the in-country activity leads to “… contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise…” lacks precision as to what is covered. We understand that the purpose of this reference is to describe the economic effects of a contract entered into by a person acting under a commissionnaire contract. Absent a clear limit to apply only to actual commissionnaire arrangements, causing some sales arrangements to create PEs and others not to create PEs based on the commercial risks borne by the supplier is highly ambiguous. There is no good policy reason to cause a PE to arise or not based on the allocation of commercial risk between the in-country reseller and the supplier.

E. Summary of needed clarifications

In summary, the clarifications which are of most significance to the software industry are as follows:

1. “Negotiation” is to be interpreted to apply only to customer-facing negotiations over terms of sale, and not to other customer-facing activity.

2. Reseller arrangements are not included, regardless of the allocation of commercial risk between the parties.

3. Contracts entered into under standard terms which do not require negotiation are not included.

4. Communicating the terms of pre-approved discounts does not constitute “negotiation”.

VII. Comments on proposed revisions to Art. 5(6)

Under all Options, the DD proposes that Art. 5(6) should be revised to exclude coverage of the independent agent rule if the person “acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises…”.

Coalition members believe that appropriate guidance on the nature of “independence” already exists in the Commentary, which notes that one factor to be considered in determining independent status is the number of principals represented by the agent.\(^\text{11}\)

If this per se rule is to be adopted, however, Coalition members suggest that it be limited to persons which act exclusively for related persons. Many software companies engage independent agents or resellers to distribute their products in a territory. This is

\(^{11}\) Art. 5 Commentary, para. 38.6.
especially common for smaller companies which have not yet decided to invest in a direct sales force in multiple jurisdictions. In many cases, the software company will invest considerable time and money in training such independent agents or resellers to educate potential users on the software product and to provide technical support to users for the product. Due to the desire to preserve confidential information or other trade secrets and to recover the investment made in training these persons, these independent persons might be engaged on an exclusive basis for the duration of the contract.

Where a software company has engaged an unrelated party, it is necessarily the case that such unrelated party will be compensated for its work at arm’s length. Accordingly, there is no policy basis for creating a PE that would result in an attribution of profits to the jurisdiction beyond what is earned by the unrelated person for the services it provides. Further, unless the contract expressly requires exclusivity, in an unrelated party case it may not be possible to know whether the agent acts “almost exclusively” for the nonresident.

We also note with concern the proposal that the exclusivity would be determined with respect to work on behalf of “one enterprise or associated enterprises”. This proposal, along with the other proposals in the DD regarding fragmentation of activities between related parties and splitting-up of contracts, deviates from the accepted international law principle that separate enterprises are respected as such, and that the activities of one enterprise are not combined with those of another to determine the taxation of either. This principle is recognized in the Commentary to Art. 5(6) on the very point of exclusive representation, as it provides as follows: “Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time.”12 The Italian Supreme Court deviated from this principle in the Philip Morris case, in its decision that a single entity acting in Italy could create a PE of multiple group entities.13 Commentary introduced subsequent to that case continued to apply the PE determination solely to the single enterprise for which the PE-creating activity was performed. The relevant language introduced to paragraph 41.1 reads as follows:

…The determination of the existence of a permanent establishment under the rules of paragraph 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.14

12 Art. 5 Commentary, para. 38.6.
13 Italian Supreme Court, 7 March 2002, “Philip Morris”, Nos. 3667, 3368, 7682 and 1095.
14 Art. 5 Commentary, para. 41.1.
We believe that the integrity of the separate entity principle must be maintained as a foundation of the international tax law. Accordingly, we recommend that if this provision is adopted, or the other proposals in the DD which refer to the actions of multiple related parties to create a tax nexus for one are adopted, that they each be described as a special rule to combat abuse, so that it remains clear that as a matter of principle, the actions of each enterprise are addressed separately for determining the tax treatment of each entity.

VIII. Comments on proposed revisions to Art. 5(4)

The first proposal under consideration is to amend Art. 5(4) so that all of its subparagraphs are subject to a “preparatory or auxiliary” condition, thereby introducing a subjective element to the application of subparagraphs a) through d) which does not now exist.

As this is a significant change, the Commentary should be enhanced with some interpretative guidance as to how such subjective assessments are to be made. The current Commentary provides that “[t]he decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole”. ¹⁵ That suggests that the proper application of this rule to all activities of a fixed place of business would be to compare the activities actually performed by the enterprise in that fixed place of business to the activities of the enterprise carried on outside that fixed place, and assess whether the activities under examination constitute an “essential and significant” part of the entire activities of the enterprise. As this type of assessment has never been necessary for the activities described in subparagraphs a) through d), some elaboration in the Commentary describing the context in which such activities would be preparatory or auxiliary would be useful.

It is important that further work in this area not obscure the fundamental point that the preparatory or auxiliary rules are applicable only if the nonresident enterprise in fact maintains a fixed place of business in the state. The preparatory or auxiliary rules do not apply to any case where the nonresident does not actually maintain a fixed place of business in the source state.

IX. Splitting-up of contracts

This proposal is relevant to Software Coalition members because of the proposal to expand these changes beyond Art. 5(3) to introduce similar concepts in treaties which have adopted service PE rules similar to the alternative provision set forth in paragraph 42.23 of the Article 5 Commentary. Many Software Coalition members provide consulting services to their clients, which involve personnel travelling to client locations.

¹⁵ Art. 5 Commentary para. 24.
In cases of long-term consulting arrangements for clients located in states with treaties including service PE rules, Software Coalition members report PEs under those rules.

We assume that tax administrations have seen cases of abuse under Art. 5(3) relating to building sites which this proposal seeks to address. If so, Coalition members respectfully suggest that this anti-abuse rule be limited to the building site rule of Art. 5(3) and not be incorporated into the alternative deemed service PE rule, on the basis that the same opportunities for abuse do not exist in the consulting industry.

The essence of the abuse being addressed here is the purposeful splitting up of contracts to avoid the Art. 5(3) threshold. In the case of a building site, which is a large, one time contract, perhaps a building contractor will find it worth while to create an artificial contracting structure. We do not believe that such incentives exist with any significant frequency among companies with a substantial consulting business. Unlike a building site which could be the subject of a one time gathering of personnel and material in a jurisdiction, an enterprise which maintains an ongoing consulting organization hires a permanent workforce to pursue these projects. Within groups, a consulting organization frequently follows a center of excellence model to concentrate personnel resources with particular expertise in one location to enhance efficiency. Similarly, to increase efficiency and avoid down time among personnel, organizations may staff projects from more than one location. These approaches to organizing a professional services workforce result from time to time in personnel of multiple related enterprises working on projects, but these organizational structures cannot be regarded as being established for the purpose of “artificial avoidance” of PEs.

In this area, there needs to be an appropriate balance between capturing true cases of abuse and not imposing unadministrable compliance burdens on business. It is exceedingly difficult for enterprises to keep track of all personnel movements in small increments of time. Accordingly, the rule should have mechanisms that distinguish between service structures that are set up for legitimate business reasons and those that are designed for the artificial avoidance of PE.

One possibility to achieve this balance would be to count personnel of a different enterprise towards the stated threshold (e.g. 183 days as proposed in the alternative provision in the Commentary) only if their days of presence exceed a reasonable threshold, such as 60 days. An alternative approach to this mechanical rule would be to create a presumption against aggregation if the personnel are employed by entities the establishment of which was not with the purpose of artificial avoidance of PE. If the presence of personnel from different enterprises is aggregated and the applicable threshold is exceeded, only the principal contracting entity should have a PE.

X. Profit Attribution

Coalition members recommend that further work on the DD be coupled with additional guidance on how profits would be attributed to notional PEs which may arise under the
application of Art. 5(5) and any constriction of preparatory or auxiliary protection under Art. 5(4). We note that the text of Action 7 states that “[w]ork on these issues will also address related profit attribution issues.” Paragraph 45 of the DD, however, notes the following:

Whilst that preliminary work has identified a few areas where additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in this note were adopted. It was acknowledged, however, that the work on other parts of the BEPS Action Plan, in particular Action 9 (Risks and capital), might involve a reconsideration of some aspects of the existing rules and guidance.

Further work on the profit attribution consequences of the existence of an Art. 5(5) PE is important for both policy and practical purposes.

From a policy perspective, any revision of the PE threshold (other than ones proposed solely to combat abuse) presumably is for the purpose of changing the relative balance between source and residence state taxation rights. Whether that policy goal is achieved through a particular change in the PE standard can only be assessed when the profit attribution consequences of the proposed change are known. The more significant the change in the PE threshold, the greater the need for guidance on the profit attribution consequences. Just as legislation proposed to be considered by a national legislature may be accompanied by estimates of costs of compliance or revenues raised, proposed changes in the PE threshold also should be accompanied by an explanation of the expected consequences.

From a practical perspective, more clarity in this area is necessary to allow businesses to plan their affairs to achieve business efficiency while also achieving reasonable certainty regarding their taxation obligations. Additional clarity would also benefit tax administrations by reducing the time and costs associated with avoidable disputes with taxpayers and between competent authorities.

In all cases, PEs which arise under Art. 5(5) are only notional presences in the source state. The guidance on the attribution of profits contained in the 2010 Report expressing the Authorized OECD Approach (“AOA”) is much less detailed for notional PEs than for real ones. The relative lack of guidance creates risk for businesses which may have a notional PE. Risk is further increased by the fact that very few enterprises adopt structures that result in a voluntary tax return reporting a notional PE under Art. 5(5). In virtually all cases, the assertion by a tax administration of a PE under Art. 5(5) reflects an inadvertent PE. Businesses which perceive that activities of dependent agents in a territory may give rise to significant PE risk normally will restructure their operations to reduce that risk. Clearer guidance on the profit attribution consequences of PEs arising
under Art. 5(5) will assist businesses to evaluate these risks and guide their decisions on appropriate sales and distribution structures.

It is conceivable that if clear guidance existed, enterprises might choose to report an Art. 5(5) PE on a voluntary compliance basis, in order to retain the business efficiencies of central revenue recognition and other features of commissionaire arrangements, as described above. It is unlikely that an enterprise would make that choice, however, in an environment of highly uncertain profit attribution exposure.

The Software Coalition proposes that examples might be provided of the application of the AOA to Art. 5(5) PEs, in the Article 7 Commentary or elsewhere. Towards that end, we offer the following observations on how the AOA should apply to such cases.

In many cases, no additional profits could be attributable to a notional PE created by a commissionaire. The 2010 Report states the following:

Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. … Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient free capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital. The analysis also focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the significant people functions relevant to the assumption and/or management of risks or to determining the economic ownership of assets. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether negotiating or risk management functions are being performed by the dependent agent on behalf of the non-resident enterprise. In general the functional and factual analysis focuses on the nature of the functions carried out and in particular whether the above-mentioned significant people functions are carried out by the dependent agent enterprise on behalf of the non-resident enterprise, such that the associated assets and risk of the non-resident enterprise should be attributed to its dependent agent PE (in

which case the profits associated with those assets and risks would be taxable in the host country) rather than to another part of the non-resident enterprise (in which case the associated profits would not be taxable in the host country).

As this text notes, the principal FAR analysis of a notional PE relates to assets and risks that might be allocated to the notional PE. The functions performed by the commissionnaire personnel themselves will be fully taken into account in the FAR analysis for the commissionnaire’s commission.17 With respect to risks, the factual analysis will determine whether personnel of the sales entity undertook the significant people functions relating to the assumption and/or management of these risks. Similarly, the analysis with respect to assets owned by the nonresident will be whether significant people functions performed by personnel of the sales entity are such as to cause the notional PE to be regarded as the “economic owner” of those assets.18 In cases where the commercial risks of sale borne by the supplier are not managed by personnel of the sales entity, and personnel of the sales entity do not control assets of the nonresident, then no additional profit is attributable to the PE under the AOA.

In other cases, it is conceivable that the profit could be attributable to the notional PE, based on significant people functions which assume and/or manage commercial risks, or which are those relevant to the economic ownership of assets owned by the nonresident.19 In the typical cases of a sales entity negotiating material terms with customers or entering into contracts with customers under a commissionnaire arrangement, the commercial risks which might be involved would be risks residing in the distribution chain such as foreign exchange risk, risk of nonpayment, inventory risks, and the like. Based on typical functions performed by commissionnaires of Coalition member companies, however, it is highly unlikely that profits arising from other assets or risks not inherent in the distribution chain would be allocated to the notional PE.

We recommend that the final report illustrate these principles through at least two examples. One example would describe a case where significant people functions performed by sales entity personnel caused the allocation of certain commercial risks of sale to the PE. The example also should provide guidance as to how profits would be attributed to the assumption of those commercial risks of sale. The second example would demonstrate the circumstances under which the significant people functions related to the assumption and/or management of the risks of sale are performed by personnel of the nonresident. In such case, no risks would be allocated to the PE and thus no profits would be attributable to the PE.

Further guidance on the profit attribution consequences of PEs arising from the activities now described in subparagraphs 5(4)(a)-(d) also will be useful. In those cases, the enterprise will in fact have a fixed place of business in the territory, so the application of

17 See, AOA para. 232.
19 See AOA paras 21 and 68 et seq for risks, and paras 18 and 72 et seq for assets.
the AOA perhaps will be a little easier than in the case of a completely notional PE created under Art. 5(5). The critical step of the application of the AOA to these cases likely will be the articulation of the deemed transaction between the activities actually conducted by the enterprise at the fixed place and those performed through the rest of the enterprise.

These examples could be based on examples given in the 2010 Profit Attribution Report dealing with inventory risk and credit risk.20 More complete examples would provide guidance as to when those risks would or would not be attributable to the notional PE.21

XI. Compliance / Unintended Consequences

Coalition members are very concerned about the compliance costs which would be required to determine and report the profits attributable to a notional PE as described above. We anticipate that one response to the proposed changes to the PE threshold in Art. 5(5) will be to convert sales entities now operating under commissionnaire arrangements to some other form of sales structure. For large multinationals, any conversion of that sort will be expensive in terms of cost, company resources and business disruption necessary to make the change.

Because of those conversion costs, and because of the business efficiencies created by the commissionnaire commercial relationship, other groups would prefer to retain their existing commissionnaire structures. Undoubtedly smaller enterprises would prefer to have the choice available to them of establishing commissionnaire arrangements if it suits their business model. A group could not make that decision and appropriately manage their business risks, however, unless it is possible to know the tax consequences of remaining in their current structure.

Action 14 calls for new measures to make dispute resolution mechanisms more effective. Either under the Action 14 workplan or otherwise, Coalition members hope that tax administrations will be willing to institute programs to provide advance determinations to enterprises as to whether a PE exists and, if so, what the profit attribution to that PE would be. For example, states which agree to include provisions in their treaties which create deemed PEs due to the use of commissionnaires or persons who negotiate material terms of contracts should provide an expedited process to agree on the amount of profit attributable to the PE in advance of filing the return.

This procedure could be an extension of a current APA program, for example. Since this guidance is most useful to business prior to filing a return, Coalition members hope that

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20 See AOA para. 242 (inventory risk) and 245 (credit risk).
21 As an example of similar guidance concerning the attribution of profits to a dependent agent permanent establishment, see International Transfer Pricing: Attributing Profits to a Dependent Agent Permanent Establishment; Australian Taxation Office (September 2005). We note that the result in Example 2 of this report would more properly be no profit attribution to the notional PE, in line with the AOA guidance, rather than a mark-up on the commission paid, on the basis that no risks or assets were allocated to the notional PE.
such procedures could be streamlined so that processing times would be shorter than for typical APA cases.

Administrations also should consider instituting simplified filing regimes for notional PE returns, especially in cases where profit attribution will be modest. For example, a useful simplification would be to allow any additional profit attributed to a notional PE to be reported on the commissionnaire’s tax return, rather than requiring the principal to report separately in the jurisdiction.

Finally, Coalition members note that the determination of a direct tax PE frequently has follow on consequences in other areas which impose compliance burdens, such as VAT registrations, liability for various local business taxes, and the like. In the case of a PE arising under Art. 5(5), the PE is solely a notional one, as the tax nexus has been created despite the absence of any actual operations of the nonresident in the jurisdiction. The final report should make it clear that any Art. 5(5) PE under the expanded rules should, in itself, have no precedential purpose for VAT registration, other local taxes, or any other obligation that arises upon the maintenance of an actual business presence in the State. National and subnational authorities, of course, would be free to establish their own tax nexus rules, but that should be done as an independent exercise of legislative authority and not as a mere follow on consequence of changes in the notional PE standards for direct tax.

We are grateful for the opportunity to provide these comments, and look forward to further participation in the BEPS process.

Sincerely,

Gary Sprague
Partner
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cc: Members of the Software Coalition
Comments on Public Discussion Draft: BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear

Thank you for the opportunity you have given us to comment on the “discussion draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status”, 31 October 2014 - 9 January 2015.

We have read the proposed changes with interest and are pleaseed to give our thoughts on such a major point as the interpretation of artificial avoidance of PE status.

We greatly appreciate the interpretation efforts made by the OECD Committee on Fiscal Affairs to update the Commentary on such a complex issue as the identification of permanent establishments, which requires specific facts and circumstances to be ascertained.

In particular, we suggest you consider such additional proposals for amendments or further clarify the following points.

Point A - Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

Point A of the Discussion Draft sets out some alternative formulations of article 5(5) of the OECD Model Tax Convention (MTC) (proposals A, B, C, D) with specific regard to commissionnaire arrangements.

Background

As general background information, we note that in civil law countries the commissionnaire agreement has a specific legal nature and in Italy in particular it is defined as [...] a contract having as its object the purchase or sale of goods on behalf of the principal and in the name of the commissionnaire (“un mandato che ha per oggetto l’acquisto o la vendita di beni per conto del committente e in nome del commissionario”). Thus the commissionnaire agreement identifies a contractual relationship consisting of authority (to purchase or sell) granted to an agent with undisclosed principal under which the commissionaire agrees to enter into one or more future sale and purchase agreements in the interest and on behalf of the person who appointed him, i.e. the principal, but in his own name, thus appearing to the third party as the seller (or the purchaser, as the case may be). In other words, the sale and purchase agreement produces its effects, and in particular its
obligatory effects, in respect of the *commissionnaire* alone and it is the *commissionnaire* (and not the principal) who assumes all the rights and obligations arising from the agreement entered into with any third parties since he has no authority to represent, and therefore legally bind, the principal. Thus, the conclusion of the *commissionnaire* agreement and of the individual purchase and sale agreements does not give rise to a relationship between the principal and any third parties but only between the principal and the *commissionnaire* and between the *commissionnaire* and any third parties. As proof of the lack of the principal’s legal obligation to the third party purchaser, the *commissionnaire* assumes all of the obligations deriving from the actions taken pursuant to the agency with undisclosed principal agreement, including the product warranty obligations, without prejudice to the *commissionnaire*’s right to be reimbursed and held harmless by the principal.

Italian civil law court decisions (for instance Court of Cassation’s decisions nos. 8512/2004 and 9289/2001) have repeatedly stated that the *commissionnaire* agreement being a specific sub-type of agency with undisclosed principal agreement (*mandato senza rappresentanza*), differs from the agency agreement because of the absence of “*contemplatio domini*” (disclosure of the principal’s name); furthermore, it has been clarified that under an agency with undisclosed principal agreement no direct relationship exists between the principal and the third party, and the agent is directly obligated to the other party, even if the agreement is in the principal’s exclusive interest and the other party is aware of the principal’s existence.

On this basis, although we are aware of the complexity of the matter and the diverging opinions of international tax experts, we wonder how the changes suggested in the Discussion Draft (Options A, B, C, D) can possibly be coordinated with the legislation in force and with the civil law and tax court decisions of civil law countries such as Italy since Italian tax courts have consistently ruled (such as for instance in the *Puma* and *Boston Consulting Group* cases) that a *commissionnaire* acting in the ordinary course of business does not have the authority to legally bind the non-resident entity vis-à-vis a third party.

Also international case law (e.g. *ZIMMER Case*, *DELL Case*), albeit with subtle differences, unanimously agrees that a *commissionnaire* acting in the ordinary conduct of business does not legally bind, and therefore cannot constitute a permanent establishment of, the non-resident principal.

In a nutshell, we envisage legislative, interpretative and case law coordination issues between the changes suggested in the Discussion Draft and the legislation and interpretations currently adopted in respect of *commissionnaire* arrangements in civil law countries, and in Italy in particular.
Therefore, we would suggest (see subsequent point) that where it is ascertained that the *commissionnaire* arrangement has been entered into solely for the purpose of diverting taxable income away from the Source State (and therefore of implementing profit shifting practices), the Commentary should provide that any (additional) income assessed in the Source state in the hands of the resident *commissionnaire* be determined – on the basis of the functions and risks assumed in the Source state – solely on an arm’s length basis in accordance with transfer pricing principles rather than in the light of the concept of “hidden permanent establishment”.

In case of finding a permanent establishment the Source State should require the payment only of a differential tax equal to the difference between the amount of taxes assessed and the amounts already paid by the person who is retrained as fiscally permanent establishment. Alternatively, should be allowed a tax credit for taxes already paid in the Source State.

That principle should find widespread application, even in Countries like Italy that instead does not recognize in such cases the tax credit for taxes already paid in Italy.

Another point is the interaction between profit attribution to PEs and transfer pricing (Point E).

The matter of the attribution of profits in the Source State to the permanent establishment is a major current issue especially in cases where “hidden permanent establishments” are deemed to exist as a result, for instance, of a recharacterisation in the Source state from *commissionnaire* to fully-fledged or limited-risk distributor. The hidden PE should be remunerated (and therefore liable to additional tax in the Source state) solely for the functions and risks carried out and assumed in addition to those already rewarded in the hands of the domestic operation, i.e. the Italian *commissionnaire*.

In summary, if there are no additional functions and risks (e.g. inventory risks or credit risk) attributable to the *commissionnaire* for the activity carried out by him on behalf of the foreign enterprise compared to those already rewarded by a commission, the permanent establishment identified should have a nil income. As mentioned, this principle should apply all the more so to the cases where the commission is set on an arm’s length basis, in accordance with transfer pricing methodologies.

If instead the *commissionnaire* has additional functions and risks in relation with the activity carried out on behalf of the foreign enterprise compared to those remunerated by a commission, then the permanent establishment allegedly identified should be attributed only the income, or the loss, associated with the performance of such additional functions and the assumption of such additional risks. If the income attributed remunerates functions already performed by the
commissionnaire, the commission paid to him and taxed in the Source state should be deducted from the assessed income.

For the above reasons, we would suggest that the Commentary to article 5 further clarify and explain - in accordance with transfer pricing methodologies - the importance of an adequate functional analysis in order to avoid the double taxation for the same or similar functions performed.

Point B (4) and Point C – Fragmentation of activities between related parties and Splitting-up of contracts

Paragraph 4 of Chapter B and Chapter C of the Discussion Draft propose the introduction of anti-fragmentation rules against situations where the activities/projects carried out or the contracts executed by the non-resident entity in the Source State are artificially fragmented (among different operations) to avoid the creation of a permanent establishment.

To this end, we would suggest that the Commentary further specifies that, in order to be considered as an aggregate, the projects and activities carried out in the Source State must constitute a consistent economic and functional whole. More specifically, the economic and functional consistency of the projects should be circumscribed solely to the projects economically and functionally dependent on one another, thus opting for a restrictive interpretation of the condition.

We would like to give an example regarding the installation and assembly of components on two planes.

Consider the case of projects concerning the installation (in the Source State) by a non-resident of mechanical/hydraulic/electrical parts in two planes for two separate end customers. In our opinion, the installation of a mechanical part in a plane has no functional and/or economic link with the installation of the hydraulic/electrical system in another, these being phases of the complex process of construction/assembly of two different planes and therefore of two different projects totally independent from one another: non-installation of the engine in a plane does not affect the operation (defined also as income-generating capacity) of another plane, and the non-installation of an electrical/hydraulic system on one plane does not affect the operation of the other.

In the above cases, functional organisation (required for a permanent establishment to exist) is there, but solely with respect to each plane (which constitutes a single and coherent project) and not for both of them.
For this reason, in order to ascertain the existence of a permanent establishment of the entity not resident in the Source State, the relevant circumstance should be whether or not the duration of the single project (e.g., the installation of the engine) on each plane exceeds the time limit provided by article 5 of the DTT (the duration test). Thus, in our example, in order to consider whether or not a permanent establishment exists, the time spent on each project - e.g., the installation of the engine – should not be added to the time spent on a different project – e.g., the assembly of the electrical/hydraulic system on another plane, since these projects are economically and functionally separate and do not constitute the “cohesive operating business” referred to on page 18 of the Discussion Draft.

Therefore we would suggest that it is further specified in the Commentary that in cases similar to those described, the individual projects (regarding products for different clients) should be individually considered and not regarded as a single whole, and as a consequence do not result in the creation of a permanent establishment if individually lasting less than the period of time stated in article 5 of the respective DTT.
Dear Ms. De Ruiter,

The Swiss Bankers Association (SBA) is the leading professional organisation of the Swiss financial centre. Its main purpose is to maintain and promote the best possible framework conditions for the Swiss financial centre both at home and abroad. The SBA was founded in 1912 in Basel as a trade association and today has 317 institutional members and approximately 18,500 individual members.

The SBA would like to thank the OECD for the opportunity to comment on the discussion draft on Action 7: preventing the artificial avoidance of PE status. The SBA has been in close cooperation with BIAC, while it was preparing its comments and can therefore basically support them.

In addition to the points raised by BIAC the SBA would like to mention issues which are particularly relevant for the banking industry.

1. **Particular Features of the Financial Sector**

The financial sector is highly regulated. Parts of the regulations are dealing with restrictions, which directly affect the chain of distribution of services and products cross border. Active distribution (soliciting) of products and services is in most countries only possible with an authorisation from the competent authority at the place of distribution. This refers in particular to the financial products that are not traded on a stock exchange, to mutual funds and to insurance policies. Therefore most of the activities performed are based on a concept of passive solicitation i.e. customers seek contact with a bank and ask for services. Such remote solicitation does not and should not fall under the concept of a PE.
Distribution channels for services have developed: in addition to so called traditional channels like telephone, facsimile or direct visits new channels enhanced by modern technology like Internet, smart tools like smart phones, tablets and most recently smart television are nowadays also in use. These new communication technologies are substitutes to existing channels. In this regard there is no ground for considering these new communication tools as creating a PE, these are rather to be associated with activities traditionally considered as preparatory and auxiliary.

2. Artificial Avoidance of PE Status Through Commissionaire Arrangements

As a matter of principle, the SBA would strongly recommend not to widen the wording of the OECD model tax convention by adopting formulations such as: "engages with specific persons in a way that results in the conclusion of contracts". Doing so would create great uncertainty and as consequence may lead to a massive increase in the number of disputes between States, which would imply additional costs. In this respect it is worth noting, that the recently published Public Discussion Draft on Action 14 – Make dispute resolution mechanisms more effective – highlights the difficulties encountered with respect to dispute resolution mechanisms. As a consequence, and even if we consider that there is some room for improvement, one should be very careful before adopting measures that would lead to more disputes, because of the actual remote chances of finding fast and cost effective solutions through dispute resolution mechanisms.

In this context, the SBA would further underline that the offering over Internet should not be considered as an activity that results in the conclusion of contracts.

Furthermore, the activities of intermediaries typically remunerated through finder’s fees should not lead to the creation of a PE.

3. Service PE

The SBA strongly recommends not to include any rules or proposals regarding Service PE in the BEPS project. The Service PE concept is not covered by article 5 of the OECD model tax convention and should not be introduced via (respectively covered by) the BEPS project.

For example, rules applying for constructions sites (which are fixed places) cannot be compared and simply adapted to the offering of services made without any fixed presence in a country.

The SBA is of the opinion that the OECD should abstain from defining rules on Service PE because such rules would trigger a need for additional clarification and definitions of issues associated with it. This cannot be properly addressed without a comprehensive reshuffle of the PE concept. It is our understanding however, that this is not the aim of BEPS.

1 See Public Discussion Draft – BEPS Action 7: Preventing The Artificial Avoidance Of PE Status, page 10: "[…] these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."
Difficulties that may arise in this respect would for example concern the definition of services and of service PE as well as the profit allocation rules. Solving the difficulties arising from the introduction of a new PE concept would not be realistic in the context of BEPS. This would require clarifications, through the introduction of coherent new definitions and explanations in the OECD commentary in a very short term. If an incoherent PE concept is introduced, it is foreseeable that an increased number of disputes on issues as important as profit allocation between States will result. This might lead to very high costs for all (including for States) without contributing significantly to addressing BEPS concerns, in particular if one considers that dispute resolution mechanisms might not be effective.

The SBA thanks the OECD for taking due account of these comments.

Yours sincerely,
Swiss Bankers Association

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Zürich, 9 January 2015

Public Discussion Draft – BEPS Action 7:  
Preventing The Artificial Avoidance Of PE Status

Dear Ms. De Ruiter,

Introduction

The Swiss Insurance Association (SIA) welcome the opportunity to comment on the public discussion draft BEPS Action 7: “Preventing the artificial avoidance of PE Status”.

Below we focus on the draft p. 25: option M. “Provision that deems a PE to exist with respect to certain insurance activities” and option N. “No specific rule for insurance enterprises; relying on the changes to Art. 5(5) and 5(6)”.  

Our desire is to ensure that measures are applicable in the context of commercial insurance operations and avoid non practicable impacts on the insurance business models.
1. **OECD Draft, p. 25:**

   **option M.** “Provision that deems a PE to exist with respect to certain insurance activities” and

   **option N.** “No specific rule for insurance enterprises; relying on the changes to Art. 5(5) and 5(6)”

**Regulatory Purposes**

New tax regulations have to consider existing and implemented regulations for insurance companies. The insurer’s capital requirement is determined by the home regulator and client considerations. The current definition of PE in Article 5 Model Tax Convention on Income and on Capital strongly correlates to the definition of PE for regulatory purposes. This ensures that tax and regulatory definitions of the term “Permanent Establishment” are consistent, which has clear benefits, e.g. accounting information reported for regulatory purposes can also be used to determine taxable profits. The applicable regulations concerning PE’s in tax and regulatory matters should remain aligned. Otherwise an substantial number of tax PEs may be created, without there being a corresponding regulatory PE, generating an additional compliance burden and potential double taxation due to different tax authorities having different interpretations of what constitutes a PE.

The taxation of insurance Permanent Establishments was considered in detail in Part IV of the OECD Report on the Attribution of Profits to Permanent Establishments. This has provided a framework that is considered to effectively work by both tax authorities and taxpayers. Therefore, anything that lessens the effectiveness of Part IV should be approached with caution.

The Key Entrepreneurial Risk-Taking (KERT) functions (e.g., assessment, assumption and management of risk) are in the underwriting country. The agent is only the contact for clients. The agent is an intermediary and do not carry and is not managing the risk. Therefore the current Article 5 Model Tax Convention does not implement a tax PE if the agent is active in another state or the risks are situated in another state. The agent receives a fee for his services and the country of the agent generates the taxes for his activity. The KERT function is in the insurance company, which is accepting and managing the risk and therefore its profit is taxed in the insurer’s home country.

Since the income of the insurer is already subject to tax in its home country a double taxation would result in option M (unless the home country offers relief). Furthermore in option M the insurer would pay taxes even if there would result losses in the “PE”-
country of the agent.

Subsequently with option M a great compliance burden would have to be implemented with profit attribution calculation to insurance premium taxes already paid, etc..

Conclusion

Therefore we do not see the need for a special treatment and a specific provision that apply to insurances and the premiums by a dependent agent as proposed in option M. The difference between the insurance specific proposal (option M) and the general proposal (option N) is, that dependent agent acting abroad and foreign risks would create tax “PE’s” without KERT functions. This would result in minimal profit but create double taxation an essential compliance burden.

Option M would have impacts on insurance business. The proposal would make insurance more expensive, would allow less availability and inhibit customer products.

Therefore, we refuse option M and prefer option N.

2. **Artificial avoidance of PE status through commissionaire arrangements and similar strategies**

Options A – D

There are differences between commissionaire arrangements and insurances. Insurance as regulated industry cannot transfer risks without economic benefits. The risk is with the insurer, not with the insurance broker.

The options A – D are widely drafted. In practice difficulties and double taxation will arise because of different interpretation by tax authorities.

All options A – D explain, that an agent who “acts … almost exclusively on behalf of one enterprise… is not an independent agent. There is a need that “almost exclusively” is defined clearly.
Option A

“Engages with specific persons in a way that results in the conclusion of contracts” is too broad and has to be defined.

Option B

Option B is the preferred option. But “negotiating the material elements” has to be defined.

Option C and D

The phrases “on the account and risk of” and “by virtue of a legal relationship” are both very vague and could be interpreted to cover a range of transactions and relationships considerably beyond the targets of the OECD BEPS project. Such uncertainty is not appropriate in tax law, and would likely result in more disputes between tax authorities over who has taxing rights.

3. Activity Exemptions

Option E

Option E seems to be the most preferable from options E – G.

4. Fragmentation of activities between related parties

Option I

Option I is our preference. But the meaning of “constitute complementary functions” and “cohesive business operation” have to be defined.
The Swiss Insurance Association thanks the OECD for taking due account of these comments.

Yours sincerely,
Swiss Insurance Association

Lucius Dürr
CEO

Marc Chuard
Head of Finance Regulation
23 December 2014

Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration  
Organisation for Economic Co-Operation and Development  
Paris, France

Via Email: taxtreaties@oecd.org

RE: Public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. de Ruiter:

On 19 July 2013, the OECD published an Action Plan on Base Erosion and Profit Shifting (hereinafter the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries’ tax bases are being eroded or profits shifted improperly. Pursuant to Action 7 of the Plan, “Prevent the artificial avoidance of PE status,” the OECD issued a public discussion draft on 31 October 2014 (hereinafter the Discussion Draft or Draft). The Discussion Draft recommends modifications to the definition of a permanent establishment (PE) in Article 5 of the OECD’s Model Tax Convention on Income and Capital (Model Convention). The modifications address when certain activities conducted by a multinational enterprise (MNE), or an agent acting on behalf of the MNE, will constitute a PE of the enterprise.

The OECD requested comments on the Discussion Draft no later than 9 January 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD’s request for comments. In addition, TEI requests the opportunity to speak in support of these comments at the public consultation meeting on the Action 7 Discussion Draft, scheduled for 21 January 2015 in Paris.
I. **TEI Background**

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.

II. **TEI Comments**

TEI commends the OECD for recommending changes to the definition of a PE in the Model Convention itself rather than modifying the OECD’s official commentary on the Convention (the Commentary). Changes to the Commentary are more susceptible to differing interpretations among tax authorities. Moreover, in certain cases, changes to the Commentary may effectively amend the language of the Model Convention without the deliberative process required for amendments to the Convention. Modifying the language of the Model Convention will more likely lead to consistent application of PE definition across tax authorities, which will provide certainty for taxpayers and result in less controversy and litigation. In addition, TEI welcomes the continued focus on physical presence in the general definition of a PE under paragraph 1 of Article 5 – “a fixed place of business through which the business of an enterprise is wholly or partly carried on” – which remains undisturbed in the Draft.

A. **Background Considerations**

Article 5 of the Model Convention was designed, in part, as a kind of “safe harbour” to avoid or minimise international disputes regarding taxing jurisdiction between source and resident countries. By both broadening the definition of a PE and limiting the exceptions to that definition, the Discussion Draft moves the tax jurisdictional line in favor of the source country. The impetus for this move is primarily tax authority dissatisfaction with commissionnaire structures that do not constitute a dependent agency arrangement under paragraph 5 of Article 5 and the perceived improper exploitation of the specific activity exceptions in paragraph 4. The move towards source country taxation and a broader reach of the PE definition, however, is in tension with the OECD’s work on transfer pricing documentation under Action 13 of the Plan and the requirement of a detailed value chain and economic analysis to set appropriate transfer prices. A proliferation of PEs within an MNE’s operations will only complicate this analysis when determining the proper amount of remuneration between a PE and the rest of the enterprise.

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1 TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).
Moreover, it should be unsurprising that MNEs strive to avoid creating a PE in a particular jurisdiction just as they strive to avoid double taxation in transfer pricing matters between jurisdictions. An unanticipated PE assertion may result in unexpected – and potentially drastic – tax consequences, an exacerbated compliance burden, and double taxation. Just as unsurprisingly, these potentially drastic consequences incentivize tax authorities to assert a PE. Indeed, in the experience of TEI’s members, some countries go so far as to assert a PE to force MNEs to settle on unrelated transfer pricing issues, or even as a way to “make up” for taxes the authorities are unable to collect on transfer pricing matters. The OECD should recognize that it indirectly encourages tax authorities in these endeavors by introducing unnecessary uncertainty into the PE definition while also lowering the PE threshold.

Regrettably, the Discussion Draft begins on the wrong footing by stating that “in many cases commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where the sales took place.” Elsewhere, the Discussion Draft labels certain taxpayer arrangements as an “abuse” or not in conformance with the “original purpose” of Article 5 of the Model Convention. Proceeding from the premise that most, if not all, of the arrangements described in the Discussion Draft are “artificial” has apparently freed the OECD to propose sweeping changes to the PE definition. These changes, however, are either more appropriate to abusive situations, such as the ability of tax authorities to ignore separate legal entities and recharacterize contracts, or would be better effected elsewhere, such as through transfer pricing rules. No matter which of the various options in the Draft the OECD chooses in the final amendments to Article 5, the changes to the PE definition will increase the uncertainty of when an enterprise’s activities, or the activities of an agent, will give rise to a PE as compared to the current rules. This will result in more controversy and litigation, consuming both taxpayer and tax authority resources.

B. Elimination of Commissionnaire Structures and Similar Arrangements (Options A through D)

As noted, the Discussion Draft generally views commissionnaires as structured “primarily” to permit MNEs to erode the tax base of the State of sale. There is no discussion, however, of the commissionnaire as a legitimate business arrangement often used by unrelated parties to conduct their respective enterprises. The Draft thus offers no analysis of why a commissionnaire should be considered an “artificial” mechanism when used by an MNE to operate its business. The Discussion Draft adopts this view of commissionnaires across the board, even in cases when a commissionnaire approach best reflects the relationships in place within an MNE, which are generally organised for legitimate business reasons (such as delineating

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2 Discussion Draft, pages 6 and 11.
3 See Discussion Draft p.7 (regarding the “abuse” of Article 5(3) through the “splitting-up of contracts”).
4 See id. (regarding the use of the specific activity exceptions in Article 5(4) to avoid PE status).
delegations of authority and responsibilities, reducing compliance costs, or avoiding tax volatility). Indeed, in some cases a commissionnaire structure may result in an increased profit allocation to a high tax jurisdiction, which is hardly evidence of source State base erosion.

In this regard, it is worth noting that many, if not most, MNEs generally no longer take a country-by-country “silo” approach to their affairs by constructing a separate, fully integrated operation in each jurisdiction. Instead, operations take place on a worldwide basis with a more homogenous approach to the activities conducted in a particular jurisdiction when compared to other jurisdictions. MNEs generate product demand through global advertising rather than via sales personnel “on the ground” negotiating and concluding contracts with customers in individual countries. In this business environment, utilising a commissionnaire arrangement in individual jurisdictions makes commercial sense from a cost minimisation standpoint by eliminating the need for a fully integrated, local sales and distribution operation, whether or not an MNE’s local tax burden is reduced. A commissionnaire structure is also relatively simple as it allows an MNE to concentrate its inventory ownership in a single company within an MNE group.

Nevertheless, the OECD has clearly concluded that commissionnaire and similar arrangements must be eliminated, at least between related parties. The Discussion Draft thus proposes four alternative amendments to paragraphs 5 and 6 of Article 5 of the Model Convention (referred to as Options A through D), each of which would likely eliminate the commissionnaire arrangement. Each of these options, however, also come with potentially negative collateral consequences for both taxpayers and tax authorities.

Before commenting on Options A through D, it bears noting that while a commissionnaire may result in the reduction of the local tax base in certain circumstances, restoring a “fair allocation” of taxation rights – in this case by eliminating commissionnaires – will not necessarily mean an increase in local taxable profits. In a number of industries, overall profit margins are much lower than prior to the 2008 financial crisis. Thus, while a commissionnaire has low – but also stable and positive – profits, this does not mean that the foreign principal is enjoying excessive profits (as the example in paragraph 7 of the Discussion Draft appears to assume). Indeed, there may be instances where a principal company bears significant losses simply because the MNE’s overall profit is not sufficient to ensure that all limited function and risk entities (e.g., manufacturers, distributors) receive an appropriate positive return. This raises an issue for OECD Member States and other participants in the BEPS project of whether they will accept that such losses will be allocated to their jurisdictions as part of “restored balance between source and residence states” through the elimination of commissionnaires. A buy-sell entity, in contrast to a commissionnaire, will not necessarily be protected from sharing in the overall loss of an MNE, which may include a local loss. That is to say, by attempting to tax a greater share of an MNE’s profits attributable to a PE under a modified PE definition, the Member States must also welcome a greater share of MNE risks and potential losses attributable to that same PE.
1. **Options A through D Amending Paragraph 5 of Article 5**

Options A through D present several alternative changes to paragraph 5 of Article 5, each of which is intended to eliminate the ability of an MNE to utilise a *commissionnaire* arrangement to distribute its products in the *commissionnaire’s* jurisdiction without giving rise to a PE. While each of these options would likely succeed in eliminating such arrangements, the cost of that result is increased uncertainty surrounding the activities of an agent that give rise to a PE of an enterprise. This undermines the primary advantage of the current text of paragraph 5 – the certainty of whether an MNE has a PE through the activities of a person as a dependent agent.

The added uncertainty of the proposed changes in Options A through D is particularly regrettable in the PE context because the consequences of creating an unexpected PE can be dire. These may include a tax on the gross amount of an MNE’s revenue through the denial of allocable deductions for all years in which the PE existed, along with interest and penalties. Moreover, the number of years subject to tax could be significant because the statute of limitations may not begin to run until a return has been filed in the jurisdiction. In addition, substantial double taxation will almost certainly result from the creation of an unexpected PE. Thus, unlike transfer pricing adjustments that generally occur along a spectrum, the “PE or no PE” determination is generally an all or nothing exercise that significantly raises the stakes of any dispute. The injection of substantial uncertainty into the PE definition and its attendant potentially substantial tax consequences will negatively affect the free flow of capital across borders, particularly for enterprises contemplating entry into new markets.

Turning to the PE definition itself, in general, under current paragraph 5, if a person acting on behalf of a foreign enterprise does not sign contracts that are legally binding on the enterprise – “conclud[ing] contracts in the name of the enterprise” in the language of the Model Convention – then the person’s activities will not give rise to a PE of the enterprise. This approach is simple to apply and draws a clear line between what the person can and cannot do on behalf of the enterprise without giving rise to a PE. Options A through D would eliminate these clear lines and introduce additional uncertainty to the PE determination.

A potential alternative to Options A through D would be to simply add to the current text of Article 5 that “any related *commissionnaire* (or similar arrangement) will be characterised as a limited risk distributor for purposes of” the Model Convention. Any resulting controversy can then be determined through a transfer pricing analysis of the proper remuneration of the limited risk distributor, rather than through a retroactive assertion of a PE and the difficult process of attributing profits to the PE under Article 7 of the Model Convention. This approach would provide clarity while addressing the OECD’s target with few unintended consequences. It may, however, be viewed as a targeted special rule not suitable for inclusion in the Model Convention, which characteristically uses broader language of general application. Absent such an approach, of the four alternatives proposed in the Discussion Draft, in TEI’s view Option D
provides the clearest indication of when the activities of an enterprise will give rise to a PE, although it is by no means perfect.

When compared to Options A through C, Option D has the advantage of requiring that person acting on behalf of an enterprise either “conclude contracts” or “negotiate the material elements of contracts” before the enterprise will be deemed to have a PE because of the person’s activities. Further, this person must also “habitually” engage in these activities – a term used in current paragraph 5 and therefore presumably one that will have the same meaning in new paragraph 5. Concluding contracts and negotiating material elements delineates the focus of any dispute over whether the activities of a person create a PE – did the person sign contracts? Did the person negotiate material elements of contracts? If so, did the person do this “habitually”? The primary uncertainty under Option D will be whether contract term is “material.” Tax authorities may view materiality differently than taxpayers or even other tax authorities. In TEI’s view, material elements may include the price, number of items, the personnel performing the contract, the delivery terms, etc. This uncertainty will undoubtedly result in a greater amount of controversy than the current text of paragraph 5. Such controversy will, however, almost certainly be lower than the controversy that would arise if the OECD adopted one of Options A through C.

With respect to “material elements” of a contract, TEI recommends inserting the word “commercial” so the text reads “material commercial elements.” This would help focus this portion of new paragraph 5 on the “business” terms of the contract. Other contractual elements that might be described as “standard” or “boilerplate” and are negotiated by, e.g., an enterprise’s legal department or other personnel responsible for the enterprise’s non-core functions, rather than its business personnel, should not be considered material elements and their negotiation should not give rise to a PE. Such elements would generally include representations and warranties, choice of law provisions, indemnifications, confidentiality and privacy provisions, audit rights, insurance, etc. TEI recommends that the OECD develop a representative list of contract terms that may generally be considered immaterial for inclusion in the Commentary, as well as examples of various approaches to determining materiality.

Option D also requires a legal relationship between the person and the enterprise, such that a contract is “on the account and risk of the enterprise.” This requirement, which is not included in Option B, provides additional certainty about who may act on behalf of an enterprise. As the explanatory note with respect to similar language in Option C states, “[t]his formulation refers to contracts that are on the account and risk of the foreign enterprise by virtue of the legal (not economic) relationship between the person and the intermediary . . . .” The use of a legal relationship to determine whether a contract is on the account and risk of an enterprise is preferable to the use of an economic relationship. A legal relationship is generally evidenced by a signed, written contract, whereas an economic relationship is indeterminate and highly

Discussion Draft, p. 14 (emphasis added).
dependent on particular facts and circumstances that constantly change and may be difficult to determine with sufficient certainty.

In sum, these elements make Option D the best of the four Discussion Draft options that would eliminate *commissionnaires* because it provides the most guidance and certainty to taxpayers and tax authorities, despite being inferior to the current text of paragraph 5 in that regard. Further, Option D is preferable to Option B because Option D requires a legal relationship between the foreign enterprise and the person acting in the local jurisdiction on the enterprise’s behalf.

Option A, on the other hand, would include the following language in Article 5(5) for determining when an enterprise will be deemed to have a PE in a Contracting State:

where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has a right to use, or

c) for the provision of services by that enterprise . . . .  

This language is too vague and overbroad to provide the necessary certainty to the PE definition. In particular, it is unclear what is meant by the term “specific persons.” The explanation merely notes that this is intended to cover situations where the intermediary (the “person” in the modified paragraph 5 language) habitually interacts with “identifiable persons” in a way that results in the conclusion of contracts. The use of identifiable persons is no more helpful than specific persons.

More problematic is the language “in a way that results in the conclusion of contracts.” It is unclear what is required for activities to “result[] in the conclusion of contracts.” Does the activity have to be a “but for” cause? Does it need to be a necessary and sufficient activity? Could it be merely a necessary activity? Option A does not specify which of these alternatives may apply (if any). The language becomes even more difficult to apply when (i) there is more than one “but for” cause for, or more than one activity leading to, the conclusion of a contract, and (ii) those causes or activities are performed by different persons in different locations. The explanation attempts to provide additional clarification by stating that the language is intended to cover situations where the intermediary’s interactions with identifiable persons “directly result” in the conclusion of contracts. A “direct result” would “require a direct causal

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Discussion Draft, p. 11-12.
connection between that interaction and the conclusion of the contract.” This attempt at clarification, however, merely repeats Option A’s proposed language in a slightly different form. The explanation also states that the language “would not, however, require that the contract be formally concluded by the intermediary.” Thus, Option A is vague and substantially departs from the clarity of the current language of paragraph 5 by removing the bright line of formal contract conclusion by the intermediary and replacing it with a nebulous “engages with” or “habitually interacts” standard that has no clear bounds so long as a contract “results” from the intermediary’s activities. Further, potentially any engagement or interaction that a tax authority could plausibly point to as “resulting” in the conclusion of contracts would create a local PE. The language is therefore also overbroad.

The same language is used in Option C, which should also be rejected for the reasons set forth above with respect to Option A.

2. **Proposed Modifications to Paragraph 6 of Article 5**

The Discussion Draft proposes to replace current paragraph 6 in its entirety. Paragraph 6 provides that an enterprise will not have a PE in a jurisdiction if it carries on business in that jurisdiction through an independent agent acting in the ordinary course of the agent’s business. This paragraph is an exception to the “deemed” PE of paragraph 5 for enterprises that operate through a dependent agent. New paragraph 6 would continue to provide an exception for independent agents operating on behalf of an enterprise in the ordinary course of agent’s business, so long as the agent also acts “on behalf of various persons.” The second sentence of new paragraph 6, however, states that “[w]here . . . 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 this paragraph with respect to these enterprises.” Thus, under new paragraph 6, the independent agent exception is not available if a person acts exclusively for a foreign enterprise, even if the person is not associated with the enterprise (i.e., where the person is an unrelated third party).

While the intent of new paragraph 6 to remove the “independent” status of exclusive agents is relatively clear, its application is problematic in certain respects. First, it is unclear how to determine whether an agent is acting “exclusively or almost exclusively” on behalf of an enterprise. The Draft does not provide a time period for measuring when a person acts “exclusively.” This raises the possibility that an “exclusive” relationship may arise over any period of time, no matter how short. TEI recommends that paragraph 6’s new language be changed to: “[w]here . . . a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises for a period of at least 12 months” then the person will not be treated as an independent agent. This would provide certainty to when a nominally

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7 Discussion Draft, p. 12.
8 Options A through D propose identical changes to paragraph 6 of Article 5.
independent agent will not be accorded that status under Article 5. Concerns that such a change would encourage a foreign enterprise to structure its contracts with an in-country agent to avoid the 12 month threshold could be addressed in the same manner as changes suggested in the Draft under paragraph 3 (discussed below).

Second, it is also unclear how to measure when an agent acts “almost” exclusively on behalf of an enterprise or related enterprises. Potential measures include revenues generated, time spent, number of clients, a combination of the three, or some other measure. For example, if an agent has a client that generates 95% of its revenue, and a single other client generates 5%, does that agent act “almost exclusively” on behalf of the first client? Suppose instead of a single other client, ten clients account for the other 5% of the agent’s revenue, and also 15% of the agent’s time – does the result change? Or what if it is three other clients and 10% of the agent’s time? And again, the Discussion Draft does not provide a time period for measuring the various gauges of exclusivity. Further, the language raises the possibility that an enterprise could end up with a PE through no activities of its own if an agent no longer acted on behalf of other clients. That is, if an agent with two clients that each accounted for 50% of the agent’s business loses one of those clients, would the other client have a PE because the agent is now acting “exclusively” on behalf of that client? For these reasons, a better approach would be to eliminate the “almost exclusively” language from new paragraph 6 and provide that an agency PE cannot be created if the exclusivity arises through the unilateral actions of the agent or the unrelated clients of the agent. Another alternative would be to prescribe, perhaps in the Commentary, measurement approaches to the “almost exclusively” analysis.

Third, it is unclear whether an agent that acts exclusively or almost exclusively on behalf of an enterprise, but only performs preparatory or auxiliary functions, could nevertheless constitute a PE of the enterprise. It appears that this cannot be the case as such an agent would then fall under paragraph 5, which states that a person acting on behalf of an enterprise will not constitute a PE of the enterprise if the person’s activities are limited to those in paragraph 4, regarding preparatory and auxiliary activities. Nevertheless, the OECD should clarify that an exclusive agent that does not qualify for the exception to PE status in paragraph 6 for independent agents is not a PE under paragraph 5 if it only performs activities described in paragraph 4.

New paragraph 6 would also subject to PE status cases where an unrelated and independent, yet exclusive, agent operates in that manner for non-tax business reasons. For example, an agent may be exclusive to a particular enterprise to protect that enterprise’s trade secrets and other confidential information from competitors and yet be unrelated to the enterprise. Despite the lack of a tax planning motive, such an exclusive agent would constitute a PE, whereas under current paragraph 6 it would depend on whether the agent was

9 This issue would be mitigated by the adoption of our recommendation to require exclusivity to run for at least 12 months.
“independent” and acting in the ordinary course of its business. This would create difficulties for certain businesses that operate through exclusive, and yet independent, agents in dozens of countries around the world. Under new paragraph 6, such a business would face the prospect of having a PE in each of those jurisdictions, potentially even in years where no contract is concluded in a particular jurisdiction. If a multi-billion dollar tender is won in such a country and a success fee is paid to the independent agent (treated as a dependent agent under the new language and thus constituting a PE), the allocation of the tax base will give rise to controversy between the enterprise’s jurisdiction and the agent’s jurisdiction, with the taxpayer in the middle.

Finally, the effect of new paragraph 6 on related party distributors, such as a limited risk distributor, is unclear. Some MNEs set up separate subsidiaries exclusively to market or distribute products or services in a new country. The subsidiary and its parent would be compensated for their respective functions and risks based on arm’s length transfer pricing principles and each would be taxed on the income allocated to their respective tax jurisdictions. Under the proposed changes, however, the subsidiary may now be considered a dependent agent of the parent, thus creating a PE of the parent in the local jurisdiction. This appears to be the case even though the related local subsidiary would already have a PE of its own in the local jurisdiction. The local country may then attempt to tax the income related to the distribution arrangement twice, once to the parent and again to the subsidiary. The OECD should provide that if the related local entity already has a PE in the local jurisdiction, then it would be considered an independent agent with respect to its parent (or other associated enterprise) and not also constitute a separate PE of the parent (or enterprise). The correct amount of remuneration to the local entity could then be determined under transfer pricing principles.

C. Proposed Modifications to the Specific Activity Exemptions in Paragraph 4 (Options E through H)

The Discussion Draft proposes several alternative modifications to paragraph 4, which currently excludes certain activities or fixed places of business from creating a PE of an enterprise. As with the Discussion Draft’s proposed alternatives to modify paragraphs 5 and 6, Options E through H would increase the uncertainty of determining whether the conduct of an enterprise gives rise to a PE.

In TEI’s view, Option E is the most administrable and practical of the proposed changes to paragraph 4. Option E would require all of the various exceptions in paragraph 4 to be of a “preparatory or auxiliary character.” Current paragraph 4 permits a business to carry out certain activities in a State regardless of the activities’ character as preparatory/auxiliary or core business functions. While the lack of a distinction between the nature of the activities is one of the primary objections to certain portions of paragraph 4, the current paragraph nevertheless provides certainty to taxpayers and tax authorities (e.g., it is usually a simple matter to determine whether an activity constitutes the “delivery” of goods). As modified by Option E,
however, paragraph 4 would continue to permit MNE’s to position goods “in-country” for
delivery to customers on a timely basis (e.g., without unanticipated logistical setbacks or
customs delays) without establishing a PE in cases where such positioning is not a core function
or profit driver of the enterprise. The primary downside to Option E is that it places substantial
pressure on determining whether an activity is “preparatory or auxiliary.” This is ultimately a
facts and circumstances determination that will depend on the key profit drivers of a particular
MNE and industry.

Options F through H present alternative approaches if Option E is not adopted. Option
F would remove the reference to “delivery” from subparagraphs a) and b) so the use of facilities
for the delivery of goods or the maintenance of a stock of goods for delivery would not
automatically be exempted from PE status. Option G would eliminate purchasing goods from
the exception to PE status for the maintenance of a fixed place to conduct such an activity,
which is now included in subparagraph d). Option H would eliminate subparagraph d) in its
entirety, so the maintenance of a fixed place of business solely for the purpose of purchasing
goods or merchandise or collecting information would no longer be automatically exempt from
PE status.

The difficulty of Options F through H is that if an enterprise, e.g., maintained a fixed
place of business solely for the delivery of goods, then many tax authorities would
automatically deem such a fixed place of business a PE under paragraph 1 of Article 5. This
would be the case even though paragraph 1 requires not only a fixed place of business, but that
the fixed place be one “through which the business of an enterprise is wholly or partly carried
on.” Of course, it could be said that anything an MNE does is part of its business, and thus any
operation carried out through a “fixed place” constitutes a PE. Current paragraph 4, however,
generally prohibits such an interpretation by permitting an enterprise to conduct certain
activities from a fixed place without creating a PE. This allows an enterprise to conduct such
activities while avoiding the attendant administrative burden and associated compliance
difficulties of a PE (e.g., allocating income and expenses to the activity for purposes of
computing a net income tax). This is a logical approach in the PE determination for activities
that are in the vast majority of cases minimal and immaterial, or at least are not key value
drivers of an enterprise. Options F through H would all but eliminate this approach in the case
of delivery, purchasing, and/or collecting information. Under these options, enterprises who
conduct such functions in their business, but where the functions are not critical to the
business’s success or failure or are not key profit drivers, would be hesitant to enter new
markets for fear of creating a PE.

Options G and H would each eliminate the exception to PE status for the maintenance of
a fixed place of business “solely for the purpose of purchasing goods or merchandise . . . .”
While these options appear to be targeted at MNEs that have a substantial in-country
purchasing team, they would have the perverse effect of creating a PE for even a minor liaison
desk at a particular supplier. Such desks are often merely maintained to pass on quality-control
data to the purchasing entity. It does not appear to be the intent of the OECD to create a PE for such an activity, which is clearly preparatory and auxiliary.

For enterprises where delivery, purchasing, or information collection constitute a profit drivers (even if only one among other drivers), Option E should be sufficient to cause such activity to give rise to a PE of that enterprise.\(^\text{10}\) In TEI’s experience, such functions will often not be key profit drivers for businesses. In particular, businesses that maintain a stock of goods in a local country to deliver to other businesses (so-called “B2B” transactions), are unlikely to view the storage of goods as something other than preparatory or auxiliary, as this is just an additional service to its customers. Even in cases where expedited delivery is critical for B2B transactions, such sales generally occur through a local entity and so the amount of revenue at stake will be much lower. In contrast, a business that sells goods directly to consumers (“B2C” transactions) may consider it critical that these goods be delivered within a very short period of time as that business competes with local retail stores. Thus, the basic ability to maintain a stock of goods in country for the purpose of, e.g., delivery without giving rise to a PE should not be of concern to tax authorities with respect to the activity of most enterprises that primarily engage in transactions with other businesses. Option E is sufficient to distinguish between these two types of transactions, and therefore Options F through H are unnecessary. If the OECD nevertheless decides to adopt one of Options F through H, TEI recommends that the changes apply only to B2C transactions.

D. **Fragmentation of Activities (Options I and J)**

Options I and J present slightly differing alternatives to address situations where MNEs fragment activities between associated enterprises to take advantage of current subparagraph 4(f). This subparagraph permits an enterprise to conduct a combination of the activities described in subparagraphs 4(a) through e) through a fixed place of business without giving rise to a PE, so long as “the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary nature.” Paragraph 27.1 of the Commentary on Article 5 limits a taxpayer’s ability to fragment activities, providing that “[a]n enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.” The aggregation principle in the Commentary currently applies only to multiple places of business of a single enterprise and only if the places are not “separated organisationally.” The Commentary notes, however, that “[p]laces of business are not ‘separated organisationally’ where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place,

\(^\text{10}\) For example, if an enterprise has a “purchasing department” located in a particular jurisdiction that substantially contributes to the enterprise’s profitability through cost savings, it may be appropriate to treat those activities as a PE, even though they are not profitable on a standalone basis due to their nature as purchasing, but not selling, activities. This would, however, create the difficult task of determining how much profit to attribute to the activities of the PE.
distributing those goods through another etc.” If an enterprise fragments its operations across separate legal entities, however, then the aggregation principle of Paragraph 27.1 cannot be applied to combine such activities to give rise to a PE.

Options I and J would add new paragraph 4.1 to Article 5 to provide that the aggregation principle in Paragraph 27.1 of the Commentary can be applied where the multiple places of business belong to associated enterprises, if the activities “constitute complementary functions that are part of a cohesive business operation.” This would prevent an MNE from fragmenting its activities across legal entities under the exceptions to PE status in paragraph 4 to conduct a fully integrated business in a contracting state without giving rise to a PE.

Regrettably, like the other Option in the Discussion Draft, the proposed anti-fragmentation rules would increase the uncertainty of the PE determination and are susceptible to subjective application. In particular, it is unclear what is meant by the phrase “complementary functions that are part of a cohesive business operation.” In many industries it is common to separate what might be complementary functions of a cohesive business into different legal entities. For example, in the real estate industry it is common to hold each investment/location in a separate legal entity to limit an enterprise’s liability, and yet the overall real estate portfolio typically would be managed in a single entity as part of a “cohesive business.” In the telecommunications industry, businesses may be held in separate entities due to different regulatory requirements or to enhance the stock value of each business. In the automotive industry, the dealership business may be held in a separate entity from the manufacturing business. These examples may be viewed as complementary functions and part of a cohesive business operation, but there are valid business reasons to operate through separate entities, such as to segregate risks or provide clear reporting line responsibility. Moreover, in many cases these businesses can be, and are, operated as separate, sustainable enterprises by unrelated parties (such as a car manufacturer and dealership) that do not have a great awareness of the other entities’ business.

In addition, many MNEs are divided functionally on a worldwide basis so that, e.g., the purchasing function is separated from the manufacturing operation, which is separated from the sales function. Each of these functions would have its own management, reporting lines, and financial statements. Commercial advantage is the primary driver behind utilising the specialisation, expertise, economies of scale, and flexibility that accompanies this manner of conducting worldwide operations. These separate organisations may then enter particular markets to carry out their specialised functions in the most tax efficient manner, which may include avoiding PE status. The proposed anti-fragmentation rules, however, would grant tax authorities a blank cheque to re-characterise and combine legal entities (based in-or out-of-country) for purposes of attracting PE status to in-country activities. This would be the case even where such entities have been set up for valid business purposes and not solely for tax

planning, and, in the case of Option J, even where none of the entities has operations in a jurisdiction that would constitute a PE on its own.

We also note that the modifications proposed in Options I and J potentially go beyond the changes to the PE definition and reach into other areas, such as recharacterisation of contracts and business structures that may be considered abusive and transfer pricing issues between related entities. The consideration and adoption of such changes should be left to other BEPS actions. By creating a force of attraction between PEs and associated enterprises, the OECD is intentionally upsetting the delicate balance that has developed in the international tax system over decades. By extending such force of attraction to activities of different functions and entities through Model Convention language that gives a blank cheque to tax authorities to interpret the PE threshold at will, the OECD is breaking a dam that will give rise to a flood of PE assertions and subsequent controversy and litigation. Stated differently, the proposed rules permitting aggregation of purportedly fragmented activities combined with a lower PE threshold effectively operate as a kind of free-standing anti-abuse or “substance-over-form” rule. Such a rule would be unmoored from a jurisdiction-specific body of statutory, regulatory, and case law to ground the analysis of the rule in certain principles and limit its application to abusive circumstances. If the OECD ultimately chooses to adopt one of Options I or J, TEI urges the OECD to limit this force of attraction rule to situations where (i) both PEs share the immediate same functional reporting line within an MNE; and (ii) both PEs are of the same legal entity.

Finally, we note that if the OECD adopts the change to paragraph 4 represented by Option E, whereby all of the activities in that paragraph would be subject to the requirement that they be of a “preparatory and auxiliary character,” then the concerns that underlie Options I and J should be substantially diminished. This would render the addition of paragraph 4.1 set forth in Options I and J unnecessary.

E. **Splitting Up of Contracts (Options K and L)**

Options K and L address situations where an enterprise splits up what should be a single contract into two or more contracts between separate entities for the sole purpose of avoiding the 12 month time threshold in paragraph 3 of Article 5 related to construction or installation projects. The Discussion Draft notes a similar concern with the application of the 183 day threshold of the service-PE provisions in the Commentary, as well as in Article 5(3)(b) of the United Nations Model Treaty. Each option would disregard the separate nature of the two contracts for purposes of the 12 month time threshold. Option K would address this issue by adding an “automatic” rule to take into account any activities performed by associated enterprises for the sole purpose of determining whether the 12 month threshold of paragraph 3 has been exceeded. Option L would address this issue through the general anti-abuse rule proposed as part of the work under BEPS Action 6 regarding treaty abuse, and supplement that provision with an example in the Commentary.
TEI agrees that separating what in substance is a single contract into two or more contracts solely for purposes of avoiding the 12 month time threshold of paragraph 3 should not be respected. However, a rule that “automatically” combines activities of associated enterprises that take place at the same construction or installation site is too harsh and ignores legitimate business reasons for conducting activity at the same site through separate entities. For this reason, while the inclusion of a general anti-abuse rule in the Model Convention is regrettable, limiting the ability of tax authorities to aggregate contracts only to cases where the splitting-up of contracts is tax-motivated, as is the case with Option L, would be preferable to aggregating any contracts that satisfy the conditions of Option K, whether tax motivated or not. Option K would be much improved if it included a minimum period of presence for an enterprise (the Draft suggests 30 days in any 12 month period) as well.

In general, legitimate business reasons for separating operations into two different entities should be sufficient to prevent tax authorities from aggregating the contracts. Examples of such circumstances include:

1. An enterprise may have two separate businesses: a residential construction company and a wireless telecommunications company. Both companies happen to expand into Country X. The residential construction company has a project that would take it 6 months to complete. The telecom wireless company has a project to set up wireless towers that would take it 6 months to complete. Tax authorities should not be permitted to aggregate the two time periods merely because the two companies are associated.

2. An enterprise wins a tender for a construction site that includes (i) construction work, (ii) the installation of electrical appliances, and (iii) the installation of surveillance and communication equipment. That enterprise installs the electrical appliances itself, yet subcontracts the construction work and the surveillance and communication equipment installation to two separate associated enterprises. Tax authorities should not be permitted to aggregate the in-country time period of both associated enterprises merely because the two companies are associated.

3. An enterprise wins a tender to build a prototype which requires ten months of in-country activity. After a five month respite, the company wins a separate contract for full rate production requiring another ten months of in-country activity. While the two contracts are related, the enterprise was not guaranteed the second contract. Under the revised language, tax authorities would not only be empowered to declare the combined contracts a PE, but would also be entitled to subject the enterprise to penalties for not timely declaring a PE for the first contract. TEI recommends that these kinds of circumstances – where entering into separate contracts is not under the sole control of the enterprise or is
required by the nature of the work – be excepted from the “automatic” rule of Option K, should it be adopted.

Finally, we note that enterprises may split up contracts to avoid or minimise the actions of certain over-assertive tax authorities for issues that are not of the type identified in the Draft’s background discussion of Options L and K.12 For example:

1. An enterprise may separate the provision of in-country services from out-of-country services to a single customer into separate contracts, so that local tax authorities may not attempt to tax the entirety of a contract due to \textit{de minimis} in-country activities and regardless of where the economic performance occurs, driving double taxation.

2. An enterprise may separate contracts for the provision of goods and services to a single customer to avoid an argument by the tax authorities in the customer’s jurisdiction that \textit{de minimis} service activity transforms the entire contract into a supply of services that are then subject to withholding taxes.

These types of “defensive” contractual arrangements should be respected as separate, and not subject to collapse under Option K or the general anti-abuse rule, because they accurately reflect the underlying economics of the arrangement (\textit{i.e.}, goods vs. services and in-country vs. out-of-country activity).

Should Options K and/or L be implemented, TEI recommends that the OECD limit the perverse effect of the current proposals by indicating in the text that (i) taxpayers may separate phases of the same contract in separate contracts if the separation accurately reflects the underlying reality of the arrangement, and (ii) the separation of contracts by activity type should continue to be respected.

F. PEs and the Authorised OECD Approach for Attributing Profits Under Article 7

In 2010, the OECD published its \textit{Report on the Attribution of Profits to Permanent Establishments} (the Report). The Report includes the primary OECD guidance for attributing profits to PEs under Article 7 “Business profits” of the Model Convention. According to the Report, under Article 7 a PE is treated as a separate and distinct enterprise from its parent company and assets and risks related to the PE’s (hypothetical) business are allocated to it. As there are no contractual arrangements between a parent company and its PE – because the PE is not a separate entity – assets and risks are allocated between the PE and the parent company by reference to the place of performance of “significant people functions.” The PE is considered to assume the risks if significant people functions relevant to the risks are performed by the personnel of the PE at the PE’s location (\textit{i.e.}, “risks follow functions”). As a second step, under

\footnote{See Discussion Draft, p. 21-22.}
Article 9, the remuneration between the two enterprises is determined through a transfer pricing analysis.

It is clear that the determination of the existence of a PE precedes the question of profit attribution. In practice, the question of attribution of profits to PE can be just as contentious and uncertain as the preliminary question of whether a PE exists. This is evidenced by the practical difficulties that arise from the application of the Authorised OECD Approach recommended in the Report. Take the example of when significant people functions are performed by different members of an MNE group with respect to a single asset. In that case, it is difficult to attribute income to the asset in such a way that is consistent with the accounting rules regarding the ownership and income of the asset. Further, many countries will readily accept an attribution of profits to a PE within their jurisdiction as a result of such an analysis, but would be reluctant to accept a share of attributed losses to the same PE under the same analysis. Double taxation results from this inconsistency. A separate shortcoming of the Report is that it focuses its detailed guidance largely on the banking and insurance industries and does not adequately address the application of the attribution rules to PEs in other economic sectors. Non-financial sector PEs will be much more prevalent than they are now after the adoption of the new PE definition set forth in the Discussion Draft, no matter which particular option the OECD chooses to adopt.

The BEPS project thus far has yet to address the questions of remunerating risks and capital, much less attempt to refine the Report’s attribution principles or extend its guidance beyond financial services and insurance. If Action 7 lowers the PE threshold resulting in a proliferation of PE assertions, TEI recommends that the OECD coordinate the adoption of a lower threshold with an update of the Report’s attribution rules, or phase in the changes to the PE threshold to give adequate time for attribution issues to be discussed and the Report updated appropriately.

G. Transition Period and Grandfathering

The Discussion Draft does not provide a transition period or grandfathering provision for implementation of the new PE definition in Article 5. MNEs that have legitimate structures under the current version of the Model Convention and the Commentary, or other arrangements that would be affected by the modifications proposed in the Discussion Draft, should be given a transition period to change their operations to conform to the new definition. The transition period should be for a minimum of three years, preferably longer. In addition, the OECD should specifically provide that tax authorities may not assert a PE under the new definition in Article 5 for open prior tax years – an all too common experience of TEI’s members across many jurisdictions.
III. Conclusion

TEI understands the need of the Member States and other jurisdictions participating in the BEPS project to modify the PE definition to eliminate certain structures and activities that enable MNEs to conduct substantial business within a country without giving rise to a PE. Lowering the PE threshold, however, will inevitably lead tax authorities to assert a myriad of PE findings that would impose a substantial new administrative and tax burden on MNEs. It is therefore imperative that the new PE definition in Article 5 draw clear lines so that taxpayers and tax authorities alike are on notice of what constitutes a PE to permit MNEs to plan their activities and tax authorities to administer the law fairly. The vague and overbroad changes presented by many of the options in the Discussion Draft would lead to a substantial increase in disputes and a significant reduction in cross-border investment and economic growth.

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding the artificial avoidance of permanent establishment status. As noted, TEI requests the opportunity to speak in support of these comments at the public consultation in Paris on 21 January 2015.

These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI’s legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,

TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President
Dear Marlies de Ruiter,

**RE: Taxand responds to the OECD invitation for public comments on the OECD discussion draft on Action 7 (Prevent the Artificial Avoidance of PE status) of the BEPS Action Plan**

Further to the publication of the OECD’s invitation for public comments on the OECD discussion draft on Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Action Plan, Taxand is honoured to provide written comments based on the practical experience we have as tax advisors.

Our response deals with practical suggestions for improving the prevention of artificial avoidance of PE status while not negatively affecting the due neutrality of taxes, and reducing the complexity of such operations for multinationals.

Taxand can confirm that we have no objections with posting the comments on the OECD website and that comments represent Taxand with input from a number of multinational businesses.

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and to participate in any further discussion on these matters.

More information about Taxand is provided below. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

If you wish to discuss any of the points raised in this letter, please do not hesitate to get in touch with us directly via the contact details below.

Yours faithfully,

Taxand

**CONTACT DETAILS**

Angel Calleja
Taxand Spain
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ABOUT TAXAND

Taxand provides high quality, integrated tax advice worldwide. Our tax professionals, more than 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent—ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. Taxand ranked in the top tier in Chambers Global Guide 2014 global network rankings and in the International Tax Review's (ITR) World Tax 2015, 41 Taxand locations were commended and a further 26 locations listed in ITR's World Transfer Pricing Guide 2015. 31 countries were voted top in the ITR Transaction Tax Survey 2014 and 29 in ITR Tax Planning Survey 2013. Taxand has received 65 national awards and 14 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include Latin America Tax Disputes Firm of the Year, European TP Firm of the Year, European Indirect Tax Firm of the Year, Asia Transfer Pricing Firm of the Year, and Asia Tax Policy Firm of the Year. Full details of awards can be viewed at [www.taxand.com/about-us](http://www.taxand.com/about-us)

[www.taxand.com](http://www.taxand.com)
Taxand would like to thank the OECD for the opportunity to respectfully provide the following comments to the discussion draft on BEPS Action 7, regarding preventing the artificial avoidance of PE status. Along with our gratitude, our recognition goes also to the work performed so far by the OECD, through different working groups, around the BEPS initiative. It is a solid, high-quality and transparent effort undertaken within a short period of time which, in all fairness, needs to be acknowledged.

Our comments below intend to be practical and experience-based, as well as constructive, in our responsibility as global tax advisors to contributing to a more comprehensive debate on the issues raised.

A. Artificial avoidance of PE status through commissionaire arrangements and similar strategies

In general, these proposals involve, in our view, 3 main challenges:

- To avoid negatively affecting due neutrality of taxes and therefore favouring certain business arrangements in respect of others
- To avoid an increase in international double taxation, in the absence in practice of automatic relief between States
- To avoid uncertainty and conflict due to the ambiguity of drafting, in the absence of detailed Guidelines. Unilateral, non-coordinated interpretation/application by States of certain proposals could, in our view, risk breaking current consensus which has validly facilitated mitigation of international double taxation

In this context, we note that specific problems associated with non-taxation at residence, if corrected (other than exceptionally through genuine anti-abuse measures), via limiting tax exclusions from taxation at source may be generally expected to originate new double taxation issues.

The four alternative drafts of paragraphs 5 and 6 of proposed article 5 of the OECD Model Tax Convention

Four alternative options (A-D) are proposed for discussion purposes:

- **Option A**: Replacement of “conclude contracts” with “engages with specific persons in a way that results in the conclusion of contracts”. Unless otherwise clarified, a strict literal interpretation by tax administrations of the proposed wording of Option A could result in automatic PE existence given that the “conclusion of contracts” is in all cases the ultimate business purpose of an agent

- **Option B**: Replacement of “conclude contracts” with “concludes contracts, or negotiates the material elements of contracts”. Detailed consensual guidelines would be required to accurately (and consensually) interpret the concept “material elements of contracts”. Otherwise, asymmetry and controversy due to different meanings under laws/court interpretations in different countries may be expected. Civil Law countries in particular would normally have their own doctrine on, for example essential contract elements, which could interfere. Current Commentaries, specifically 32.1-33.1 seem
to sufficiently have covered this matter so far making this amendment arguably unnecessary

- **Option C**: Option A plus an additional replacement of “contracts in the name of the enterprise” with “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”. While the aim of the provision is acknowledged, the extent of the “legal relationship” concept should be duly clarified, since it might give rise to significant interpretation discrepancies between different States. A general substance over form anti-abuse provision may work in this field.

- **Option D**: Option B plus an additional replacement of “contracts in the name of the enterprise” with “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”. Same comments as in Option C above.

- **Options A-C, paragraph 6**: The last sentence of the revised paragraph excludes an independent agent condition where “a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprise”. This statement rests on a strict business issue and could affect the due neutrality of the tax, given that being an exclusive agent is in itself a valuable business status. A multinationals’ ultimate purpose could be viewed to be equal to placing in the market unique products/services. In this context, an exclusive (or almost exclusive) agent status in respect of such unique products would be a much sought-after status by third/associated parties under normal market conditions. Making exclusivity (or almost exclusivity) an objective condition for PE existence unduly impacts the business organisation and may contradict guidelines on the independent agency test, specifically Commentary 38.6 which, while acknowledging that independence status is “less likely” within exclusivity, reasonably appears to subject such factual matters to case by case analysis and proof. As a final comment, safe harbour rules on the “almost exclusivity” concept would be required, likely on an industry by industry basis to ensure that a fair result follows.

B. **Artificial avoidance of PE status through the specific activity exemptions**

- **Option E**, the exceptions are not restricted to preparatory or auxiliary activities: The proposed amendment would literally require that all listed activities, if performed via a fixed place, need to be preparatory or auxiliary, versus core, in order for a PE not to be deemed to exist. However, Commentary 24 duly recognises that “it is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not”. The existing current consensus on these objective exceptions may be viewed as one of the main contributions of the Model Convention, not least because it eliminates extremely difficult profit attribution discussions between States at a time when international double taxation still needs to be fairly, ie promptly and efficiently, resolved. Increased international double taxation situations based on unilateral domestic rules, which may sometimes collide with TP principles, could be derived from the acceptance of this option.
Option F, the word “delivery” in subparagraphs a) and b) of paragraph 4: Deleting the word “delivery” may be viewed as contradictory with Option E above since the mere delivery of goods is, in most businesses, a genuine auxiliary activity. Concluding sales would, under current principles of article 5, including paragraphs 5 and 6, be the true nexus to taxable PE activity. In this sense, a fixed place where sales are concluded, a shop in fact, remains a consensual taxable fixed place. Delivery of goods whose transfer was previously agreed elsewhere does not appear to be a condition enough to define a PE. It rather constitutes a commodity service which is frequently outsourced. We view this proposal possibly as non-neutral since it could affect the way business is conducted. Furthermore, discussions on profit attribution would be extremely challenging with the risk of unilateral action by States resulting in attribution rules ultimately based or construed on product value rather than on mere service value, and therefore in undue excessive taxation at source, inconsistent even in some cases with current TP consensus. This Option, therefore, does not seem sufficiently justified.

Options G and H, the exception for purchasing goods or merchandise or collecting information: For most businesses purchasing and information collection functions may be regarded as preparatory/ancillary. Therefore, this Option should, in practice, only residually be affecting a limited number of arguable cases. Where Alternative E were not adopted and G or H were implemented, a key concern would again be to define due rules for the attribution of profits (eg on a cost based profit attribution), to impede application of uncoordinated domestic rules. Consensus to-date on purchasing goods and information gathering activities as objectively non-taxable at source under PE status has been an effective tool in mitigating possible international double taxation.

Options I and J, fragmentation of activities between related parties: It is acknowledged that activity fragmentation is an issue which has already been subject to judiciary controversy in several countries and, therefore, one requiring reflection. However, Commentary 11 to Article 7 states that “the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each permanent establishment test”. This separation principle would be contradicted by both proposed Options I and J. Moreover, the same Commentary refers to the “international consensus that until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profit”. In summary, if treaty application and source taxation is levied on an enterprise by enterprise basis and the PE test directly or indirectly relies on an auxiliary/preparatory analysis per enterprise, enactment of either I or J to combat fragmentation could result in risk of overall excessive taxation at source. This could cause an uncertain impact in the due interpretation of concurring treaties with no clear guidelines on how profits, particularly in sophisticated chains, should be attributed per PE, based on domestic
rules. Solution to this type of issue lies, in our view, with the state of residence rather than at source, as addressed in these options.

C. Splitting-up of contracts

- **Options K and L:** These options define essentially different ways of addressing a concern which is not new and which has justified diverse literature and court cases in different countries. Due to its highly factual nature and to the fact that existing specific commentaries provide sufficient guidance it would appear preferable to leave the matter in the hands of a general anti-abuse provision and in no case refer to Option K.

D. Insurance

- **Options M and N:** These refer to a particular industry it being, in our view, debatable if it would require specific BEPS action. In spite of the outlined problems, which are acknowledged, it would be arguable that in fact in this business truly artificial avoidance of PE status concurs. Due to its restrictiveness and the doubts about the existence of true PE artificial avoidance we believe that Option N would be more justifiable.

E. Profit attribution to PEs and interaction with Action Points on transfer pricing

While we understand the references to other working areas, as mentioned previously, we believe that the implementation of some of the above proposed PE avoidance countermeasure options could give rise to specific profit attribution issues derived from the difficulties to fairly define the amount of taxable profits to be reported at source, by one or more concurring PEs, particularly within sophisticated/integrated supply chains. The fact that numerous domestic rules on PE profit attribution exist, and that based on purely local rules they may in different cases be based on indirect factors, is not helpful and could adversely impact due solution to fragmentation and splitting scenarios discussed above. Likely problems originated would require further detailed guidance, reference to current profit attribution and TP principles not being sufficient.

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We appreciate this opportunity to provide comments to the OECD and would be pleased to discuss this further and to participate in any further discussion on these matters.

More information on how to contact Taxand is provided above. Taxand is wholly committed to supporting the OECD and we look forward to contributing to further debate.

Yours faithfully,

Taxand
This response is the sole view of Taxand advisors and does not represent the opinions of Taxand clients or contacts. As provided in Treasury Department Circular 230, this response is not intended or written by any Taxand firms to be used, and cannot be used, by a client or any other person or entity for the purpose of avoiding tax penalties that may be imposed on any taxpayer. The information contained herein is of a general nature, is up to date as of January 2015 and is subject to change. Readers are reminded that they should not consider this response to be a recommendation to undertake any tax position, nor consider the information contained therein to be complete. Before any item or treatment is reported, or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. Even though all reasonable care has been taken in the preparation of this response, Taxand and all of its firms do not accept any liability for any errors that it may contain or lack of update before being submitted, whether caused by negligence or otherwise, or for any losses, however caused, or sustained by any person. Taxand is a global organisation of tax advisory firms. Each firm in each country is a separate and independent legal entity responsible for delivering client services.
Marlies de Ruiter,
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division,
Organisation for Economic Co-operation and Development
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75775 Paris Cedex 16
France

Via e-mail to taxtreaties@oecd.org

January 9, 2015

Dear Ms. De Ruiter

TD appreciates the opportunity to submit comments on the OECD’s Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status issued on October 31, 2014.

Before turning to the specific issues with respect to this Discussion Draft, we want to express grave concern about the implications of these proposals with respect to the permanent establishment (PE) standard, together with the other pending BEPS proposals, for cross-border trade and investment and the global economy. Changes of the type being contemplated under the rubric of the BEPS project, and the uncertainty that would be created by abandoning clear standards and principles in favor of vague and subjective concepts, would have a profound adverse effect in terms of stifling global business. We of course recognize the need for governments to raise revenue to support essential government functions. However, they must do so efficiently and without having a chilling effect on essential commerce.

We urge the OECD to ensure that the work on all the BEPS Actions include full consideration of the microeconomic and macroeconomic implications of any changes. The OECD has the world-class resources needed to contribute to the global debate by educating participants about the economic, policy, and revenue dimensions of the issues to be addressed and the solutions to be developed. This should go beyond the corporate income tax system and include the whole range of tax approaches available to governments.
With respect to the Action 7 work on PE issues, the narrow focus on corporate income tax is particularly troubling because much of the impetus for this Action comes from concerns about ecommerce and the digital economy. Questions regarding the digital economy have attracted public attention, headlines and legislative hearings in many countries. The view seems to be that there must be a serious BEPS problem that requires immediate attention because ecommerce transactions are occurring in the particular country without corresponding corporate income tax payments from the ecommerce seller. However, the ecommerce transaction in question may well involve little or no productive activity in the country where the sale occurs that would attract corporate income tax. Rather, such country merely is the place of consumption in the ecommerce transaction. Consumption is the basis for imposition of a VAT or sales tax or some other form of consumption tax; it is not a basis for imposition of income tax. The focus on the corporate income tax in general and the PE standard in particular is dangerously misplaced.

Turning to the specifics of the proposals in the Action 7 Discussion Draft, for the reasons discussed in more detail below, we are concerned that the proposals would create unacceptable uncertainty for cross-border activity in the ordinary course of business and we believe that any BEPS concerns in this area should be addressed through more targeted changes.

**Previous OECD Work on Financial Institution Matters Should be Taken into Account**

The OECD extensively studied the global banking and securities industry in the work that led to the production of the OECD’s 2010 Report on Attribution of Profits to Permanent Establishments. We strongly urge the OECD to take this prior work into account in developing guidance with respect to PE issues that would impact the financial institutions.

Consistent with this prior work, we recommend that greater focus be given to the use of existing transfer pricing guidance in dealing with areas of concern rather than the creation of new PEs. The use of such an approach is particularly important for regulated entities such as financial institutions, because the activities of financial services entities are largely dictated by the regulator in the particular jurisdiction. The creation of new PEs that would not otherwise exist could result in significant unintended consequences for financial institutions, such as potential withholding taxes that would further add to the administrative compliance burden. This overall focus on transfer pricing could be coupled with a more targeted approach with respect to PEs that would address any specific BEPS activities of particular concern.
Changes to the PE Standard Should be Approached Cautiously

We believe the OECD should take a cautious approach to any changes to the PE standard. It is important not to lose sight of the fundamental purpose of the PE standard to provide a minimum threshold of activity in a country before a business becomes subject to full tax obligations in the country. Given this purpose, it is essential that the PE standard be clear and certain.

Any changes that would lower the PE standard and create more PEs would increase administrative burdens for both taxpayers and tax administrations. These costs must be considered in assessing the merits of any such lowering of the standard. Moreover, any changes that would newly create PEs for low levels of activity in a country would have a chilling effect on cross-border activity, discouraging a business from beginning to conduct an activity in a country, even when it would be most economically efficient to do so, if it does not already have operations in the country and there is a risk that the activity could create a PE. The global economic cost of this chilling effect also must be taken into account.

Any changes that would bring vagueness to the PE standard and uncertainty about whether or not a particular activity rises to the level of a PE would create significant risk of double taxation, stress on the dispute resolution system, and substantial administrative burdens for the taxpayer and both tax administrations involved. In addition, vagueness in the PE standard alone would have a chilling effect on cross-border activity as businesses would have to consider forgoing entry into a new country in order to avoid PE uncertainty. These are deadweight costs that must be avoided.

We believe that changes in the PE standard are an extremely blunt instrument for addressing BEPS concerns, because such changes would apply to cause businesses in high tax countries to have PEs in other equally high tax countries even though the presence or absence of such a PE does not implicate any concerns about BEPS activity. The need for a BEPS response that involves changes to the PE standard should be evaluated in the context of the substantial information that will be available to tax administrations with the new master file and country-by-country reporting requirements that are to be implemented. With these new sources of information, tax authorities will have the tools needed to identify and address any potential abuse in the PE area under the existing standard.

For these reasons, we believe that any changes that are made to the PE standard should be very narrowly crafted to target the specific BEPS activities that give rise to particular PE issues.
The Proposed Options Creating Independent Agent PEs are Overly Broad and Overly Vague

We are very concerned that Options A through D in the Discussion Draft create significant uncertainty and could result in substantial double taxation in situations that do not involve any artificial avoidance of PE status. These Options would create a deemed PE in a situation where an affiliated entity is considered to be acting as an “agent” of an entity even though the two are separate entities.

Options A through D are described as addressing commissionaire arrangements, but they would go well beyond such arrangements and would potentially implicate the whole range of situations where one affiliate conducts activities for another affiliate. In the banking business, an affiliate in one country often will act for an affiliate in another country for regulatory, capital, or commercial reasons. Such ordinary course of business arrangements do not raise the kinds of BEPS concerns that the OECD describes with respect to commissionaire arrangements.

Options A through D involve situations where each of the affiliates already is reporting the income from the activities it conducts in its country. The affiliate serving as agent is compensated for the activities it performs for the affiliate serving as principal and it is taxable on the income it earns. Treating the agent affiliate as creating a PE for the principal affiliate would not change the value of the activities it performs. Therefore, the allocation of income between the two countries should not be significantly different with a PE than it was without the PE.

Deeming a PE in this situation would create compliance and administrative burdens for the taxpayer and the tax administrations that would be disproportionate with any income reallocation or new taxes. Deeming a PE in this situation also would create significant risk of dispute and double taxation because the country where the deemed PE is located may believe it should get more income simply because of the creation of the PE, even where that would not be the right economic result and would not be acceptable to the other country.

In a situation involving such a deemed PE, it is possible that more income could be allocated to the deemed PE if there is a difference in the results under the Article 7 attribution of profits rules and under the Article 9 transfer pricing rules. However, such a difference would seem to reflect a flaw in those rules that should be corrected through better coordination of the two sets of rules. Tax administrations should not be given a windfall by allowing them to pick and choose between the two income allocation approaches by deeming a PE or not depending on which income allocation approach gives the country the better result.
In addition, Options A through D involve changes to the independent agent definition that would effectively ignore separate legal entities in any situation where an entity works exclusively or almost exclusively for affiliates. In the banking businesses, activities are conducted in different entities for regulatory, capital or commercial reasons. Separate entity status should be respected even if an entity only transacts with other affiliates. The allocation of income between entities is properly addressed through transfer pricing.

Finally, stakeholders cannot appropriately evaluate Options A through D proposals without being able to evaluate the associated profit attribution rules. The OECD should complete any work in this area and issue a discussion draft on any proposed changes so that stakeholders can make a comprehensive evaluation.

For these reasons, we believe that Options A-D should be replaced with a more targeted proposal to address any specific BEPS concerns raised by commissionaire arrangements.

**The Proposed Options Restricting the Preparatory or Auxiliary Exception are Overly Broad and Overly Vague**

Under the current OECD Model Tax Convention and related Commentary, the preparatory or auxiliary standard is defined largely through the list of specific activities set forth in Article 5(4). The Option E proposal to add the phrase “preparatory or auxiliary” to the list as an additional requirement to be satisfied would leave the phrase essentially undefined. Therefore, consideration of the Option E proposal would require substantial additional work to develop a definition of the “preparatory or auxiliary” concept. In order for Article 5(4) to be workable and to serve its intended purpose, it is essential that the preparatory or auxiliary concept be clearly defined and universally understood.

The Option H proposal to eliminate the exception from PE status provided under the current OECD Model Tax Convention for information collection activities is overly broad and would capture activities that are appropriately considered preparatory or auxiliary. In the banking business, information collection activities could include, for example, gathering credit information with respect to customers. Such activity alone should not be considered to give rise to a PE.

Any concern about inappropriate use of the preparatory or auxiliary activities exception from PE status should be addressed through a more narrowly crafted approach that targets the
particular BEPS concern. Clarity must be provided to avoid creating unacceptable uncertainty for ordinary course of business activities.

The Proposed Options on Fragmentation of Activities are Overly Vague

The Options I and J proposals to create a PE where "complementary business activities" are carried on by affiliates at the same location or by one or more affiliates at different locations would create significant uncertainty. Therefore, consideration of these two options similarly would require significant substantial additional work on definitional requirements. A clear and universally understood definition of "complementary business functions that are part of a cohesive business operation" would be essential.

In the banking business, it is common for multiple entities to be involved in an activity for regulatory, capital or commercial reasons. The risk that these ordinary business arrangements would trigger PE characterizations under the Options I and J proposals would create substantial compliance and administrative burdens.

Any concern about inappropriate fragmentation of activities should be addressed through a more narrowly crafted approach that targets the particular BEPS concern. Clarity must be provided to avoid creating uncertainty for ordinary course of business activities

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We appreciate the opportunity to provide these comments on key issues with respect to the Action 7 Discussion Draft. We would be happy to respond to questions or to provide any further information that would be useful as the OECD continues its work in this important area.

Sincerely,

Peter van Dijk
Senior Vice President, Tax
TD Bank
Warsaw, 9 January 2015

For the attention of
Ms Marlies de Ruiter
Head of Tax Treaties, Transfer Pricing and
Financial Transactions Division
OECD/CTPA
taxtreaties@oecd.org
sent by e-mail

Subject: COMMENTS ON THE DISCUSSION DRAFT ON ACTION 7 (PREVENTING THE ARTIFICIAL AVIODANCE OF THE PE STATUS) of the BEPS Action Plan

Dear Madam,

“Transfer Pricing Centre” Association (“TPCA”) welcomes the opportunity to provide comments on the discussion draft on Action 7 (Preventing the artificial avoidance of PE status).

“Transfer Pricing Centre” Association (“TPCA”) is a non-profit organization aimed at promoting transfer pricing knowledge in Poland, founded by specialists working for capital groups in Poland, mainly in energy and industry sector. Hence we hereby present the comments as representatives of business. However, since the Association is a legal person, we present the comments only on behalf of the Association. The comments expressed in the letter should be interpreted as opinion of the Association and not particular members of the Association.

We would like to confirm that have no objections with posting our comments on the OECD website.

We are at your disposal to discuss any aspect of our comments. We look forward to developments and further discussions on the topic.

Yours faithfully,

Sylwia Rzymkowska
Chairman of TPCA

sylwia.rzymkowska@cct.org.pl
Subject: COMMENTS ON THE DISCUSSION DRAFT ON ACTION 7 (PREVENTING THE ARTIFICIAL AVIODANCE OF THE PE STATUS) of the BEPS Action Plan

We understand the need to update the treaty definition of PE and the PE tresholds. However, we also recognise some concerns as regards the current proposals published by the OECD/CFA in the discussion draft of October 31st, 2014 in this matter (it is noticed that proposals included in the discussion draft do not represent consensus view of CFA or its subsidiary bodies). Below we present our concerns for your kind consideration.

Comments to Section A – Artificial avoidance of PE status through commissionaire arrangements and similar strategies

It is widely recognised that commissionaire and similar structures can be used to erode taxable base of the state where sales takes place. However, structures of this kind only take place between related parties. The issue of introducing commissionaire structures between related parties was addressed in the Transfer Pricing Guidelines (“TPG”) in Chapter IX relating to Business Restructuring. Since there are special means introduced in TPG, we are concerned by the current proposals that are aimed at preventing avoidance of PE status. The current proposal included in the discussion draft introduces a possibility that the tax authorities will act in two directions – firstly the tax authorities will use business restructuring provisions of TPG to tax transfer of profit potential when the commissionaire structure is introduced, secondly the tax authorities will recognise one PE or more PEs in the source state where sales takes place under the commissionaire structure and tax part of the profits derived by a foreign principal.

Taking it into account we would welcome some comments from the OECD/CFA and the OECD Member States on the issue of potential application of both rules – business restructuring taxation and PE taxation to the same commissionaire structure. We see the need to clarify what are the intentions of the tax authorities and some safeguarding language that should limit the possibility of taxing the income derived through the same structure twice (using BR and PE provisions). In our opinion the safeguards should be introduced both in the BEPS report and in the commentary to the OECD model tax convention.

Comments to Section B, point 4 – Fragmentation of activities between related parties

We recognise that fragmentation of activities can be sometimes primarily tax driven. However, it is not the rule and fragmentation is often business driven. There are frequent situations where MNE’s companies are highly specialised and responsible for particular area in the value chain of the group. Therefore, we are concerned by the proposal that the anti-fragmentation rule (expressed in par. 27.1 of the commentary on article 5) should not be restricted to cases where the same company maintains different places of business in a country but should be extended to cases where there places of business belong to related parties (see point 30 of the discussion draft).

In our opinion the proposal is not specific enough and as such will introduce much uncertainty to business. We fear that in highly integrated groups fragmentation of cohesive operating business is a rule and sometimes it is even required by the law (e.g. EU regulations on energy companies). A highly
integrated group of associated enterprises can be seen as “a cohesive operating business” and we are concerned that the tax authorities will abuse that notion to recognise PE.

We see also difficulty related to the definition of the related parties. As we understand, the concept will base on the definition of the associated enterprises provided for in article 9 of the OECD model tax convention. That definition is very wide and embraces many entities that can be recognised as associated enterprises. There is a practical difficulty in recognising all related parties in a group where a parent company is publicly listed and the stock can be held by collective investment vehicles.

We would like to express our concerns whether the expanding of the anti-fragmentation rule to related parties will lead to force-of-attraction of the PE and will be used also in the cases where companies of a highly integrated group perform various activities in a country due to purely business reasons.

If any of the proposed options of addressing the fragmentation of activities (for the purposes of par. 4) is agreed by the OECD, we see a strong need to introduce a clear commentary in what situations business activities of two associated enterprises will “constitute a complementary functions that are part of a cohesive business operations”. We are afraid that such a rule will introduce greater subjectivity into the determination of whether a PE exists.

Let’s assume an example: MNE group A publicly listed in country A participates in a project together with another MNE group B publicly listed in country B. The project is undertaken in a country C. There are no direct relations (capital, managerial etc) between group A and B. However, since the parent companies of both groups are listed, the groups have a common stockholder (e.g. investment fund registered in country D). Would it be possible that for the tax authorities in the country C where a project is undertaken, both MNE groups will be related (taking into account a common shareholder) and the project will be recognised as “cohesive operating business”? Would the functions of both groups “constitute complementary functions”?

We see a need for commentary as to how an expanded anti-fragmentation rule will be applied to situations where the activities carried on by associated enterprises are not contemporaneous but follow one after the other or are split by some period of time.

Comments to Section C – Splitting-up of contracts

We recognise that splitting-up of contracts to abuse the 12-month PE rule for construction sites can be sometimes primarily tax driven. However, it is not the rule and there can be legitimate business reasons to splitting-up of contracts.

We see difficulty related to the definition of the associated enterprises. The definition of AE is very wide and embraces many entities that can be recognised as associated enterprises. There is a practical difficulty in recognising all related parties in a group where a parent company is publicly listed and the stock can be held by collective investment vehicles. In such a situation we see a substantial risk that the proposed provisions to address splitting-up of contracts will lead to a materially increased uncertainty for business.
January 9, 2015

VIA E-MAIL

Ms. Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2, rue André Pascal
75016 Paris, France
taxtreaties@oecd.org

Re: Treaty Policy Working Group Comments on Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. de Ruiter,

We are writing to share the comments and recommendations of the Treaty Policy Working Group on the Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status, released for comment on October 31, 2014.

As you know, the Treaty Policy Working Group (TPWG) is an informal association of large global companies based throughout the world, which represent a broad spectrum of industry sectors.1 TPWG members have been working since 2005 with the OECD, and more recently with the UN, to analyze and provide constructive comments on tax policy and administration concerns regarding permanent establishment (PE), profit attribution, transfer pricing, and related issues that are critical to our ability to avoid double taxation and conduct international trade and investment. In addition to our specific comments of October 16, 2013, on Action 7 of the BEPS Action Plan, the TPWG has provided comments on all OECD discussion drafts and participated in all OECD consultations on PE issues over the past decade and provided input on recent UN deliberations on PE issues.

The Discussion Draft raises many issues of concern to TPWG members. While we appreciate that it does not constitute a consensus proposal, our member companies have identified some concerns and recommendations regarding its provisions that we would like to share at this time. TPWG members also hope that stakeholders will have an opportunity to provide additional input as specific PE consensus proposals are developed.

1 The membership of the Treaty Policy Working Group is currently comprised of the following companies: Amazon.com, Inc., BP plc; Cisco Systems, Inc.; Procter & Gamble Co.; Salesforce.com Inc.; TD Bank Group; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
I. Executive Summary

Treaty Policy Working Group member companies believe that a clear, certain, and administrable international consensus on what does and does not constitute a PE is essential to the operation of tax treaties and to the international trade and investment they are negotiated to foster. Both businesses and tax administrations need a clearly articulated, certain, and administrable PE threshold that businesses can apply without double taxation or compliance issues and that tax administrations can apply without interpretive controversies. We hope that the outcome of the work on Action 7 will promote, not impede this goal.

For the reasons discussed below, however, we fear that the result of the Options set forth in the Discussion Draft would be quite different. In their current formulations, none of the Options is defined with adequate precision to enable either businesses or tax administrations to determine consistently whether a PE exists in a particular case. Most if not all of the Options appear to go well beyond the scope of the BEPS Action Plan. The rationale for many of the Options is either lacking or less than fully persuasive, with no indication of why legitimate concerns are not addressed by the numerous anti-avoidance measures in the current Commentary or cannot be addressed through minor clarifications. Each of the options presented also raises additional concerns, which we describe briefly below.

The Discussion Draft needs the missing guidance confirming how the profit attribution rules would apply to cases affected by Action 7, which was to have been provided in conjunction with the PE threshold work. A failure to provide this confirmation now will lead to very significant increases in unproductive compliance and administrative costs, a large increase in new PE assessments, and a dramatic rise in double taxation and controversies, both between taxpayers and tax administrations and among tax administrations. Unless the dispute resolution procedures recently proposed for Action 14 are significantly strengthened, we fear that many of these controversies will prove impossible to resolve, with the double taxation remaining unrelieved. The end result would be the creation by treaty of an impediment to the very international trade and investment that the tax treaty network was created to foster. We believe that this outcome would especially disadvantage developing countries and, in some instances, other smaller or newer markets.

TPWG members respectfully submit that any reconsideration of the PE threshold should be informed by certain fundamental principles. After discussing the importance of the PE threshold, we offer our views below on appropriate design, drafting, and policy principles, followed by a brief summary of our main concerns regarding the specific Options offered by the current Discussion Draft. We believe, however, that it would be possible to address the PE-related BEPS concerns in a manner that avoids these pitfalls. Our comments and recommendations below are offered with a view to facilitating this.
II. General Comments

A. Importance of the PE threshold

The PE threshold plays a critical role in the international tax treaty network. It has been a fundamental building block of tax treaties since their inception, because it determines both the point at which attributable business profits of a foreign enterprise may be taxed by the treaty partner and the point at which the enterprise’s residence jurisdiction must provide relief for the resulting taxation or the treaty partner must allow any associated losses. The OECD and UN model income tax conventions and their antecedents have always set the PE threshold at levels designed to preclude taxation in many common scenarios, with the twin aims of encouraging cross-border trade and investment and excluding cases in which the burdens associated with such taxation would be disproportionate to the potential revenue benefits.

The PE threshold is critically important to businesses engaged in international trade and investment, because it allows them to engage in a certain level of activity without triggering immediate tax and other local obligations and disproportionate compliance burdens, including the need to understand the intricacies of all domestic tax laws and procedures of every country with which they have any contact. This ability is especially important for smaller and newer markets, so any lowering or obscuring of the PE threshold can be expected to have a particularly negative impact on smaller markets and more recent entrants in international trade.

A clear, certain, and administrable PE threshold is essential for other reasons as well. While the existence of a PE may be most directly relevant to the application of Article 5 (Permanent Establishment) and Article 7 (Business Profits), it can also affect the application of most of a treaty’s other operative provisions, including those under Articles 6 (Income from Immovable Property), 10 (Dividends), 11 (Interest), 12 (Royalties), 13 (Capital Gains), 15 (Income from Employment), 21 (Other Income), 22 (Capital), 23A (Exemption Method), 23B (Credit Method), and 24 (Non-Discrimination).

Businesses must know in advance whether they have a PE in a particular jurisdiction in order to:

- comply with any applicable tax payment obligations,
- comply with any applicable return filing obligations,
- satisfy any applicable withholding tax obligations,
- satisfy any applicable reporting requirements,
- satisfy any applicable registration obligations,
- set up accounting systems and books and records to track any relevant profits and expenses,
- satisfy any applicable financial reporting requirements, and
To avoid economic double taxation, the taxation of a PE also needs to be considered simultaneously with that of any group subsidiaries operating in the same country to ensure that the same functions, assets, and risks are not compensated more than once.

The existence of a PE obviously affects the business’s tax position in its residence jurisdiction as well, and the business needs to know whether the PE’s profits or losses are reportable there or, alternatively, whether it can claim relief for taxation imposed by the treaty partner in respect of the PE.

Failure to satisfy local tax obligations on a timely basis can lead to significant interest charges, civil or criminal penalties, gross-basis taxation of business profits, forfeiture of expenses attributable to the PE, indefinite extension of statutes of limitations, accounting issues, and, increasingly, even negative press, reputational risk to the business, and legal action against directors and executives.

In addition, although there is no tax treaty basis for the position, some countries automatically require VAT registration and payment wherever a PE exists and deny input credits if these asserted obligations are not satisfied currently.

Whether a business has a PE in a jurisdiction can even affect the personal income taxation of its employees due to the application of Article 15(2).

A clear, certain, and administrable PE threshold should also be important to both contracting states. Only a clear, certain, and administrable threshold will enable them to apply the PE provisions of the treaty efficiently, predictably, and consistently to similarly situated taxpayers, as good tax administration requires. A clear, certain, and administrable threshold will also minimize controversies, both with affected businesses and with treaty partners, and avoid the associated drain on administrative resources. Finally, a clear, certain, and administrable threshold will promote the reciprocal application of their treaties consistent with their provisions, as intended by the negotiators.

For all of these reasons, it is critical that the PE threshold be known with certainty in advance and be readily administrable both by businesses and by tax administrations. The absence of a clear, certain, and administrable PE threshold would be a barrier to cross-border trade and investment.

**B. Suggested design and drafting principles**

Fortunately, with a few variations (mainly between treaties based on the OECD Model Tax Convention and those based on the UN Model Tax Convention), the PE provisions of tax treaties and the OECD and UN Commentaries interpreting them have been remarkably consistent for many decades. TPWG member companies share the general business preference for these
traditional types of PE provisions, as they articulate a relatively clear, certain, and administrable threshold.

If changes to the current PE threshold are agreed, we believe they need to be designed and drafted with a view to avoiding the creation of new uncertainty and controversy, unrelieved double taxation, and compliance and administrative burdens that are disproportionate to the revenue at issue. This is in the interest of tax administrations and treaty partners as well as businesses.

Achieving these goals will require:

- A broad international consensus;
- A clear tax policy foundation;
- A precise and clear articulation of and guidance on the new PE threshold; and
- Rules that taxpayers can apply without undue compliance burdens and that tax authorities can administer efficiently, predictably, and consistently.

These principles can be difficult to achieve in the best of circumstances. It is important for the sustainability of the BEPS outcome, however, that they not be sacrificed in the rush to meet deadlines. The BEPS timing is short, but the OECD Model Tax Convention and Commentary provisions will be long-lived and applied by many countries throughout the world.

Treaties are contracts between two different jurisdictions, with different legal systems and frequently different languages. They are relied upon by millions of external stakeholders to provide accurate guidance on the rules agreed by the contracting states. Therefore, to operate effectively and fairly and avoid controversy, treaty texts must be precise. Important terms and must be defined, to avoid the uncertainty and conflict that would otherwise result under Article 3(2) interpretive concepts. Compared to domestic statutes, treaty rules also need to be relatively simple, in order to serve effectively as a bridge between different legal systems.

While the current provisions of Article 5 have not avoided all controversies, the Article 5(5) dependent agent PE rule turning on contract conclusion has the benefit of being relatively precise and administrable. If it is agreed that there must be a change to that aspect of the current PE threshold, the new threshold should be at least as precise and understandable as the current contract authority rule is. The same goes for any other changes that may be agreed to the current PE provisions.

Unfortunately, as discussed below, the Options offered by the Discussion Draft are unusual, in our experience with OECD proposals, in the relative lack of clarity in both their drafting and their policy purpose. It is not clear to what extent this is a function of the very limited time allotted for this important task and to what extent the lack of clarity reflects an underlying lack of consensus or even perhaps an affirmative desire to avoid clear thresholds. For example, we have
heard suggestions in past OECD consultations that there is a general reluctance among Delegates to adopt “bright-line” tests in the PE area because the PE determination is “inherently factual” in nature or because “taxpayers will plan up to the line.” Our view is that all determinations under treaties (like those under domestic law) involve the application of law to particular facts, and that taxpayers should be entitled to rely on the standards that have been agreed by the contracting states in applicable treaties. We respectfully submit that an intentionally vague approach to defining the PE threshold would be unwise, as it would generate increased uncertainty and controversy on this key question – one that must be answered in order for the business to know what its obligations are and satisfy them on an accurate and timely basis. It would also be patently unfair to businesses that are actively seeking guidance and attempting to comply with applicable treaty provisions.

In any event, given the central importance of the PE threshold, if changes are to be agreed, the participants in the BEPS process should take the time they need to make sure both the design and drafting are right, so that the fundamental principles above are satisfied and the result is sustainable. If that cannot be finished in the few months before the final Action 7 final report is due, we recommend that the focus of the work at this stage be to identify with precision in the final report the agreed policy grounds for change and the particular business transactions that are meant to be covered. Drafting of the necessary treaty text then could be completed by WP1 thereafter.

C. Suggested policy principles

Action 7 of the Action Plan on Base Erosion and Profit Shifting states that its purpose is to address “artificial avoidance of PE status,” with “commissionnaire arrangements” and certain specific activity exceptions being the only areas identified for review. The Action Plan discussion preceding Action 7 specifies that the focus is on countries that are unable to find an agency PE following the conversion of a distributor arrangement into a commissionnaire arrangement that reduces taxable profits from the sale of goods. It concludes with a brief mention of concerns regarding multinational groups that “artificially fragment their operations among multiple group entities” in order to qualify for preparatory or auxiliary exceptions to PE status under Article 5(4).

Action 7 itself provides only for the following:

Prevent the artificial avoidance of PE status

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

The Action Plan does not explain what is considered to constitute “artificial avoidance” or “artificially fragment[ing].”
We note that the September 2014 Action 1 Report of the Task Force on the Digital Economy went beyond Action 7’s original focus on commissionnaires and fragmentation of activities under Article 5(4) in providing that:

The work on Action 7 (preventing the artificial avoidance of PE Status) should consider whether certain activities that were previously considered preparatory or auxiliary for the purposes of these exceptions may be increasingly significant components of businesses in the digital economy. If so, the work should also consider the circumstances under which such activities may be considered core activities and whether a reasonable, administrable rule to this effect can be developed. For example, that work should consider whether and under what circumstances the maintenance of a local warehouse may constitute a core activity such that it should be outside the scope of the exceptions in Article 5 of the OECD Model Tax Convention. In addition to broader tax challenges, these issues raise BEPS concerns when the lack of taxation in the market country is coupled with techniques that reduce or eliminate tax in the country of the recipient or of the ultimate parent. The work would also consider whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. This would be relevant where, for instance, an online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients.

While most of this wish list goes well beyond scenarios that even arguably involve “artificial” avoidance of PE status under current law, all of these suggestions are contingent on a confirmation of their particular increased significance in the digital economy that has not yet occurred. It is also not clear how the specific focus on the digital economy for this purpose can be reconciled with the clear conclusion elsewhere in the Action 1 Report that the digital economy may not be ring-fenced from the economy at large. Therefore, these proposals from the Action 1 Report should also be evaluated for their appropriateness and viability with respect to other sectors of the economy before they are recommended as changes to the PE threshold.

Even with the additions relating to the digital economy, however, we note that almost all of the Options proposed by the Discussion Draft appear to go well beyond both the Action 7 mandate and the Action 1 Report. Indeed, the only Options that purport to address “artificial” avoidance of the current PE provisions are those in section C relating to the splitting-up of contracts, and the only other ones contemplated by the BEPS Action Plan are Options I and J regarding the fragmentation of activities between related parties. The Action 1 Report further suggests that “artificial” arrangements used to avoid PE status might include the online situations it refers in
which a company may use the sales force of a local subsidiary to negotiate and effectively conclude sales, although current PE provisions do not preclude that other than in very limited circumstances.

We believe that it would be more appropriate, and more consistent with the mandate for the BEPS PE work, for all of the Options under consideration to focus on addressing the issues specified by the BEPS Action Plan and, to the extent appropriate, the Action 1 Report. While we remain of the view expressed in our past comments that it would be ideal to reestablish consensus at some point on all of the PE interpretation issues that have been identified in WP1’s recent work, we agree with the stated position of the BEPS Action Plan and the Discussion Draft that the BEPS project is not the proper forum for revisiting the balance between residence and source taxation, including that established by the current PE threshold. In addition to its severe time constraints, the focus of the BEPS project on base-erosion and profit-shifting concerns under current law would provide an inappropriate context for a broad rethinking of the PE threshold. There should be no general presumption of base erosion or profit shifting, or “abuse” or “avoidance” more generally, merely because a PE cannot be found under current law, because the very purpose of the PE provisions is to establish a threshold below which local taxation is not permitted. Any changes to the PE threshold should be agreed on objective grounds and articulated clearly, after careful consideration of all relevant policy and administration issues, if the PE threshold is to continue to fulfill its central balancing function in the operation of the international tax treaty network.

All of the Options presented in the Discussion Draft other than the ones relating to fragmentation of activities and contract-splitting presumably respond to policy goals other than those identified by the BEPS Action Plan. They may reflect the fact that some jurisdictions have recently begun to view the PE provisions less as a threshold and more as a potential source of incremental tax revenue and may be viewing the BEPS project as an opportunity to propose additional changes to the current treaty provisions.

For example, the purpose of the Options relating to Article 5(5) seems to be to change the balance between source (or market) and residence state taxation, which would be contrary to the explicit assurances in both the BEPS Action Plan and the Discussion Draft that the Action Plan is “not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”

The policy ground for the Options relating to Article 5(4) is not clear, unless it is a purely outcome-driven judgment that the prior policy to not impede international trade for small amounts of tax is now outweighed by a desire for additional tax in spite of significant compliance and administrative burdens.

If any of the proposed Options are pursued notwithstanding the more limited BEPS mandate for PE changes, it would seem more appropriate to state the policy grounds that are the actual
motivating factors. Each Option should then be considered against the relevant ground, to ensure transparency, consensus and clearly and appropriately targeted measures.

III. Comments on Article 5(5) Options

A. General comments

All four of the proposed Options are problematic in that they are (1) overbroad if the purpose is, as stated, to describe commissionnaires; (2) highly ambiguous; (3) thus highly unclear as to what business activities are affected by the rule; and (4) therefore inevitably leading to a huge increase in disputes and unrelieved double taxation if adopted. As discussed below, and as indicated by the reference in the caption of section A to “similar strategies,” each of these options would clearly reach beyond the mandated scope of Action 7 to sweep in transactions other than “artificial” commissionnaire arrangements.

If adopted as proposed and interpreted consistent with current trends, these measures could impede much or all cross-border information gathering, delivery, marketing, participation in negotiations, and other customer-facing activity, and perhaps even mere storage. We respectfully submit that this would be not only incompatible with the purpose of the PE threshold but also objectionable on protectionist grounds, especially if coupled with other initiatives to impose corporate income tax in addition to consumption tax on profits from remote sales to local residents. The result clearly would be to undermine the facilitation of international trade and investment that is the key purpose of tax treaties.

If that is not the intended aim and scope of the proposed Options, it should be made clear why the anti-avoidance rules of the current Commentary are seen as insufficient, and why the perceived shortcomings cannot be addressed by further clarifying in the Commentary the application of the existing contract conclusion test to common business examples.

B. Option A

The clause “engages with specific persons in a way that results in the conclusion of contracts” is problematic because it is overbroad and ambiguous. As it does not specify who the reference to “specific persons” is intended to cover and what types of activity may be considered to “result in” contract conclusion, this language might be interpreted by overly zealous tax administrations to describe almost any market-facing activity, as all market-oriented activity is intended at some level to result in sales of goods or services. For example, might it be read to cover mere meetings with potential or current customers or other form of general sales solicitation, attendance at trade shows, distribution of marketing materials, or even the planning of web-based advertising campaigns, none of which presumably should create PEs?

The clause in Option A referring to “transfer of ownership of…” describes the transfer of property by nonresidents even if there is no contractual privity with market jurisdiction customers. While this obviously is intended to describe the commercial facts of a commissionnaire relationship, we are concerned that it could also be seen as applying to any
buy-sell arrangement between nonresident suppliers of local resellers, regardless of how the arrangement allocates risks. To avoid serious, presumably unintended disruption to international trade, any provision along these lines that may be adopted needs to state clearly that there is no possibility of a PE arising if the local entity is structured as a reseller, even one with limited economic risks. For example, if the real goal is to reach commissionnaires in order to put civil law and common law countries on a par under Article 5(5), as indicated by the BEPS Action Plan, this circuitous language is not needed, because commissionnaires do habitually conclude contracts with customers. A better remedy would be to provide a specific legal definition of commissionnaire (perhaps in the form of a reference to applicable statutory provisions in bilateral treaties) to both make sure the goal is achieved and to make clear that other types of distributors are not covered.

Option A would also sweep in contracts for the provision of services by the foreign enterprise, a measure that would represent a significant expansion, as most commissionnaire arrangements deal only with goods.

C. Option B

The clause “negotiates the material elements of contracts” would have a huge practical effect, as it would cover the business practices of a wide range of companies that do not give rise to PEs under current Article 5(5), even if they involve some “negotiation.” This text would obviously be interpreted by those inclined to lower the PE threshold to refer not only to commissionnaires but also to many standard trade arrangements in which foreign enterprises sell through local distributors, for example under ordinary buy-sell arrangements. The sole apparent benefit of Option B is that it is at least more precise than the “engages with specific persons…” threshold proposed by Option A.

In any event, clear confirmation would be needed that this clause refers only to negotiation, not solicitation or any other market-facing activity, and that it does not cover sales made pursuant to standard contracts (including rate cards with pre-agreed discounts). To ensure consistency, facilitate compliance, and avoid controversy, specific guidance would also be needed on what constitutes “negotiation,” how to determine which terms are “material,” and how to avoid overlapping claims of jurisdiction to tax. This is because many international contract negotiations involve activities that occur in more than one jurisdiction. In a typical case, negotiations are led by a responsible account executive, who is often located in the project jurisdiction but receives support from colleagues located in multiple jurisdictions. For example, separate persons may be responsible for negotiating pricing terms, warranty obligations, delivery schedules, IP indemnities, and the like. Absent guidance that precludes it, each of those jurisdictions might well assert that “material elements” of the contract were “negotiated” in, and thus gave rise to PEs in their territories. This could easily give rise to overlapping claims of taxing jurisdiction quickly exceeding total profits. To avoid this situation if this Option is adopted, we believe that it is important to provide a rule to ensure that only one PE can be created in such a case. We believe that the most sensible remedy would be to issue guidance
providing that any PE could be created only in the jurisdiction where the lead account executive, who is responsible for the main customer-facing relationship, is primarily located during the negotiations, as that is the most logical place of nexus for negotiations occurring in multiple locations.

The proposed clause relating to contracts “for the transfer of ownership” of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use” raises similar issues of ambiguity, definition, and scope. For example, it turns in part on whether a person “negotiates the material elements of contracts” without defining either negotiation or material elements. It apparently would apply, like Option A, without regard to whether the contract is binding on the enterprise. Nor is it clear, for example, how it would be determined that the enterprise “has the right to use” property, or that such right to use would have to exist in the contracting state seeking to assert the existence of a PE on this basis.

Like Option A, Option B would represent a significant expansion beyond the scope of most commissionnaire arrangements, as most such arrangements deal only with goods.

This proposed introduction of negotiation as a PE-creating activity would have a far more substantial effect in increasing source (or market) state taxation rights than would expanding the PE threshold to cover commissionnaire arrangements. Therefore, at a minimum, the scope of Option B should be refined and narrowed to ensure that it applies only to the commissionnaire arrangements that Action 7 was intended to target.

D. Option C

The clause “…which, by virtue of the legal relationship …, are on the account and risk of the enterprise…” is obviously trying to refer to commissionnaire relationships. However, the reference to “account and risk” of the nonresident suggests that the PE test will depend on the allocation of commercial risk between the market jurisdiction entity and the nonresident supplier. If that is the intent, there needs to be consensus and guidance as to what “on the account and risk” means, as it is not a defined treaty term, and which risks are the material ones. There can be many risk elements which can be allocated between the two entities: inventory risk, currency risk, warranty risk, nonpayment risk, and others.

As above, this language arguably could be read to apply to a local entity acting as reseller for a nonresident supplier. Indeed, current experience with tax authorities already testing the boundaries of Article 5(5) leads us to expect that many would, in fact, attempt to read it in this manner. It should be clearly confirmed that this is not intended.

E. Option D

The changes proposed by Option D are identical to the provisions of Option B that reference negotiating the material elements of contracts and to the provisions of Option C regarding contracts on the account and risk of the foreign enterprise. They thus raise similar issues described above.
III. Comments on Article 5(6) Proposal

We believe that Article 5(6) generally operates well enough in its existing form, which includes numerous provisions in the Commentary to prevent inappropriate use of the independence exception. The provisions of Article 5(6) were not identified as a concern in the BEPS Action Plan, and there does not appear to be any solid rationale for the proposed change.

However, if it is agreed that a change is necessary, we submit that this proposal needs to be limited, at a minimum, to transactions between related parties. While this appears to be the assumption of the Discussion Draft, the proposed treaty text does not so provide. This means that its application could be read to extend to the thousands of unrelated agents used by some principals around the world.

To ensure a clear and consistent interpretation of the Article 9 “associated enterprises” threshold for this purpose, a specific test, such as control of more than 50 percent of the company’s voting stock, should be provided.

We note that the proposal permitting reference to multiple members of a group to make the PE determination is counter to the fundamental international tax principle that each entity is respected as such. The OECD has objected to violation of this principle in the recent past, in reaction to the Italian Philip Morris case. The same concern arises under the proposals below regarding fragmentation and splitting up of contracts. If this approach is adopted, it will be important, at a bare minimum, to acknowledge explicitly that this is a departure from the still generally applicable principle of respect for separate legal entities on which all tax treaties and most domestic tax laws are based.

IV. Comments on Article 5(4) Options

A. Option E

As the current Article 5 Commentary acknowledges, determining what is “preparatory or auxiliary” is difficult. Neither the current treaty text nor the Discussion Draft even makes an attempt to define the term. There is a negative statement in the current Commentary that an activity is not preparatory or auxiliary if the activity “in itself forms an essential and significant part of the activity of the enterprise as a whole” and an oblique Commentary reference to “services … perform[ed that] are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.” These statements do not, however, define what “essential,” “significant,” and “so remote from the actual realization of profits” mean in this context. We therefore see great practical value in, and have a strong preference for, continuing to retain in Article 5(4) a list of activities that are per se excluded from

2 Italian Supreme Court, 7 March 2002, “Philip Morris”, Nos. 3667, 3368, 7682 and 1095.
creating a PE. This would also seem more consistent with the BEPS Action Plan mandate, which calls only one aspect of Article 5(4) into question, and the fact that the Discussion Draft does not explain why each of the Article 5(4) exceptions should be subjected to a “preparatory or auxiliary” requirement.

If Option E were adopted, a clear consensus on the meaning of this currently undefined term would need to be developed and adopted to avoid creating widespread confusion and controversy. It is difficult to imagine how an adequately clear general definition of the concept could be developed if there is no consensus even on the current per se exceptions. However, without such guidance, this Option seems sure to raise questions about a wide variety of distribution chain structures and fundamentally change the current balance between residence and source (or market) taxation in a manner beyond the scope of the BEPS project.

B. Option F

We believe that it would be inappropriate and confusing to delete the delivery exception. It is not clear when or how this rule would apply, as all goods stored in a warehouse must ultimately be delivered in some way or other. Is the real intent to preempt such storage altogether for all businesses operating internationally, although the stated concern seems to be limited to a narrow warehouse scenario? If not, in which cases would the storage exception continue to apply in practice, and on what legal basis would they be distinguished?

Would the deletion of “delivery” from Article 5(4)(a) and (b) be meant to suggest that storage could never qualify as preparatory or auxiliary under the general provision of Article 5(4)(e)? We presume not, as we see no apparent rationale for that position and none is given, but this should be clearly stated to avoid any unintended negative inference.

Could there be any conceivable BEPS concern regarding storage and delivery in a regional warehouse for export to other countries? Even if storage or delivery were considered to create a PE in the warehouse jurisdiction with respect to deliveries to customers in that jurisdiction, surely there would be no latitude to attribute profits in respect of exports to customers in other jurisdictions? We presume this is not intended, as the proposed text does appear to reach that far, but it would be advisable to confirm these points explicitly as well, to avoid disadvantaging export-related activities.

It is perhaps telling that, despite the fact that the “delivery” term is not included in the UN Model, there seems to be very little experience in interpreting that different language. The deletion of delivery certainly has not met with universal adoption even among countries that generally follow the UN Model, perhaps because the UN Article 5 Commentary warns that its deletion could cause countries to attribute too much income in practice. We believe that this is a very real risk, as it is difficult to imagine how much profit could be attributed to a mere delivery function under the Authorised OECD Approach (AOA). This would be especially true if, as is
typically the case, the warehouse is owned by a third party or a separately incorporated affiliate that itself reports income locally on the associated profits.

C. Option G

We believe that purchasing should remain excluded under Article 5(4). While local purchasing functions are common throughout many industries, purchasing is very rarely a key profit driver for businesses. This is, therefore, another case where the compliance and administrative costs and business disruptions clearly would outweigh any tax that might be imposed through the attribution of profits to a PE. We do not find the stated concerns generally applicable to purchasing; indeed, the discussion in Option G of the allocation of purchasing discounts conflicts with the discussion of the same topic in the Action 8 Discussion Draft.

We note that a major benefit of the purchasing exception is that it encourages purchases from local suppliers, so deleting it would create a barrier to trade with local suppliers that does not exist today. Although this would affect most countries to some extent, it would undoubtedly put developing countries at a particular disadvantage.

D. Option H

We disagree with the proposed deletion of the purchasing exception for the reasons noted above. We are also concerned about the additional proposal to delete the exception for the collection of information, as the example provided as the rationale is again very narrow and not apparently in need of the change, given the restrictions already in place in the Commentary.

It needs to be made clear, at a minimum, that the collection of information to explore market opportunities will continue to be respected as preparatory or auxiliary. Data on market share, market trends, and supply sources are often only available locally, so erecting a tax barrier to their collection would hinder, rather than foster, cross-border trade and investment. This, too, would have a disproportionate negative impact on developing countries.

While our very strong preference would be not to have Option E adopted, we note that there would be no need for Option H (or Option G) if Option E were adopted.

E. Options I & J

The anti-fragmentation provisions proposed by Options I and J are similarly concerning. We are concerned that these proposals could easily lead to the creation of PEs in unexpected and unwarranted situations that would be difficult to administer and comply with.

These Options would directly reverse a long-standing and widely-held PE concept confirmed as recently as 2005 in paragraph 41.1 of the Article 5 Commentary:

The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each
company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

The standard for triggering these anti-fragmentation measures is unworkably vague: whether the business activities concerned constitute “complementary functions that are part of a cohesive business operation,” with no definition of any of the operative terms. Option J could apply to create a PE even if no member of the group otherwise has a PE in the country concerned. And the amounts attributed by various countries under this group rule could easily overlap, leading to attribution of an aggregate amount in excess of the group’s total profits.

At a minimum, if either of these Options is adopted, the practice of aggregating activities of separate legal entities would need to be expressed clearly as a limited exception to the principle that separate entity status is normally respected, and very clear guidance to prevent the over-attribution of profits would need to be provided somehow, despite the obvious coordination challenges.

V. Splitting-Up of Contracts

We see some similar issues with the proposals on the splitting-up of contracts among related parties. They are also premised on a fundamental disregard of separate legal entities, also would be prohibitively difficult to apply in practice, and also would create the risk of excessive taxation. In addition, as the Discussion Draft acknowledges, they would create the possibility of clearly disproportionate taxation of related parties making very minor contributions to a large project led by another.

There needs to be more attention given to establishing a reasonable balance between the administrative complexity of these proposals and the perceived artificial avoidance that is being combatted. For example, it would be tremendously challenging for global enterprises to track movements of their hundred of thousands of employees for the time periods required by these rules (i.e., daily). This could become even more problematic if, as the proposals suggest, similar rules were applied for deemed services PE purposes, as assertions of such PEs often arise unexpectedly after the fact.

We believe these proposals amount to overkill to address what is surely a limited number of cases, and therefore do not favor their adoption. If such changes are agreed, then they should, again, clearly state that they are limited exceptions to the normal rule of respecting legal entities. There should be measures providing exceptions for cases that qualify under either a specific physical presence rule or an anti-abuse rule. To be meaningful, the physical presence rule would need to provide reasonable thresholds of activity that can practically be measured, to address administrative and compliance burdens – perhaps at least 60 days within a taxable period or 25 percent of the normal presence threshold (i.e., 90 days for the 1-year rule and 45 days for the 183-day rule). Businesses should also have the opportunity to demonstrate a lack of “abuse”
intent if that is easier to evidence than physical presence. For the sake of administrability, all profit appropriately attributable to the PE should be attributed to a single entity, perhaps the principal entity performing the service.

VI. Compliance Costs

As noted throughout our comments, we are seriously concerned about the additional compliance costs that would be created by the proposed Options. It is discouraging that compliance costs are given such short shrift in the Discussion Draft and that there is no perceptible effort to balance them against the potential revenue at stake, as has always been done previously with respect to these issues. PEs that attract little profit create disproportionate compliance burdens for the tax revenue raised. We would have thought that tax administrations would have similar concerns regarding the associated administrative costs.

All of the Article 5(5) Options would create deemed PEs where the enterprise has no actual presence in the state of the taxpayer. Deemed PEs create disproportionate compliance burden, as there are no books and records or systems in place to report such activity, and they more often yield costly controversies because of the very limited profit attribution guidance that is available. The Article 5(4) Options would find new PEs where there is actual presence, but, as discussed above, that presence could be very modest indeed and the costs thus also disproportionate.

VII. Profit Attribution

The time clearly has come when discussions regarding the PE threshold need to be coupled with discussions of the profit attribution consequences. It is important to recognize that the attribution and allocation of profits between and among enterprises and PEs is, economically, a zero sum game, not a recipe for raising additional revenue. The absence of the guidance promised by the BEPS Action Plan on how the profit attribution rules would apply in cases affected by Action 7 is, therefore, one of the most surprising and significant shortcomings in the Discussion Draft.

Many of the changes being proposed, especially in the Article 5(4) arena, would yield little or no profit attribution under the AOA.\(^3\) We are concerned that the failure to conduct this analysis and provide confirmation of that at this time will likely encourage the assertion of PEs in many cases in which little or no profit may properly be attributed. Once the existence of such a PE is asserted, disproportionate compliance and administrative burdens will have already been imposed on both businesses and tax administrations and, judging from current trends and positioning, many tax administrations will have difficulty resisting the monetary and political temptations to assert sizeable attributions of profits against foreign enterprises, without regard to competing claims.

\[^3\] While the Action 7 work is focused on changes to the OECD Model, we note that a similar analysis would apply under the UN guidance on profit attribution, which closely tracks the pre-AOA OECD Article 7 guidance.
The situation is particularly concerning for the Article 5(5) PE Options, as they all create only deemed or notional PEs. Under AOA principles, such PEs frequently have few or no functions, assets, or risks to which profits can properly be attributed beyond those already accounted for and taken into account for tax purposes in the hands of affiliates, dependent agents, or other persons. There is similarly little basis to allocate additional profits to actual low-function, low-risk operations.

It is disconcerting that the Discussion Draft shows no appreciation of this situation, as that presumably reflects contrary expectations among WP1 participants. If the BEPS PE work is finalized in its current state, it would, therefore, portend a period in which both the conduct of international business and the final determination of tax liability will prove extremely challenging. We urge OECD member countries, associates, and others participating in this important work to take steps now, as was wisely contemplated by the BEPS Action Plan, to discourage rather than encourage these outcomes.

VIII. Dispute Resolution

As PE disputes have increased in number and magnitude around the world in recent years, it has become clear that they are unusually difficult for competent authorities to resolve. Presumably this is because they involve binary determinations: either an enterprise has a PE in a particular jurisdiction during the taxable period or it does not. The outlook under the Action 7 Discussion Draft, therefore, becomes even more troubling when it is read together with the Action 14 Discussion Draft on Dispute Resolution, which rejects the arbitration remedy held out by the BEPS Action Plan and signals little hope at present for material improvements in tax treaty dispute resolution.

This means that the increase in PE controversies that can be expected to result from the Action 7 work will almost certainly result in a substantial increase in cases with unrelied double or multiple taxation. This will make it very difficult indeed for businesses to continue to operate across borders to the same extent as they now do and can thus be expected to have a negative economic effect on many world economies.

* * *

The Treaty Policy Working Group hopes that these comments will be helpful as deliberations continue on these important issues. We would welcome the opportunity for further dialogue and
additional input as the work proceeds. As previously indicated, I would appreciate the opportunity to speak on behalf of the TPWG at the January 21 consultation.

Sincerely yours,

For the Treaty Policy Working Group

/ signed/

Carol A. Dunahoo
January 9, 2015

Dear Ms. Marlies de Ruiter,
Head - Tax Treaties,
Transfer Pricing and Financial Transactions Divisions - OECD/CTPA
via email: taxtreaties@oecd.org

Re: Public Discussion Draft – BEPS Action 7: Preventing the artificial avoidance of PE status

Dear Ms. de Ruiter,

We are pleased to present our response on the OECD Public Discussion Draft, BEPS Action 7: Preventing the artificial avoidance of PE status (hereinafter, the Draft).

Approaching the PE concept laid down in the OECD Model (MTC) and in the Commentary (MC) in a more straightforward and certain way is a key factor for MNEs.

Therefore, we are honoured to submit our comments and observation to the Draft in an attempt to offer our contribution to the huge efforts employed by the OECD in fighting BEPS.

Yours sincerely,

TTCC Team

Fabrizio Bulgarelli Ph.D., MBA, LL.M.
Roberto Scalia Ph.D.
GENERAL REMARKS
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COMMENTS AND OBSERVATIONS  
(BEPS - Action 7: Preventing the artificial avoidance of PE status)

GENERAL REMARKS

1. Interpretation/amendment to the OECD Model and Commentary

The scope of the Draft BEPS, Action 7: Preventing the artificial avoidance of PE status (hereinafter, the “Draft”) is routed along some pre-requisite.

The Draft aims at ‘updating’ the PE definition (¹), hence it shall not lead to substantial amendment to the PE threshold. The stance taken is supported by the assumption that the relevant Action “are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income” (²).

Against this background we hold that some statement contained in the Draft should be reconsidered.

We would like to draw Your attention to two aspects, mainly.

First of all, the decision that a re-valuation by Action 7 shall be carried out “putting aside (…) interpretation issues” may lead to wrongful and unintended effects. As a matter of fact, we share the opinion that “interpretation issues” should remain at the very center of the BEPS concern, in that, e.g. mismatches between civil law and common law aspects of the agency-PE may still give rise to fiscal loopholes(³).

Secondly, if one accepts the idea that the proposed amendments are coherent with the scope of PE clause (as it currently stands) we wonder whether a modification undergone in the Model (shortly, MTC) and not in the Commentary (MC) might be uphold in interpreting already existing Tax Treaties (DTCs).

OBSERVATIONS: Delete references to the lack of relevance of “interpretation issues” and clarify the temporal scope of proposed amendments

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2. Action 7 and EU Law issues

(¹) See at pages 4 and 9 of the Draft. Expression employed in the Draft are ‘change’ (page 5), ‘develop changes’ (page 4) and ‘re-word’ (page 6).
(²) See page 10, § 3 of the Draft.
(³) See the stance taken in R. VANN, Tax Treaties: The Secret Agent’s Secret, in British Tax Rev., 2006, at 345-382 and, consistently, in S. BARAGNER et al, The 2012 Leiden Alumni Seminar: Case Law on Treaty Interpretation Re Commissioner and Agency PEs, in Eur. Tax., 2013, at 175. We do refer, of course, to new differences that may arise in respect of legal institutes and concepts whose interpretation slightly diverge, (since, e.g., they do belong to only one of them).
Although Action 7 addresses general themes directed to all the OECD countries, EU Law perspective deserves some attention as well as some caution. We hold that – in EU context – interpretation of rules and principle endorsed in EU primary and secondary legislation should be kept in mind while addressing BEPS cases (4).

Setting aside Abuse of Law doctrine, which we merely mention here but may address in a forthcoming contribution, we would like to focus on the interaction of the Draft with [the primacy of] EU primary and secondary Law.

In general, interaction with EU Law is self-evident, in our perspective, in analyzing two further aspects: (i) agency-principal relationship and; (ii) insurance and reinsurance.

Agency-PE issues should imply some analysis of Dir. 86/653/EEC on ‘commercial agent’. To this token we support the view that concepts such as ‘performance’ or ‘negotiation’ of contract or ‘trustee’ (5) shall be interpreted according with Articles 3(1); 3(2)(a) or 1(3), 3rd ind., Dir. 86/653/EEC.

The same pre-assumption holds true, in our opinion, as for the insurance and reinsurance activities are involved, and we wonder, for instance, whether a ‘reinsurance’ contract (6) shall bear the meaning shown under Article 13(7)(a) and (b) Dir. 2009/138 (sc. Solvency II).

OBSERVATIONS: Provide – within the general and widespread scope of OECD Model – guidance as to what influence shall be attributed to EU Law in DTCs’ interpretation, with a view to some specific issues.

OBSERVATIONS ON PARAGRAPH A.
(Artificial avoidance of PE status through commissionaire arrangements and similar strategies)

3. Options B. and D. interaction with Option L.

Solutions provided for in Options B. and D. may be triggered grounding upon their interaction with Option L. dealing with split-up of contracts.

The first two Options (B. and D.) are conditional upon the agent negotiates the ‘material elements’ of the contract while the second (Option L.) merely refers to ‘negotiation of the contract’ (7).

(4) Reference to specific EU Law issues are nowadays embodied into the MC; see, for instance, par. 75.1. MC on Article 7 (as for ‘trading permits’) and par. 67, MC on Article 25.
(5) See, namely, page 11, § 10; page 13, sub Option B. of the Draft.
(6) “Very small insurance” (below EUR 5 Million) is not within the scope of the Directive and fall under the scope of the basic freedoms (see Whereas (5) Dir. 2009/138).
(7) see Example E.
If one accepts that the wording of Options B. and D. amounts to a wider scope of the rule (8), tax loopholes may arise.

Consider the following case: a General Contractor (shortly, GC) acts as an agent negotiating only part of the “material elements” of the contract related to a bid. The contract execution has a duration of 9 months only and, hence, does not reach the 12-month threshold.

Although the 12-month threshold (as per par. 3 of Article 5) is not fulfilled, an agent-PE could be deemed to exist.

However – grounding upon the difference in wording of the first two Options with Option L. – a taxpayer may hold that not all of the “material elements” have been negotiated (as provided for in Options B. and D.) but just some of them (as could be inferred by Option L. wording). The above result could be further supported holding that it creates for a coherent reading of rules under Article 5(5) and (3) (9).

**OBSERVATION:** Clarify the scope of Options B., D. and L. as for the one true meaning of “negotiating” the “material element” of the contract.

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4. **Options A. and C.: interaction with “specific” persons**

Article 5, as it stands, requires the agent to be a “person” but nothing is held about the customers.

Options A. and C., instead, are conditional upon: (i) the customer is a ‘person’ and (ii) the customer shall be ‘identifiable’.

In the lack of one of the two pre-requisites above, the rule provided for in Options A./C. shall not apply.

In our opinion, Options A. and C. introduce a set of prerequisites that may threaten their anti-avoidance purpose.

If the State of residence of the customer considers that non-resident trusts are ‘entities’ (and taxes them accordingly, as a company), a transaction involving a resident trustee of a non-resident trust (on the buyer side) and the agent (on the seller side) will be ‘attributable’ to the trust itself and not to the trustee. Here we wonder where the ‘sufficient taxable nexus’ is justified.

On the contrary, if the State of source is treating the trust as ‘transparent’ for tax purposes (and, even before, not as a person) and taxes its beneficiaries, accordingly, transaction entered

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(8) Not merely a negotiation shall be carried on, but a negotiation of the “material elements”

into with the trust should fall outside the scope of the rule (even worst, where beneficiaries are not specifically identified, no ‘sufficient taxable nexus’ is easily assessable).

In the light of the above, we believe that the clause of ‘interaction with specific persons’ narrows the scope of the Options and, as a consequence, may threaten their anti-avoidance purpose.

**OBSERVATIONS:** Delete any reference to negotiation with ‘specific persons’

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5. **Options A. to D.: partnerships’ issues**

*Options A. to D.* arise concern in respect of partnerships’ taxation.

*Options C./D.* provide that contract be ‘on the account and risk’ of the non-resident enterprise. Should a partner act as an agent on behalf of the partnership, one must point out “who” is the non-resident enterprise (10).

All of the partners, only part of them or the partnership itself?

Answering to the above question lead to different consequences and, presumably, double taxation (and non-taxation) scenarios.

To the same token *Options A./B.* create the room for unintended consequences in that the scope of agent-PE is grounded upon the pre-assumption that: (i) traded property is ‘owned’ by the non-resident enterprise and (ii) the contract creates for a ‘transfer’ of the ‘legal title’ (ownership, right to use, al.) over such property.

The question is, once more: who is deemed to hold a (legal title over the) property?

The partners, a part of them or the partnership itself?

**OBSERVATIONS:** Clarify the scope of the expression ‘on the account and risk’ of non-resident enterprise and ‘ownership’, ‘right to use’ in flow-through entities scenario

**OBSERVATIONS ON PARAGRAPH B.**

(Artificial avoidance of PE status through the specific activity exemptions)

(10) Even before the exact meaning of ‘enterprise’ within the intricate formula adopted in article 5(1) MTC.
6. Exception for ‘purchasing’ activities in insurance sector

Option N. provides that no specific rule shall be provided for in Article 5 and “the issue of insurance enterprises would be dealt with through the more general changes proposed to Article 5(5) and 5(6) (see Options A to D above)”.

Admittedly, Options provided for excluded activities (as per Article 5, paragraph 4) are outside the scope of the quoted throwback rule.

However, States may treat insurance ‘passive poolers’ as purchasing office (11). Hence, if Option N. will be adopted, it is doubtful whether lack of any reference to Options G. and H. is unintended.

If Option M. is adopted further guidance may be required in order to stress whether (and to what extent) ‘reinsurance activities’ may arise an agent-PE, due to the mere “purchasing” of insurance policies.

OBSERVATIONS: Clarify the scope and interactions of Options M. and N. with Options G. and H.

OBSERVATIONS ON PARAGRAPH C.
(Splitting-up of contracts)

7. Option K. on ‘splitting-up of contracts’

In accordance with Option K. splitting-up of contracts aiming at lowering the time threshold under Article 5(3), MTC may be contrasted including in Article 5 a provision whose scope “(...) follows the “automatic” approach put forward in paragraph 42.45 of the (...)” MC.

The rationale behind paragraph 42.45 of the MC on Article 5 is coincident with that underlying paragraph 18 of the same MC (12).

Against this background the scope of Option K. is quite clear and unambiguous and, in our opinion, it fits fairly within the rationale behind paragraph 18 of the MC.

However – according with a strict literal interpretation – Option K. could be invoked by Tax Administration wishing to widen the scope of the ‘construction clause’. Paragraph 18 of the MC on Article 5, as a matter of fact, relies upon the foreword that abuses arose in respect to

(11) This approach is consistent with the stance taken by the Dutch Tax Administration in Decree Nov 14, 2013, No. IFZ 2013/184M; unofficial translation in Intern. Tr. Pr. Journ. (2014), at 140, § 11.
(12) Expressly devoted to ‘splitting-up’ of contracts in respect of construction clauses.
building/construction/installation projects that form a “(...) coherent whole commercially and geographically (...)” (13).

Option K., applies to activities carried on “(...) at a building site (...)” etc. and activities “(...) carried on at the same building site (...)” by two related enterprises but fails to focus on the identity(unity) of the ‘projects’ activities are devoted to.

In the light of the above further clarification could avoid unduly extension of ‘construction clause’ scope.

OBSERVATION: Clarify that Option K. applies only to abuses quoted in first part of paragraph 18 of the Commentary on Article 5(3)

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8. Option K.: aggregation of ‘time’

Explanation to Option K. stresses “(...) the limited scope of the rule, which does not affect the attribution of profits (...)”. Furthermore, the scope of the rule is clear in that any day spent by each of the enterprises involved in the project cannot be “counted twice”. The quoted rule provides that the “different period of times” (at the same place) rule shall lead to an aggregation of time spent by the other enterprises to that spent by the former.

We hold that uncertainties may arise as for “who” is the first (the one in letter a) of Option K.) and who is the “second” enterprise (quoted in letter b) of the same Option).

The above doubt turns in the following question: who shall be considered the “first” enterprise (whose time threshold shall be upgraded) and who shall be considered the “second” enterprise (whose time spent is added to that of the “first” enterprise)?

The relevance of the question is quite clear if one is confronted with a project arising 100 in the hand of ACo (who starts carrying on its activities on Jan 1, Year 1 and lasts for 3 months) and BCo (starting its activities on May 1, Year 1 and lasts for 10 months). The relevant DTC provides for a twelve months time threshold.

If one considers that BCo time shall be added to ACo’s, the latter would have a PE, since the time threshold is reached. To the same token, BCo has not a PE (no 12-month threshold) and, therefore, its income shall be taxable only in its State of residence.

Conversely, if one holds that ACo time shall be added to BCo time, the latter will be taxable, due to the presence of a PE in the State of source.

It goes without saying that ACo and BCo would find convenient to lower BCo threshold ‘shifting’ BCo’s time upon ACo (14).

(13) See, also, paragraph 5.3. Commentary on Article 5(1).
OBSERVATION: Provide for further clarification on the scope of Option K. in order to avoid 'time shifting'

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9. **Option K.: ‘place’ requirement**

Option K. provides for the ‘time aggregation’ upon the pre-conditions that:

- activities are carried on (by the two enterprises whose time spent is aggregated);
- “at a place” that constitutes a building/construction/installation site/project

In providing for a “place” requirement, the anti-avoidance scope of Option K. may be weakened, in our opinion.

In first place, the ‘construction clause-PE’ per Article 5(3) – unlike Article 5(1) and (2) – may arise where a ‘moving object’ (15) is at stake.

Secondly – at least in our opinion – the ‘commercial and geographical whole’ rule (provided for in par. 18 of the Commentary on Article 5) is fairly consistent with aggregation of activites carried out at different places.

OBSERVATION: Re-phrase Option K. in order to fit within Article 5(3) scope

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OBSERVATIONS ON PARAGRAPH D.

*(Insurance)*

10. **Application of Options M. and N. to ‘reinsurance’ arrangement**

Although ‘reinsurance’ is an efficient arrangement (mainly, in captive insurance schemes) it may give rise to serious BEPS concern.

*Option M.* shall not be applied to re-insurance arrangements.

Exclusion provided for in *Option M.* (fitting to the UN Model draft) is not self-evident and, obviously, paves the road to BEPS (16).

Other issues arise in respect of *Option N.*, throwing back to *Options A. to D.*, whose scope is strengthening the requirement of independence in Article 5(6). *Options A. to D.* achieve their

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(14) Fitting to the same rationale underlying splitting the time threshold in a triangular scenario, according with the analysis carried on by J. SCHAFFNER, *How fixed is a Permanent Establishment*, Alphen aan den Rijn, 2013, 119, § 4.01., [A].

(15) See, in tax literature, E. REIMER (footnote 9), at 71, m.no. 171.

(16) Merely employing reinsurance (in place of straightforward insurance) arrangements
objective expanding the scope of Article 5 to “associated enterprise” as per Article 9 MTC
(17).

We forecast that uncertainties may arise where an agent-PE acts ‘on behalf and risk’ of the
non-resident enterprise due to participation in reinsurance captive arrangements schemes of a
plethora of persons (at least, the cedent and reinsurer, but – most notably – many other entities
belonging or not to the same group of the cedent or the reinsurer).

OBSERVATIONS: Delete (or clarify the scope of) ‘reinsurance’ exclusion and clarify
interaction of Article 5(6) in relation to “associated enterprise” involved in reinsurance
captive arrangements

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11. Meaning of ‘insurance contract’

Explanation under Option M. makes clear that the rule shall apply to “insurance contracts”.

Since Option M. aims at merely expanding the scope of the agency-PE (18) we support the
view that principles and guidelines endorsed in Options A. to D. shall apply.

Against this background the “legal (not economic) relationship” (between non-resident
enterprise and the agent) (19) could weaken the anti-avoidance purpose of this Action.

US practice provide for useful guidance in dealing with the issue above.

US Courts and IRS (roughly, along the same line) developed extensive guidance on what shall
be deemed an “insurance contract”. According with US practice such qualification is
conditional upon “risk shifting” plus “risk distribution” related to the relevant contract (20).

Whether in ‘reinsurance arrangements’ (involving captive structures) shall be upheld the
“legal (not economic) relationship” clause, we are of the opinion that there could be a room
for insurance schemes that, although drafted along a group “risk shifting”, have a quite
different economic meaning (21).

OBSERVATIONS: reference to legal (not economic) relationship in Alternatives C. and D.
may lead to tax planning opportunities in respect of Alternative M.

SUMMARY AND SELECTED ISSUES

(17) See Explanation to Option A.
(18) See Explanation to Alternative M. We, further observe that this pre-assumption is conditional upon the fact the
clause under Option M. follows Article 5(5) (which applies “notwithstanding the preceding provisions of this Article”).
(19) The “legal (not economic)” clause in embodied in the Explanation to Option C.
12. **Summary**

The Draft aims at finding solutions against BEPS in respect of selected PE issues.

The result, according with some proposals is duly fulfilled but in others, in our view, still give rise to uncertainties.

Although the Draft target is one of the most complex, it is at the heart of DTCs.

To this token, we respectfully submit the opinion that some aspects (see *supra* the relevant *Observations*) shall be revaluated in order to reduce uncertainties that may hamper DTCs’ objective of eliminating or reducing double taxation.

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13. **Impact of Action 7 proposals on pending (Milan, 2015) and forthcoming (Dubai, 2020) EXPO**

Some events – like the EXPO – are unique, rather than unusual.

The shortcoming amendments that will replace/(delete, amend) some parts of the MTC, could have a dramatic impact on the tax treatment of income arising in this context.

We address some PE-issues that could impact over current (Milan 2015) and next (Dubai 2020) EXPO.

To track a short outline as for tax treatment of business income in Milan EXPO 2015; (i) income deriving from “non-commercial” activities will not be charged from income tax while income from “commercial” (business) activity will; (ii) commercial activities can be carried out in an area not exceeding 20% of the space at disposal (the pavilion) and (iii) limited period of time (6 months) is enough – according with Italian Revenue Service (*Agenzia delle Entrate*, shortly, IRS) – to fulfill a material-PE.

The IRS held that acting through a General Contractor (GC) may be enough in order to assess the existence of an agent-PE in Italy. The IRS recognized, however, that a GC is necessary, for Institutional participants, to set-up and manage a pavilion but avoid to lay down a more specific outline on effects deriving from interaction of different PE cases due to the fact that GC activities could be part of a construction-PE (since the pavilion set-up amount, at least, to installations) (22).

To this token, we wonder what is the impact of *Example E.* which, in our view, narrows the scope of ‘construction clause’.

In fact, in our opinion, it is debatable whether SUBCO (in a fact-of-the-case as the one puts forward in *Example E.*) is acting with the “principal purpose” of gaining Article 5(3) time threshold benefit. Involving a newly established entity (moreover residing in the same State of the GC) seems to be a quite normal event, even if it happens just to develop part of the bid.

Shifting activities (and related risks) may arise as a consequence of the negotiations (23). To the same token, joint and several liability of the GC is absolutely consistent with a genuine business where SUBCO does not want to shift the overall bid and wish to be sure that the “newco” activities will be performed, in any case.

If Example E. merely interprets the OECD MTC as it stands (hence it does not aim at amending it), enterprises involved in Milan 2015 EXPO shall be careful in implementing strategies substantially similar to the one in hand which, prima facie, is within BEPS. If one – on the opposite – holds that such interpretation does amend the one true meaning of the ‘construction clause’ embodied in the OECD MTC (and drafted along Italian DTCs), such interpretation shall be duly put aside.

The issue already discussed affects also U.A.E. EXPO, to be held in Dubai in 2020.

When EXPO 2020 will take place, Action 7 outcome will be embodied in the MTC.

One preliminary question is the impact of the relevant amendments on the DTC that will be entered into after 2015 (or that are already signed but not yet ratified). We wonder whether such interpretation could be applied to contracts “negotiated” by the GC, acting in UAE as an agent of Participants (24).

**OBSERVATION:** Clarify the meaning of “negotiating” the contract, in the context of the Draft and narrow the scope of the fact-of-the-case in Example E.

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(23) E.g. SCO may be ready to pay in advance part of some services, to the extent that such activities are carried out by a separate – although related – entity.

(24) However, also in the lack of an explicit Position against the Commentary, Draft impact could be limited in scope as, for instance, in respect of technical services related to constructions plans since relevant DTCs could still have a wider scope than the Draft proposal; see point 2(b), Protocol to the Germany-UAE DTC.
Comments on the OECD Public Discussion Draft on the BEPS Action 7:
Preventing the Artificial Avoidance of Permanent Establishment Status
Paris, 9 January 2015

1. The TUAC welcomes the opportunity to provide comments on various OECD amendment proposals to article 5 of the OECD Model Tax Convention to fulfil the commitment by the G20 to prevent the artificial avoidance by multinational enterprises (MNEs) of the permanent establishment (PE) status for the legal setting of their foreign activities, as outlined under Action n°7 of the Base Erosion and Profit Shifting (BEPS) Action Plan. Action 7 specifies the OECD and G20 commitment to “develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionnaire arrangements and the specific activity exemptions”.

Why it matters for workers

2. Trade unions are especially concerned that international tax rules should be reformed to ensure that multinationals are taxed “where economic activities take place and value is created”, as mandated by the G20 Leaders. Corporate BEPS tax avoidance practices by MNEs matter for governments and their tax collectors. They also matter for other corporate stakeholders. When an MNE escapes its obligations vis-à-vis the tax collector, its obligations vis-à-vis other stakeholders, including workers, may also be at risk. Trade union experience suggests that tax liability issues are intertwined with employer responsibility issues. There are two reasons for this, which are interrelated:

- Firstly, a central technique used by MNEs for evading their tax obligations is to elaborate formal corporate structures in which the allocation of functions to the various entities of the MNE is fragmented in a way that does not reflect the distribution of economic risks and added-value within the MNE group. These corporate restructurings aim at tax planning and tax arbitrage – but are not limited to this. They can also be used to evade other regulatory requirements, including in the areas of employment protection legislation, of collective bargaining and of worker representation. For trade unions, corporate tax avoidance planning is one form of a broader problem of corporate “regulatory planning” with short-termist goals.

- Secondly, corporate tax avoidance generally entails changing the entity to which profits are formally attributed, from a high to a low-tax jurisdiction. In practice, such profit shifting is likely to entail a profit shift from employment-rich or employment-generating entities to entities with either zero or irrelevant levels of employment.

Fragmentation and artificial avoidance of the PE status

3. The artificial avoidance of the PE status is part of a bigger problem of fragmentation of corporate functions. Dealing with the problem of fragmentation would require governments
and tax administrations to adopt a less formalist approach to the design and interpretation of tax treaties. So far, the prevailing view in such treaties is that different entities are assumed to be “independent” from each other as long as there is a formal contract establishing this. This view will prevail even if the very same entities are de facto dependent from each other and are under common control by the same management and even if there is clear evidence that their employees are operating under a single economic employer.

4. When an MNE’s local businesses are fragmented into several separate entities and, accordingly, PE rules are not respected – either because the use of a PE status only covers part of the MNE’s local operations or because there is no PE status in the first place – the rights and well-being of local workers that are economically dependent on the MNE are likely to be at risk or less protected. Three aspects are to be taken on board:

- Employee remuneration, as a result of an artificial fall in local profits that would not reflect the level of risk to which workers are exposed (case of absence of a PE, or partial coverage of it, case of fragmentation);
- Coverage and quality of the collective bargaining agreement (case of fragmentation); and
- Worker information and consultation rights (fragmentation).

5. The annex to this paper provides a concrete example of fragmentation of an MNE subsidiary. Local profits fell sharply after a restructuring process without corresponding changes in the functional responsibilities or exposure to risk of the subsidiary’s activities. According to trade unions of the subsidiary entities and their advisers, the fall in profit was due to a combination of factors:

- Manipulation of transfer pricing;
- Shift of status of the local entities from primary contractor to subcontractor and from fully fledged to limited risk distributor (LRD);
- Fragmentation of the local activities in several separate entities;

6. While the case primarily relates to manipulation of intra-group transfer pricing, it has some bearing on the PE discussion and the consequences of fragmentation of activities and of an undue shift to LRD status.

Comments on the proposed amendments to article 5

7. TUAC welcomes the proposals put forward by the OECD to strengthen existing #5 of article 5 on the requirement for PE for persons “acting on behalf” of an MNE company, by focusing on the substance of the contract (“what is the object of the contract”) rather than its form (“who is bound by the contract”) as is currently the case (those who have “authority to conclude contracts”) and to limit the exemption for sales agents paid on commission under #6 – by strengthening the criteria for independence (vis-à-vis the MNE) to benefit from the exemption.

8. Looking at the four proposed alternative amendments (A, B, C & D), our preference goes to options A and C which require PE status for intermediaries that regularly “engage with specific persons in a way that result in the conclusion of contract”. As such, both A & C focus on the substance of a contract rather than its form and are comprehensive enough to cover the various contractual processes between a sales staff or entity and their clients that MNEs can set in place to avoid the PE regime.

9. We also welcome the proposals of amendments to #4 to restrict the specific activity-related exemptions. We support proposals that make explicit that any exempted activity
should be of preparatory or auxiliary nature (option E). We support the proposal to add an anti-fragmentation clause under a new #4.1 whereby complementary business activities would qualify as a PE regime – if there is evidence that, on aggregate, those activities would go beyond auxiliary or preparatory functions (option J).

10. More fundamentally however, the question remains as to whether the proposed OECD amendments are robust enough to ensure:
   • A full coverage of the PE status to entities that are controlled or dependent on the MNE beyond those involved in sales and logistics and including marketing, manufacturing and back office, other services;
   • A correct application of the PE status that truly reflects the economic distribution of risk between the MNE and its local entities and that, among others, would prevent abusive use of the LRD status.

11. We also note and welcome the separate contribution by the BEPS Monitoring Group (BMG) to this OECD public consultation.
Annex: A case study, the restructuring of CP France

Up until 2005, “CP Global” operated a decentralised organisation outside its parent jurisdiction in the US. The French subsidiary, CP France, was structured around a holding company which controlled all operational activities, including two production sites and several local commercial companies. From a tax point of view, the holding company was the Principal and “primary contractor” and hence reported all profits and net incomes generated in France.

The restructuring

In 2005 the European operations went through important structural changes. A new company was created in Switzerland, CP Beta, and became the primary contractor for all operations in Europe. As a result of this centralisation of businesses in Europe, the status of local distribution companies of CP France went from that of fully fledged distributor to limited risk distributor (LRD). The LRDs were buying CP finished products and selling them to French customers at pricing and terms of reference set by CP Beta which were equivalent to a 2.5% margin on the turnover made in France. LRDs nevertheless continued to hold important marketing and sales functions including: business development, contract negotiation; sales order and taking and execution of the marketing strategy set by CP Beta. Similarly the industrial sites became sub-contracted manufacturers with specific terms of reference and pricing arrangements that were also set unilaterally by CP Beta. The French holding company, which previously had a primary contractor role, became a service provider for the other French entities or for CP Beta, the pricing of which was set by CP Beta at cost+6%.

The business restructuring of CP France in 2005

Before:

After:

As a result of the restructuring, profits reported by the business entities in France fell sharply. The operating margin of the French commercial companies was divided by 4, from 10% to 2.5%. Suspecting illicit transfer pricing and transfer of profits abroad, the French tax administration launched a tax audit of the French subsidiary over the period 2005-2008. The French administration challenged the status of CP Beta as the primary contractor for French operations on the ground that:

- The reorganisation around CP Beta as the principal contractor did not lead to a growth of the turnover and of profits generated in France;
- CP Beta did not have the means to fulfil its responsibilities as shown by the fact that essential functions were subcontracted to the French holding company and other entities;
CP Beta was under-capitalised to cope with the operational and market risks to which it claimed to be exposed to as a primary contractor in France; and

- It did not own the trademarks of the global brands.

Several millions of euros were claimed by the French tax administration in tax arrears. CP Global contested the decision by defending the primary contractor status of the Swiss entity and arguing that the fall in the margin rate of the French subsidiary was simply due to the transfer of risks to the Swiss entity. It further argued that the Swiss entity held the licensing rights for the use of the global brands in Europe, and that CP Beta controlled and was exposed to operational and market risks in France regardless of the fact that essential functions were indeed subcontracted to French entities.

**Impact on workers employed by CP France**

The restructuring of 2005, including (i) the fragmentation of CP France and (ii) the transfer of the primary contractor function to Switzerland had profound implications for the workers employed by CP France in three areas:

- The remuneration of workers, via the profit-sharing scheme of the company;
- The quality of the collective bargaining agreement; and
- The right of workers (established by French and EU law) to information and to consultation.

The restructuring of 2005 had a clear impact on the employee profit-sharing scheme of the French subsidiary. Profit-sharing schemes are common in France and may represent a non-trivial part of workers’ income, particularly for large companies and for subsidiaries of foreign MNEs. The schemes are regulated by law, including with regard to the formula for setting the share of profits to be reallocated to workers. The formula is entirely dependent on the level of equity or capitalisation of the company: the higher the level of equity, the lower the share of profits being distributed to the employees. The restructuring plan resulted in excessive levels of capitalisation of the French subsidiaries considering their supposedly reduced exposure to market and operational risks. Combined with an overall decrease in profit levels, the share of profits redistributed to workers fell sharply after the restructuring. It is estimated that the net gains for the MNE were over €1m per year more for 2006-2012 than in 2000-2005.

Workers’ rights to information and to representation were also negatively impacted. As a result of the fragmentation and restructuring in 2005, the status of the French entities shifted from limited liability company (société anonyme, S.A.) to “simplified” limited liability company (société anonyme simplifiée, S.A.S.). The SAS status was introduced in French corporate law to meet the specific needs of small companies, not those of mid-size companies. Compared with the SA regime, the SAS status offers much lower levels of worker rights to representation and information. The fragmentation of the French subsidiary into a plurality of small entities led to a considerable loss of information and of rights to consultation for workers of CP France, and thereby to a net loss of bargaining power of their representative institutions (works councils and trade unions).

It also led to a downgrading of the quality of the collective bargaining agreement covering the workers. In France, all workers (whether they are unionised or not) are covered by a collective agreement of the sector of activities under which the employer is registered. As a result of the

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1 CP Global also submitted a comparability analysis which showed that its transfer pricing policy between the French and Swiss entities was indeed within the range of its competitors. It was however located in the lowest quartile of remuneration – while the exposure of the French entities to risk was located in higher quartiles. The French subsidiaries were remunerated at the lowest levels compared to its exposure to operational risk in France.
shift from SA to SAS status and from primary contractor to sub-contractor roles, the French entities were registered under a different sector of activity covered by a collective agreement that had lower provisions and lower benefits than the one that prevailed prior to the restructuring.

Overall, the quality of social dialogue deteriorated fast following the restructuring, to the point where it can now be considered as close to non-existent. According to trade union representatives, the company’s human resource policy has shifted to a situation of “permanent redundancy planning”. A works council representative summed up the situation: “the farther you are from where tax is being declared within the MNE group structure, the higher the risk for worker misery”. The unions have attempted to bring attention to the aggressive tax planning scheme of CP Global before the French parliament – including calling for an official inquiry.

In 2012 CP Global generated USD17bn in net sales and USD2.5bn in net income. That year, CP Global spent USD3.2bn in dividends and share buybacks, USD865m in investing activities and USD1.3bn in payment of income taxes. From 2006 to 2009, net income / net sales ratio grew from 11.1% to 14.9% globally and has remained stable at 14.5% since then. The number of workers employed by CP globally has grown by a mere 3% between 2003 and 2012.
January 6, 2015

VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 7: Prevent the Artificial Avoidance of PE Status

Dear Ms. de Ruiter,

USCIB is pleased to have this opportunity to provide comments on OECD’s discussion draft on BEPS Action 7. USCIB would like the opportunity to present comments at the public consultation.

General Comments

USCIB generally supports the comments submitted by BIAC. We write separately in order to emphasize certain points and highlight our member’s perspective on the discussion draft.

Countries have a jurisdictional basis for taxing any business profits that are earned within their jurisdiction. Treaties have historically included a permanent establishment (“PE”) threshold, which limits this right to tax, because of the potential negative impact of assertions of taxing jurisdiction on cross-border trade. If the costs of engaging in cross-border trade exceed the profits, particularly if the activities driving the costs are minor, then business will actively seek ways to avoid engaging in those activities. Therefore, there is and should be a relationship between the expected profit from an activity and whether that activity should be considered to create a PE. USCIB is concerned that the proposals contained in the Discussion Draft, rather

USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.
than being limited to addressing abuse cases, as Action 7 requires, would merely lower the PE threshold for all activities. We believe this approach is flawed since simply lowering the threshold will have an impact on non-abusive cases, discourage cross-border trade, and result in a rebalancing of the split between “source” and residence taxation.

Both PE and transfer pricing rules are concerned with the proper allocation of taxing jurisdiction between countries. They serve different functions, however, and it is not appropriate to try to fix the perceived flaws in one (the transfer pricing rules) by expanding the other (the PE rules). When the transfer pricing rules are working correctly, the income earned by the local agent will properly reflect the activities performed in the local jurisdiction. Creating a PE based on those activities will create many PEs with little if any additional income and will result in complexity, disputes as to both the existence of the PE and the profit attributable to it, and the possibility of retroactive indirect tax adjustments.

The recently published discussion draft on BEPS Action 14: Making Dispute Resolution More Effective, is a disappointment to USCIB members. In the absence of a commitment to mandatory binding arbitration, there is no guarantee that disputes will be resolved. It is essential, therefore, that the operation of the PE rules be clear and unambiguous. As pointed out repeatedly below, unresolved disputes between countries as to the existence of a PE are likely to result in unresolved double taxation since both countries may assert alternative bases for taxing the same income.

The proposed rules would significantly lower the threshold at which an enterprise of the state of residence would be considered to have a PE in the other (“source”) state. The exact scope and intent of the rules is unclear, but USCIB expects that adoption of the proposed rules would result in the proliferation of PE assertions. The burdens of complying with a corporate income tax obligation, including the administrative and reporting burdens, are significant and companies consider these obligations in deciding whether to and how much of an investment to make in another country. The administrative costs are primarily those associated with the cost --- which can run into multiple millions of dollars --- of creating systems that generate the financial data specific to each PE. These costs include not only costs associated with complying with income tax obligations, but also with other obligations that may arise as result of having created a PE. These costs may include complying with indirect tax obligations, local registration and reporting requirements, and other local annual filing requirements. The compliance costs for both taxpayers and tax authorities would be disproportionate to the amount of tax that would be raised. Businesses may decide that an investment is not worth the administrative and

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2 We working with BIAC to gather information relating to these costs and will provide such data as soon as possible as part of the BIAC appendix to its comment letter. Some information is already included in that appendix. See also footnote 15.
tax cost and reduce or eliminate an investment to ensure that PEs are not created.\(^3\) These decisions will reduce the global footprint of a business and local employment and investment. For each individual company, these decisions may not have a significant impact, but replicated globally, such decisions in the aggregate could have an important, negative impact on cross-border trade and investment. Thus the discussion draft’s significant expansion of the PE concept will create a significant trade barrier.

The adoption of these rules would create PEs from little, if any, activity by the nonresident enterprise within the “source” jurisdiction. If the foreign enterprise performs no functions and assumes no risks itself in the local jurisdiction, then the only activities to look to are those performed by other parties, whether a local affiliate, independent agent or dependent agent. Creating a PE from these activities and attributing profit to it would result in double taxation. This double taxation would be especially pernicious because it would be a case of the same country taxing the same income twice. This proliferation of PEs would have a significant negative impact on companies, and USCIB expects companies would respond by making fundamental changes in their business models. A number of examples of these types of changes are set out in the BIAC comment letter.\(^4\) USCIB members agree that companies might adopt these and other new business models in response to the proposed rules. Additional examples would likely be identified with more time to consider the impact of these proposed changes.

The rules proposed in the discussion draft would create significant uncertainty. Recently, particularly in Western Europe, authorities have been asserting criminal liability (including at the individual non-resident director level) for failure to file tax returns when the tax authorities asserted a PE existed. Individuals should not be at risk of criminal penalties when the rules are subjective and/or uncertain.

The discussion draft dismisses\(^5\) as insubstantial the issues relating to attributing profits to these new PEs. To the contrary, we believe profit attribution is the most significant issue in a PE controversy. Countries want to create more PEs because they want to attribute profits to them to raise tax revenue. To the extent that a PE is “virtual” or essentially “virtual” because functions, assets and risks of that PE are minimal, no significant profits should be attributed to that PE. Countries may, however, attempt to use these marginal PEs to attribute significant

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\(^3\) USCIB strongly opposes the UK’s recent diverted profits tax proposal. Taxpayers should be able to take tax laws into account when adopting their structures and should not be penalized for taking steps to avoid PE status.

\(^4\) USCIB believes that the response of business to these proposed changes is a prime example of why the corporate income tax is inefficient.

\(^5\) Whilst the preliminary work has identified a few areas were (sic) additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in this note were adopted. Paragraph 45 of the discussion draft.
profits based on the value of the market or other attribution theory. The discussion draft notes that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.” Broad PE rules, combined with a lack of clear guidance on profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed. Other countries may not share this view and the lack of clarity may cause companies to be caught in the middle with profits attributed to both jurisdictions resulting in double taxation. The final guidance should clearly state that this is not intended to be the case.

There are many function-specific profit attribution questions. For example, some assert that warehouses generate significant profits, even though warehousing and delivery functions are routinely outsourced and third party comparables demonstrating low profit margins may be readily available. It is not difficult to imagine disputes on the value of this function. USCIB expects that the value of raw data to be controversial. We elaborate on this below.

The discussion draft does not address the potential interaction of these rules with the limited force of attraction principle that is part of the UN Model. These proposed rules are intended to only affect the OECD Model. However, if these changes are implemented through the adoption of a multilateral instrument that would amend bilateral treaties that contain both OECD-based business profits articles and UN-based business profits articles, then it is necessary to consider the impact of the force of attraction principles on profit attribution. Significantly expanding the PE rules has the potential to significantly expand the application of the force of attraction rules.

The PE proposals also fail to recognize the bilateral nature of tax treaties. PE rules that restrict the ability of a “source” country to impose tax are particularly appropriate in the context of trade relationships in which the flow of foreign direct investment runs both ways. Each country will be both benefitted and burdened by rules restricting the creation of PEs. The proposed rules would create significant burdens with no significant net tax impact between the treaty partners. The proposals are, therefore, particularly inappropriate in the context of economies where FDI is reciprocal. After five years of rapid growth, Chinese annual FDI in the US now exceeds FDI by US companies into China by most measures — including China’s own official statistics. Countries may be willing to agree to a PE provision that permits more “source” country taxation in the context of a relationship where the FDI is more one way, or in exchange for other concessions by the “source” country in the bilateral relationship, but that should not

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6 Discussion draft, paragraph 3, page 10.
become the model.\textsuperscript{8} Lowering the PE threshold will inevitably give rise to additional disputes both as to the existence of a PE and the profits attributable to it. Taxpayers, therefore, must have access to effective dispute resolution procedures. USCIB continues to believe that mandatory binding arbitration is necessary to improve currently ineffective dispute resolution. If dispute resolution continues to be ineffective, maintaining a higher PE threshold is essential because ineffective dispute resolution will lead to increased unresolved double taxation. In determining the costs of these proposals, the OECD should consider the impact of disputes and dispute resolution. These costs may be significant and business will seek to avoid them. These high costs will all have a negative impact on cross-border trade.

\textbf{A. Artificial avoidance of PE status through \textit{commissionnaire} arrangements and similar strategies}

The current text of Article 5(5) of the OECD Model has led to many controversies regarding the proper interpretation of the clause "has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise".

In recent years, litigation over application of this clause to enterprises operating under a \textit{commissionnaire} commercial relationship has reached the highest courts of France, Italy and Norway.\textsuperscript{9} Each of the three cases involved an Article 5(5) that was essentially the same as Article 5(5) of the OECD Model.\textsuperscript{10} In all three cases, the highest court of the jurisdiction concluded that no deemed PE could exist since as a matter of law the \textit{commissionnaire} does not enter into contracts in the name of its principal.\textsuperscript{11}

USCIB understands that the purpose of the changes proposed in the Action 7 discussion draft is, in contrast to these decisions, generally to treat \textit{commissionnaire} and similar arrangements as

\textsuperscript{8} To the extent that countries might agree to a more expansive PE rule in a bilateral agreement based on the one-way nature of FDI or in exchange for other concessions such as reduced rates of withholding, addressing the PE rules in the MLI will be extremely difficult because taking these bilateral aspects into account will be difficult and countries may be unwilling to make multilateral concessions that would take away their ability to bargain on other issues such as withholding taxes.

\textsuperscript{9} CE 31 mars 2010 n°304715 et 308525, 10° et 9° s.-s., Sté Zimmer Ltd.; Boston Scientific, Italian Supreme Court, Tax Section, n. 3769 of Mar. 9, 2012; Borgarting Lagmannsrett, dated 2 March 2011, Dell Products vs. Skatt Øst, ref 10-032855ASD-BORG/03.

\textsuperscript{10} As relevant to Boston Scientific, the Italy-Netherlands Tax Treaty contains the dependent agent PE test in Article 5(4). It states, “A person acting in one of the States on behalf of an enterprise of the other State--other than an agent of an independent status to whom paragraph 5 applies--is deemed to be a ‘permanent establishment’ in the first State if it has in this State, and habitually exercises, an authority to conclude contracts in the name of the enterprise, unless the activity of said person is limited to the purchase of goods and merchandise for the enterprise.”

\textsuperscript{11} In Boston Scientific, the Regional Tax Court (lower court) concluded that the commissionnaire entered into contracts in its own name and therefore did not exercise “an authority to conclude contracts in the name of [the principal]”. The Supreme Court did not decide the case on the merits, but instead, rejected the tax authorities’ appeal on procedural grounds.
creating a taxable nexus for the nonresident enterprise in the jurisdiction in which the commissionnaire performs its activities.

1. **Need to clarify policy grounds for the proposed changes**

As a threshold matter, USCIB believes that the Focus Group should clearly state the policy goals the proposals are intended to achieve. A clear statement of the policy goals is a necessary prerequisite to evaluating the policy and assessing whether any particular proposal will serve that goal.

   a. **Policy to prevent artificial avoidance of PE status**

The Action 7 text states that the policy goal of Action 7 is to prevent the "artificial" avoidance of PE status. If this indeed is the policy goal, then USCIB believes that the proposals should focus on structures which have no business substance or are abusive.

If combating abuse is the policy goal, we respectfully object to the assumption in the Discussion draft that the decision by a corporate group to regulate the commercial activities of a sales solicitation and marketing entity through a commissionnaire contract constitutes an "artificial avoidance of PE status". A corporate group may choose among several commercial relationships to govern the activity of sales solicitation and/or marketing personnel located in a market jurisdiction, including reseller, agent with power of representation, agent without power of representation, and (in some countries) commissionnaire. As long as the parties' actions are consistent with the commercial and legal relationships, simply making a choice of one commercial relationship over the other cannot be regarded as abusive.

   b. **Policy to prevent income shifting**

USCIB believes that the main policy goal motivating the focus on commissionnaire commercial relationships is based on the assertion that such arrangements erode the taxable base of market jurisdictions. The Executive Summary states as follows: "[i]t is clear that in many cases commissionnaire structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place." This is a transfer pricing matter, and should not be used to justify creating a PE based on a commissionnaire relationship. If the essential issue is a transfer pricing matter, then the focus of this portion of the Action 7 work

12 For example, the German Civil Code and Commercial Code (Bürgerliches Gesetzbuch, BGB, Handelsgesetzbuch, RGBl. 1897 S. 219) have differentiated between buy-sell distributors (Wiederverkäufer), commissioned agents (Handelsvertreter), brokers (Handelsmakler) and commissionnaires (Kommissionaire) since these laws came into effect in the year 1900. Each of these forms of distribution relationship allocate risks, responsibilities and opportunities differently between the two parties (see, for example, [www.wirtschaftslexikon24.com/d/kommission%C3%A4r/kommission%C3%A4r.htm](http://www.wirtschaftslexikon24.com/d/kommission%C3%A4r/kommission%C3%A4r.htm)).
should be on the transfer pricing aspects of business restructurings and the compensation of sales entities operating under *commissionnaire* contracts.

The mere choice by a group to use *commissionnaire* contracts to govern the activities of its sales solicitation and marketing entities does not constitute either an "artificial" avoidance of PE or a potential abuse of the transfer pricing rules. In the case of a newly established entity, for example, where there has been no business restructuring, the choice to use a *commissionnaire* contract cannot be considered an abusive transaction of any kind. Groups are entitled to decide the levels of investment in functions and infrastructure for any particular jurisdiction and the profit allocation should follow from those decisions.

2. **Clearly define commercial transactions to be addressed through a change in the PE rules**

In the event that the final report under Action 7 will include proposed changes to Art. 5(5), USCIB believes that it will be essential to provide a more precise statement of the commercial structures which the Focus Group believes should constitute a deemed PE under a revised Article 5(5). The Action Plan itself refers only to the use of "*commissionnaire* arrangements and the specific activity exemptions." The policy statement in the Executive Summary of the Discussion Draft, however, seems to describe sales solicitation activities of a considerably wider scope than merely those conducted by entities operating under *commissionnaire* arrangements. It states as follows:

"As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed 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."

If the policy goal is to cover only *commissionnaire* arrangements, then the final draft should state that clearly. If the policy goal is to cause sales solicitation activities of a wider scope than those conducted under *commissionnaire* arrangements to create deemed PEs of the nonresident supplier, USCIB suggests that greater precision as to what commercial arrangements are covered is necessary. USCIB believes that the expansion in the scope of the PE rules should be limited to abusive activities.

a. **Distributorship/reseller arrangements to be excluded**

USCIB understands that the Focus Group intended that in no case could a deemed PE be created by the activities of an enterprise acting as a distributor / reseller of goods or services in its own name, but not acting pursuant to a *commissionnaire* arrangement. This should be clarified, as the language in certain of the options is sufficiently ambiguous that absent
clarification, tax administrations perhaps not aware of the intended scope of these new provisions could assert that such distribution arrangements are also covered by the new language.

Each of the options includes the clause that Article 5(5) applies to persons who act "on behalf of" an enterprise. Distributors / resellers act on their own behalf, and not on behalf of another. Accordingly, it should be made clear that distributors / resellers are outside the scope of any of the options.

The final report should be clear that distributor / reseller arrangements are excluded, even if the commercial terms between the supplier and the distributor / reseller allocate certain commercial risks to the supplier. Such arrangements exist between unrelated parties and do not create a taxable presence for the supplier in the jurisdiction of the distributor. The PE rules should not create unnecessary distinctions between the treatment of related and unrelated party transactions, such distinctions would violate the arm’s length principle and will create perverse incentives to structure business using unrelated parties. An example would be inventory consignment arrangements, where the risk of damage to inventory or unsold inventory is retained by the supplier.

This confirmation is of paramount importance, as otherwise significant uncertainty (especially in light of the absence of effective dispute resolution mechanisms) will be introduced into the tax treatment of cross-border distribution arrangements which uncertainty does not exist today.

b. Definition of commissionnaire arrangements

If the Focus Group wishes to modify Article 5(5) of the MTC so as to cause a sales solicitation and/or marketing entity operating under a commissionnaire contract to create a deemed PE of its principal, USCIB suggests that a better means to achieve that goal is to use a much more precise definition of the targeted activity. The commissionnaire commercial relationship is a well-known element of the commercial law, so precise references to that relationship will be easily understood by taxpayers and tax administrators. Each of the four proposed options has the possibility of causing extensive unintended effects for distributor and reseller arrangements. If the policy goal is to describe only commissionnaire commercial relationships, we believe that such arrangements should be defined with precision. Since commissionnaire relationships exist only in certain countries, any proposed changes should address those specific arrangements only.

As a preliminary matter, it is useful to refer to the civil law basis of the commercial relationship of commissionnaire. Articles L132-1 to L132-9 of the French Code of Commerce are representative of the enabling statute defining the commercial nature of a commissionnaire.
contract. Article L 132-1 defines the *commissionnaire* relationship as follows: "A commissionnaire is a person who acts in its own name or under a corporate name on behalf of a principal" ("Le commissionnaire est celui qui agit en son propre nom ou sous un nom social pour le compte d'un commettant."). While the laws of various civil law jurisdictions show some variations in this expression, the general terms of the commercial mandate are the same in the civil codes of most countries which authorize this commercial relationship.

A *commissionnaire* commercial relationship exists only in the form as created and governed by the applicable commercial code. Therefore, the most precise approach to achieve the policy goal expressed in the Discussion draft is to define the arrangements subject to Article 5(5) by means of an explicit cross-reference to the applicable statutes. Since the terms of most *commissionnaire* statutes are fairly uniform and the *commissionnaire* commercial relationship is distinct under the law from distributorship, agency, trustee, or other commercial relationships, the operative language of an amended Article 5(5) could simply refer to persons which act on behalf of another under the authority of a "*commissionnaire*" statute. To remove any doubt as to what relationships are covered, the Commentary could include references to the applicable statutory provisions of those jurisdictions which authorize *commissionnaire* relationships and which agree that such relationship should create a deemed PE of the nonresident principal.

3. **Comparison of options**

If, instead, the Focus Group chooses to define a broader scope of activities as within the scope of Article 5(5), USCIB believes that substantial refinements to Options A - D are needed to avoid unintended consequences.

The four options have been created through the combination of two sets of alternative changes to the text of Article 5(5). The first set of alternatives describes the actions which, if taken by the dependent person, could give rise to a PE of the nonresident enterprise, as follows:

- "...habitually engages with specific persons in a way that results in the conclusion of contracts..."; or

- "...habitually concludes contracts, or negotiates the material elements of contracts...".

The second pair of alternatives describes the commercial attributes of the contracts which are concluded as a result of the dependent person's activities, as follows:

- "...contracts, that are a) in the name of the enterprise, or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or
that the enterprise has the right to use, or c) for the provision of services by that enterprise..."; or

- "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise..."

Of the first pair, USCIB considers the expression "habitually engages with specific persons in a way that results in the conclusion of contracts" to be exceedingly ambiguous and overbroad which will increase uncertainty and disputes. Again, the absence of effective dispute resolution should mean that language this unclear should not be adopted.

One could argue that almost every activity a marketing entity performs is intended to help the principal sell products but these activities should not create a PE. The current rule that creates a PE upon the exercise of the authority to conclude a contract in the name of the nonresident enterprise is simple and, for the most part, clear in practice. Personnel in a market jurisdiction may perform a wide variety of activities towards a potential customer base in the jurisdiction, including any or all of the following: market development; demand generation; education; marketing; sales solicitation; negotiation; returns; training; service; repair; and support. The "habitual engagement" term provides no guidance as to which, if any, of these activities are meant to be covered. If this option were to be adopted, it would be essential to provide clarity to taxpayers and tax administrations as to the type of commercial activities that are intended to be covered. Because of the broad scope and ambiguity of this option, it should be rejected. If the OECD were to adopt this proposal, then it would be necessary to define and significantly narrow the covered activities.

Of the second pair, the first expression which refers to contracts for the transfer of ownership of / right to use property or the provision of services by the nonresident enterprise is more precise than the alternative. This option, however, could be read to cover any sale to a distributor because the local distributor has to buy from the principal before it can complete a sales transaction. If distributors are not intended to be covered (we believe they are not and should not be covered) then this provision needs to be clarified. There are many commercial relationships commonly entered into between suppliers and distribution intermediaries which either prescribe or allow for the allocation of commercial risks to the supplier. For example, an agency relationship normally would allocate to the supplier as a matter of law all inventory risks, as the agent does not take title to inventory. In contrast, in a distributor relationship, the parties generally would be free to allocate various commercial risks between them as they see fit, such as through price protection clauses, rights of return of unsold inventory, warranty claim indemnification, and the like, all of which serve to allocate by contract commercial risks arising in the distribution chain between the supplier and distribution intermediary. A rule which refers to the allocation of commercial risk between the supplier and the distribution
intermediary is highly ambiguous. Substantial further clarification would be needed for this second alternative to provide useful guidance to taxpayers and tax administrations, particularly in light of the lack of effective dispute resolution.

Of the four proposals, Option B provides more clarity than the other three but needs significant further clarification to make it practical for business and tax administrators to apply.

4. Suggestions for clarification of scope of Option B

If Option B were implemented, Article 5(5) would read as follows:

Notwithstanding the provisions of paragraphs 1 and 2, but subject to the provisions of paragraph 6, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting in a Contracting State on behalf of an enterprise and, in doing so, has, and habitually exercises, in a Contracting State an authority to concludes contracts, or negotiates the material elements of contracts, that are:

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

The proposed inclusion of the clause "or negotiates the material elements of contracts" means that this proposal extends considerably beyond the case of commissionnaires, and includes activities involving negotiation of terms which currently do not cause a deemed PE of the nonresident enterprise. Accordingly, USCIB requests that the Focus Group clarify this clause by reference to actual business models. We provide the following suggestions:

- Material elements. Guidance will be necessary as to what elements of contracts are to be regarded as "material". Depending on the type of transaction, a business may

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13 Para. 33 of Article 5 Commentary states as follows: "The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise."
consider a wide variety of contractual provisions to be material, in other cases those same elements may not be considered material. This will make the test very subjective and tax administrations may assert that an element is a material element, when the business believes it is not. In some cases, different persons in an organization will be responsible for negotiating different material terms (for example the sales organization may have responsibility for pricing while the legal group would have responsibility for indemnities), so guidance will be necessary as to which set of negotiations is the determinative one for PE purposes.

- Marketing or sales solicitation. It should be clarified that all marketing, sales solicitation, demand generation, and other customer-facing activities that do not involve the actual negotiation of terms of sale are not described by this text.

- Rate cards. It is common for enterprises to authorize local representatives to communicate prices to potential customers through rate cards, which may include pre-agreed discount ranges. The local personnel normally will have no authority to deviate from the ranges prescribed on the rate card. This should not be regarded as "negotiation", due to the absence of authority of the local personnel to deviate from agreed terms. Business policies which require escalations for approval of deviations by management personnel located outside of the market jurisdiction should be sufficient to establish that no PE would arise in the market state if behavior is consistent with the policy.

- Standard contracts. Many enterprises sell their goods and services through standard contracts, including online contracts. Since the terms of those contracts are not negotiated, it should be confirmed that Option B cannot apply to any sales made pursuant to standard contracts.

5. Confirmation that any new rules can be applied prospectively only

Any of these Options would represent a clear and substantial expansion of the OECD Model grant of authority to market jurisdictions to impose tax on sales made by nonresident enterprises. USCIB suggests that if these proposals go forward, the final report should clearly state that the purpose of the amendment is to change the existing international standards on the allocation of taxing rights on cross-border income. This is important in order to ensure that tax administrations cannot argue that these proposed changes are merely clarifications of existing treaty provisions.

The final report should expressly state that the new rules apply only to taxable periods beginning after a grace period following the effective date of the treaty amendments which incorporate the new rules. This will allow groups to restructure the commercial relationships among group members as necessary to conform to the new standards. Since such restructuring will in many cases require significant time and cost to reconfigure financial systems and
implement other associated changes to business processes, it will be essential to provide a transition period of sufficient duration to allow enterprises to implement the necessary changes.

6. **Strengthen the requirements of "independence"**

In all four Options, the following amendment is proposed for Article 5(6):

6. **Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of that business. 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 within the meaning of this paragraph with respect to these enterprises.** An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

USCIB does not believe that exclusivity should create dependent agent status. The principle of exclusivity seems to be directed at the ability of one party to control the other party because of bargaining power of the parties. If the agent is willing to engage on the agreed upon terms, it is not clear why this should not be considered arm’s length and if it is arm’s length then creating a PE will create double taxation from the additional profit attribution to the PE.

USCIB also does not believe that the OECD Model should accord different direct tax consequences to an enterprise simply because the agent is related to its customer. This proposal is a major erosion of the long-standing standard of respecting the separateness of entities and is in tension with Article 5(7) of the OECD Model which states that the fact that parties are related does not in itself constitute one a PE of the other.

If the final draft nevertheless contains this proposal, USCIB recommends that this restriction be limited to related persons.¹⁴ It is very common, especially for small and medium sized enterprises, to engage independent marketing representatives to promote the enterprise's goods in a jurisdiction. These arrangements are particularly common when a growing business is first seeking to expand sales into a new market.

Under those circumstances, there can be no BEPS concern, as the independent agent will always be compensated at arm's length. Since the agent has been fairly paid, using any of the

¹⁴ Affiliation though 50+% direct or indirect stock ownership could be an appropriate test.
activities of the agent to attribute profit of the foreign enterprise to the local country creates
double taxation of the income from those local activities. It may be difficult for the enterprise
to know if its independent agent is acting "almost exclusively" for it. Since this business model
is used especially by smaller enterprises, this would impose a compliance obligation where it is
least appropriate.

7. Compliance and administrative costs

As mentioned above, the cost of implementing structures and annual compliance for each PE
can be significant. The BIAC annex contains examples of the costs that will be incurred. If the
real problem is transfer pricing, then creating more PEs does not solve that issue, it simply
creates another transfer pricing issue for the PE. As pointed out in multiple points in this
comment letter, creating PEs that have little or no functions, assets or risks will only create
more difficulties with respect to transfer pricing, with little profit attribution to be gained under
current OECD guidelines. That problem is most evident in the context of commissionnaires
where the PE is created entirely by the activities of another entity. Thus, if the
commissionnaire is properly compensated for its activities, it is difficult to see what additional
profit ought to be attributed to the new PE.

B. Artificial avoidance of PE status through the specific activity exemptions

The purpose of the specific activities exemption is to provide relief from filing and tax payment
obligations for activities that are generally preparatory or auxiliary and also do not contribute
significantly to the profits of an enterprise. Filing and payment obligations can create
significant costs for a non-resident enterprise and will discourage investment in smaller and
emerging markets. In revising these exceptions the OECD and member countries should keep
these fundamental principles and their consequences in mind.15

1. The exceptions are not restricted to preparatory or auxiliary activities

Option E would not delete any of the activities from the list, but would make all of the activities
subject to the condition that the activity is preparatory or auxiliary in nature to the business of
that enterprise. USCIB does not support this option because it would create uncertainty with
respect to every item on the list, would lead to a proliferation of PEs and a proliferation of
disputes concerning whether a PE exists. Certainty of outcome is an important principle for
business and subjecting all the items on the list to a subjective test would increase uncertainty.
If this approach were to be adopted it would be essential to articulate a standard for
consistently determining whether an activity is preparatory or auxiliary and to include many

15 If it costs 1 million dollars to set up the accounting systems to generate data specific to each PE and 250,000
dollars to comply annually, a company will not make that investment for an activity that is only expected to
generate minimal profit. It will find another way to accomplish that function.
examples. There is no evidence in the discussion draft that such a standard has been considered or could be developed within the time available for the BEPS project. It would be inappropriate to adopt this option without further guidance especially in light of the current ineffective dispute resolution procedures.

As discussed in detail below, USCIB believes that delivery, purchasing and data collection can be preparatory or auxiliary. If, however, countries do not accept that outcome (e.g., they believe delivery can never be preparatory or auxiliary) then adopting this option will mislead taxpayers (and other countries). Examples would be particularly important in these cases, because considering the deletion of some items will raise greater concerns about the scope of the exceptions.

Adopting one (or more) of the other options would preserve clarity for those items that remain on the list and would still permit taxpayers to make a case under existing subparagraph 4) e) that, for example, delivery could be preparatory or auxiliary.

USCIB generally believes a more targeted approach is better than introducing subjectivity into all of the specific activity exemptions. We offer comments on the more targeted approaches below.

2. The word “delivery” in subparagraphs a) and b) of paragraph 4

Option F would delete delivery from subparagraphs a) and b) of paragraph 4 of Article 5.16 This option would be more appropriate if countries believe either that maintaining a fixed place of business through which delivery activities are conducted cannot be preparatory or auxiliary or would in most cases constitute a PE.17 If this option is adopted, then it is important to be clear about a number of points. First, a shipper of goods using an unrelated shipping company (e.g., a common carrier) to deliver goods would not create a PE on behalf of the shipper because the unrelated shipping company’s warehouse would not be a place of business of the unrelated shipper.18 Further, these unrelated parties have been appropriately compensated, and using their activities to attribute profit from the foreign enterprise to a PE in the local country would create double taxation of those activities.

16 Since the current UN Model does not cover delivery, it would be useful to know whether those countries that follow the UN Model have seen much scope for the application of the “storage” or “display” parts of that exception. It would also be useful to know whether they have seen companies attempting to fragment “storage” or “display” from delivery.

17 To the extent that there is scope for delivery to be considered preparatory or auxiliary under the provision relating to other activities of a preparatory or auxiliary character, the OECD should consider examples of when delivery could continue to be considered preparatory or auxiliary.

18 This is another example where the proposed rules may create perverse incentives to restructure operations using unrelated parties to avoid PE status.
Second, on determining profit attributable to a warehouse that would be a PE under the proposed rules the OECD should make clear that the only profits that are attributable to the PE are those attributable to activities actually performed in the country where the warehouse is located, that is the warehousing activities.¹⁹ The profit attributable to the PE should only be that which arises from a deemed dealing between the PE and the head office that relates to the distribution function. That is, the profit attributable to warehousing and delivery should not include the profit from the sale of the delivered goods. The entity that earns the profit from the sale should be the entity that actually sells the product, not the entity performing the warehouse and the delivery function.

Third, countries should recognize that these new PEs ought to share in the expenses of the enterprise. For example, warehouses should bear a share of management costs and a share of interest expense among others.

Fourth, an enterprise that maintains a centralized warehouse in one country for delivery of goods to customers located in multiple countries will only have a PE in the country in which the warehouse in maintained. This reinforces the second point above, since the profit of that warehouse ought to include a service fee for the deliveries to other countries but certainly not the profit from sales within those countries.

USCIB is especially concerned that the focus of countries in examining the delivery exception has been on marketing to ultimate consumers and that not enough thought has been given to the exception in the context of business-to-business transactions where BEPS concerns would be significantly less. For example, it might continue to be the case that maintaining a warehouse for the ultimate delivery of heavy equipment should be preparatory or auxiliary to the manufacture and sale of such equipment. In the oil and gas industry storage and distribution raises special issues that are described in detail in BIAC’s appendix. These issues ought to be explicitly considered before substantial changes are adopted. If, after such consideration, it is concluded that these business-to-business transactions do not raise BEPS concerns, the OECD should include examples in the Commentary that make it clear that the delivery exception remains available under Article 5 (4) (e) in these cases. Since the UN Model does not contain an explicit exception for delivery, the OECD ought to consider what impact the absence of this exception has had on those jurisdictions which have adopted the UN Model on this point and on the businesses doing business in those jurisdictions.

3. The exception for purchasing goods or merchandise or collecting information

¹⁹ For transfer pricing purposes, the PE created by a warehouse should be able to be the tested party and profitability should be computed using available comparables.
Option G would eliminate the preparatory or auxiliary exception for purchasing goods. USCIB believes that the exception for purchasing should be retained. Narrower solutions are available for cases that are considered problematic. In most cases the mere purchase of goods is too attenuated from earning profit to justify the creation of a PE. The PE rules are attempting to find the amount of activity that strikes an appropriate balance between requiring an enterprise that is not resident in a contracting state to comply with the tax and reporting burdens imposed by that state, and the revenue implications for the taxing jurisdiction of foregoing that tax. No business can function without purchasing goods, whether for internal consumption or processing and ultimate resale. The issue is not whether a purchasing function does or does not contribute to profit or loss; it clearly will. The issue is whether that contribution is sufficient to justify the creation of a PE? USCIB believes it is not.

Generally the tax and compliance burdens to business from a purchasing PE arising from such modest business activity will outweigh the tax benefit to governments. As pointed out above, the costs of setting up the structure to collect data to implement PE reporting can be millions of dollars. The profit attributable to the purchasing of goods should be minimal, the cost of implementing the PE structure could eliminate all of this profit, resulting in no benefit for the taxing jurisdiction to justify the time and expense of finding a PE, attributing profit to the PE, and auditing the result. Business is concerned that some countries will use purchasing PEs to attempt to attribute a significant portion of the profits earned by the combined business to the country of purchase. Given that possibility, businesses will restructure their purchasing functions to minimize PE risk. Purchasing will become even more centralized than it already is; local purchasing offices will be closed. Countries should also consider this burden in light of the reciprocal nature of these rules. That is, if purchasing is ordinarily an activity that generates little profit, the balance between administrative burden on taxpayers and versus revenue concerns of the countries, should be resolved in favor of minimizing the burden on taxpayers. In cases of reciprocal trade, goods are purchased in all countries, so exempting purchases burdens all countries and will benefit cross border trade in all countries.

If countries wish to create PEs from purchasing then they also need to accept that purchasing can contribute to losses. Sometimes this contribution may be direct. One company overpays for its inputs and therefore cannot sell its products at competitive prices and suffers losses. Another company misjudges the demand for a particular product and purchases too much and realizes a loss on its excess or spoiled product. Are countries willing to accept at least some portion of these losses? If not, they should not demand an additional share of the profits in cases in which the global value chain is profitable.

Turning to the three examples, the first example seems to ignore the recent work on transfer pricing. The benefit of group synergies, particularly in case of bulk purchasing power should
benefit enterprises that make the bulk purchasing possible. It is not clear from the example what happens to the purchased goods, but if enterprises in multiple countries use the goods in their business, then the profit from that bulk purchase would in the most part be attributed to those enterprises and the purchaser would only be left with a commission for its services. The enterprises using the purchased goods might be in country S, country T or elsewhere.

The examples also seem to ignore the fact that these examples are arising in the context of a bilateral treaty relationship. That is, the “source” country is giving up its right to tax based on negotiations that are allocating taxing jurisdiction to the other state. As part of the bilateral negotiations the countries should be determining whether the other state will impose tax. Residence countries frequently condition exemptions for business profits on the existence of a PE in the source jurisdiction. So, this sort of interaction between the “source” and residence country raises the issue of conflicts of qualification. Business does not object to rules that resolve the issue of conflicts of qualification by only applying the territorial or exemption system in cases in which the “source” state imposes tax. This would be a narrower and more appropriate solution to address any unintended double non-taxation arising in the first example. Eliminating double non-taxation through the proper resolution of conflict of qualification would – consistent with the current norms – eliminate double non-taxation by ensuring that the country of residence imposes tax. This narrower solution is therefore consistent with the Action Plan and the discussion draft which state “these actions are not directly aimed at changing the international standards on allocation of taxing rights on cross-border income.”

In recent UN discussions, however, some delegates objected to rules implementing this result, despite the fact that a rule resolving conflicts of qualification would only limit unintended double non-taxation and would not limit the ability of a country to adopt tax incentive legislation. The only reason to object to the principles set forth on conflicts of qualification would be that such principles are inconsistent with more “source” taxation (even if it is not exercised). Because BEPS is not intended to rebalance “source” and residence taxation, that objection ought not to be given any weight in this debate. Another narrower solution to the problem posed by the first example would be to adopt appropriate CFC rules dealing with foreign base company sales transactions, of which this a classic example; again this would preserve the current allocation of taxing rights between “source” and residence states.

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20 This is one of the difficulties inherent in the MLI approach. Income tax treaties should reflect the bilateral relationship between the countries negotiating the agreement and the MLI will complicate this.
21 This issue does not of course come up in those countries (including the US) which eliminate double taxation through a credit mechanism. Thus, this example is irrelevant for those treaties in which the US is the residence country.
22 See the OECD commentary on Article 23 A and 23 B paragraphs 32.1 et seq.
23 Action Plan page 11 and discussion draft para. 3 page 10.
In the second example, it is not clear why SCO is not also considered to be selling in State S. A more appropriate solution might be to make clear that SCO is both purchasing and selling, that is the buyers are also conducting selling activity in State S, so that the PE is not merely purchasing goods but also considered by the authors to be substantially participating in the sale of those goods.

USCIB agrees with the conclusion of the third example.

We also note that the UN Model treaty includes a specific exemption for purchasing activities.

In most cases, purchasing will make only a minor contribution to the overall profitability of the enterprise. The amount of tax due on these minor contributions will not justify the cost of establishing the structure necessary to create the financial information necessary to comply with PE rules and the annual compliance costs, and may, therefore, cause companies to close purchasing offices. Any abuse cases have simpler solutions. Therefore the exception for purchasing should be retained.

Option H would delete subparagraph d) of paragraph 4 of Article 5. The proposal would delete both the exception for purchasing and the exception for collecting information. The only justification offered for deletion of the collecting information exception is that “concerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for those enterprises.”24 This justification strikes USCIB as particularly weak. Before considering adopting changes that would have a significant impact on taxpayers, the OECD should at a minimum first confirm that the concerns are well-founded.

Valuing raw data will be both difficult and controversial. As USCIB pointed out in our comments on the discussion draft on the Digital Economy:

> The discussion draft provides that data gathered from various sources is a primary input into the process of value creation in the digital economy. (Para. 183) A key challenge is the attribution of value to this data and the extent of value relative to other sources of value – systems, software and people. It may be challenging to assign an objective value to raw data (Para. 183) and determine the ownership of that data. Personal data is generally considered to be owned by the individual to whom it relates, rather than by a company. (Para. 183)

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24 Discussion draft paragraph 28.
USCIB believes that raw data has little or no intrinsic value, especially generally available raw materials such as usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources.25

The amount of raw data is exploding, particularly in connection with the internet of things. If countries take significantly different views on value of data that is collected, then the likely outcome is increased disputes and double taxation.

The “repackaging” of information is the value-adding activity. Repackaging information can mean sifting through enormous quantities of data to identify the important, relevant data. As noted above, USCIB believes that raw data has little or no intrinsic value, especially generally available usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources. The profits created by these activities should be taxed in the jurisdiction in which these activities occur.

We also note that the UN Model includes an exemption for information collection activities. USCIB believes that the exception for collecting information should be retained.

4. Fragmentation of activities between related parties

Options I and J would address fragmentation of activities among associated enterprises, rather than among separate parts of the same enterprise. Most of our objections to these rules apply to both options, since the objections relate to the basic application of the anti-fragmentation rule. Both options would significantly undercut the concept of separate entity reporting. They would also create vastly different results for enterprises dealing with related vs. unrelated parties, undercutting the arm’s length standard, which the Action Plan continues to support. As discussed above in the general comments section of this letter, this would cause companies to reconfigure their operations in ways that might be inefficient and therefore harmful to global trade and investment.

The proposed rule seems to be limited to activities that would otherwise be within the scope of Article 5 paragraph 4 and does not seem to cover other activities that would not create a PE. If, for example, an MNE owns an affiliate that operates a contract manufacturing facility in country A and another affiliate maintains a stock of goods at that manufacturing facility solely for the purpose of processing by that the first affiliate, it would seem under the proposed rules that the second enterprise would now have a PE in country A. If, however, the two entities were

unrelated, no PE would exist. If the contract manufacturer is a low-value activity, this will discourage the MNE from maintaining ownership of that affiliate. The only activity that the second affiliate is engaging in is “maintaining a stock of goods for purposes of processing by another enterprise.” How much gross income should be attributable to that PE? What are the functions, assets and risks that will be analyzed in determining the amount of that profit?

Assuming that the purchasing exception is retained, if a State R enterprise purchases goods through a local purchasing office in State S on behalf of many of the associated enterprises in the affiliated group and any of the goods purchased by the State R enterprise were used by an affiliated enterprise with a PE in State S, State R would have a PE in State S. What profit would be attributed to that PE? Only profit attributable to the goods used in State S? Any profit of the State R enterprises on products purchased in State S? How would the UN force of attraction principle apply? USCIB believes that the proper answer to these questions is that no PE should be created because the tax gained by the local jurisdiction would not justify the burden created.

As another example, if an MNE purchases the output of a manufacturing affiliate, and does not maintain a stock of goods (the affiliate owns its own inventory), but the MNE sends an employee to the manufacturing facility to inspect and perform quality control functions, is the anti-fragmentation rule applicable? As we read the proposed rule, it should not apply because there is no fixed place of business that is maintained solely for the purpose of carrying on an activity of a preparatory or auxiliary character. That is, the MNE would not have a PE because it does not have a fixed place of business to begin with and therefore the exceptions of paragraph 4 cannot apply. If the proposed rule is intended to apply in such a case, then the rule would be unadministrable. Virtually any time an employee of one company visited the offices of another associated enterprise, it would at least create the possibility that a PE would be created.

Finally, USCIB would like to the OECD to consider the facts of the first example in the OECD’s recently released discussion draft on profit splits\(^\text{26}\) in the context of PEs. According to the example, the three OEMS are highly-integrated with a complex web of transactions. If that “web of complex transactions” includes transactions that would violate the proposed anti-fragmentation rule would each of these companies also have a series of PEs in various jurisdictions with accompanying burdens? As we stated above in the general comments, the PE threshold should not be used to fix problems with the transfer pricing rules. If there is a transfer pricing problem in this case, then the appropriate place to fix that problem is under the transfer pricing rules, not by creating additional duplicative PEs that will result in administrative burdens and double taxation.

\(^{26}\) Paragraph 11, page 4, OECD discussion draft on the use of profit-splits in the context of the global value chain.
C. Splitting-up of contracts

The discussion draft proposes two alternative approaches for dealing with the problem of splitting up of contracts to avoid the time thresholds of the "building site or construction or installation project" rule of Art. 5(3) and the alternative service PE provision included in paragraph 42.23 of the Art. 5 Commentary. Option K essentially adopts an "automatic" approach as suggested in paragraph 42.45 of the Art. 5 Commentary. Option L would address this issue through adding an Example in the Commentary to the principal purposes test as proposed in the report on Action 6.

Of the two, USCIB believes that the automatic approach in Option K is preferable, for several reasons.

As noted in USCIB's comments on Action 6, USCIB does not believe that the "one of the principal purposes" test is an appropriate approach to a limitation on benefits rule. Accordingly, USCIB believes that any approach based on the very subjective "one of the principal purposes" test is flawed. The principal purpose test is even more problematic given the weakness of the dispute resolution draft.

In contrast, the "automatic" approach of Option K is precise and administrable. It also reflects accepted OECD guidance, as shown by the fact that the proposal is based on existing paragraph 42.25 of the Art. 5 Commentary. We offer the following additional suggestions for clarification or enhancement of Option K.

The proposed text suggests that all enterprises whose personnel contribute to the aggregation of activities would be regarded as maintaining the building site or services PE. This will create unnecessary reporting complexities. The PE should be of only the main provider, not of all entities whose activities contribute to the aggregation of days of presence. An appropriate rule would be that the enterprise which has the greatest number of days of presence would be the enterprise which is regarded as maintaining the PE. There is no guidance on how this rule would operate in the context of services PEs. If any enterprise which "contributes" days to the total is deemed to have a PE, this rule would be unadministrable in the context of services. In order to implement such a rule, the enterprise which is the main contractor for the project would need to track not only its employees (which is of course reasonable), but also the employees of all associated enterprises (which is not).

The discussion draft acknowledges that in many cases, enterprises may send specialists to work on a project for only a few days, and that in many cases there is no BEPS motivation behind the commercial fact that a contract may require the participation of personnel employed by different related enterprises. For example, many groups organize their service operations through "centers of excellence", in which persons with certain areas of expertise are
predominantly hired and trained by a single group enterprise. In the event that a project requires the deployment of one or more personnel from such an enterprise to support a contract principally being performed by another related enterprise, it is hard to see any circumstance where the use of such personnel could be regarded as having a BEPS purpose.

The two proposed exceptions are different in nature in that one operates mechanically, while the other operates with a subjective requirement. In this context, USCIB believes that it would be appropriate to include both in a revised Option K, on the basis that they address different circumstances.

We note that the subjective alternative includes the same reference to "one of the principal purposes" which we believe is inappropriate for the general limitation on benefits proposal under Article 6. In this case, however, the scope of undesirable uncertainty and capricious application is much more limited, as the subjective test will only come into play if the more objective thresholds of the main rule and the proposed 30 day exception have already been exceeded.

Finally, USCIB suggests that any further Action 7 draft clearly describe this rule as an anti-abuse rule which is a specific and limited departure from the foundational principle of the international tax law that the business activities of separate legal entities will be respected as such. This principle has been expressed in Art. 5(7) of the OECD Model for many years. The PE determination is an entity by entity determination. Under the OECD Model, an enterprise can have a PE based only on its own activities, or in certain precisely defined circumstances, those of its dependent agent. In no other area of the international tax law, as governed by the OECD Model, are activities of separate enterprises aggregated. One of the reasons for USCIB's preference for the "automatic" rule is that such a departure from basic international tax principles should be allowed only if expressly authorized by treaty language. We suggest that any Commentary to be issued under this provision reinforce this point.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)
Comments to the OECD Discussion Draft

“BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS”

October 31, 2014

1. Introduction

Action 7 of the BEPS Action Plan calls for the development of “changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions”.

The OECD Discussion Draft “BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS” outlines the various aspects of the permanent establishment (PE) definition that could give rise to BEPS concerns and identifies the strategies resulting in the artificial avoidance of PE status.

These strategies would be addressed by a number of options for changes to Article 5 of the OECD Model Tax Convention.

Valente Associati GEB Partners (VAGP) welcomes the initiative aimed at tackling any arrangements resulting in the artificial avoidance of PE status. However, VAGP is not entirely persuaded that the recommended amendments have been adequately re-crafted such to attain the envisaged goals of clarity, prevention of abuses along with the assurance that no further, nor unnecessary burdens be created, nor that any unwarranted complexity be entirely avoided. If the foregoing objectives
are not achieved, an unwelcome intensification of legal disputes, uncertainty and subjective tests may be expected. In view of the above, it is VAGP’s opinion that further provisions and clear-cut guidelines are essential in order to create more certainty and reduce any kind of source that might give rise to tax litigation issues between Tax Authorities and taxpayers.

Greater certainty and lesser subjectivity on PE tests would prove most helpful to taxpayers and Tax Authorities alike. VAGP is particularly concerned that the application of the proposed norms might engender an escalating number of PEs, which would, in turn create a trade barrier, negatively impacting thus a level playing field between foreign and local investments. Some aspects which, in today’s tax scene, might further intensify the focus on tax litigations within the context of the taxpayer-Tax Authorities relationship are that on the one side, taxpayers will be suffering the impact of greater uncertainty/increased subjectivity/heavier compliance burdens, on the other side, Tax Authorities are clamping down on tax audits and assessments, challenging the PE test.

Based on the foregoing, streamlined procedures to support businesses and taxpayers are essential, as is any enhancement of present dispute resolution mechanisms currently being applied, in order to reduce to the utmost any potential side effects that might derive from this new framework, and to foster the adoption of objective criteria where possible.

2. Specific Considerations on:

2.1. SECTION A of the Discussion Draft - Commissionaire Arrangements

It is VAGP's belief that the various options put forth in the Discussion Draft do not represent optimal solutions. The above being stated, it appears nonetheless that among the various options set forth, Option B seems the most reasonable as it limits the risk of inconsistent application and avoids the creation of substantial double taxation cases as well as the artificial avoidance of PE status; hence, the above is the option that could grant businesses most certainty on tax matters. Further guidance on Option B should be set forth in the OECD Model Commentary.

It is a known fact that most tax issues deriving from commissionaire arrangements arise from the various legal/tax concepts and treatments applied in common law as opposed to those applied in civil law systems.

Moreover, the Commentary’s guidelines do not clearly identify effective solutions to tackle the dependent versus independent agents issue. We are aware that the PE definition is creating further difficulties to already existing BEPS issues, and that it is important to go beyond simply relying on the legal form whenever analyzing such kind of commercial
arrangements (functional aspects should also be considered). One of the core issues is the assessment of the substance of the arrangement, by focusing on functions, assets and risks assumed; it will allow us to understand whether the commissionaire did or did not have sufficient authority to bind the Principal.

It is also VAGP’s opinion that some further elucidations and examples ought to be provided on the various concepts contained in the Discussion Draft:

1. What does “other similar arrangements” refer to? Some further examples would be useful.
2. What are/should be the required elements to assess an intermediary’s authority to bind the Principal? The Commentary should provide further clarifications (Paragraph 33).
3. The meaning of the phrase “engages with specific persons in a way that results in the conclusion of contracts” should be further specified. Whether it strictly refers to an engagement by the intermediary which ensues in the conclusion of contracts, by the intermediary, that are binding on the foreign company, or whether it is comprehensive enough such to include any engagement (i.e., participating in negotiations without exerting any decision-making power) by an intermediary which, although not sufficiently adequate to produce the conclusion of contracts, does contribute to the contract being concluded by the foreign company. It is our view that the latter engagement which falls short of the “contract conclusion” threshold, should not represent a PE;
4. What effects would derive for PE purposes, where a contract negotiated by an intermediary includes an explicit clause that subjects acceptance of contractual conditions to Principal’s further approval (and in the case where that specific condition is clearly explained and conveyed to the client)? Our opinion is that the foreign enterprise should not be considered as being bound by the contract.
5. What effects would derive for PE purposes, where a foreign company gave specific and detailed instructions to an intermediary – merely playing the role of a “spokesperson” – to negotiate a contract (but in fact has no “authority”)? It is our opinion that such case should not constitute a PE.
6. What effects would derive for PE purposes where a foreign company grants an intermediary a narrow margin of authority for a minor number of contract terms? Such case should not constitute a PE in our opinion.
7. What do the “material elements of the contract” consist in?

It is VAGP’s understanding that the Discussion Draft does not restrict the scope of Article 5 to the conclusion of contracts involving the sale of
goods but goes well beyond it, by including therein the conclusion of leasing contracts or the supply of services. Further clarifications and guidance should also be provided in connection with toll manufacturers engaging in both, purchasing (on a Principal’s behalf) and manufacturing activities. The treatment should be the same for toll manufacturers that strictly engage in manufacturing activities as well as for such manufacturers that also purchase materials for the production of goods.

The expression “contracts which [...] are on the account and risk of the enterprise” included in Section A, paragraph 11, page 13 of the OECD Discussion Draft raises some concern as it may create increased PE risks at commissionaires’ level in source countries as well as for other limited-risk activities, which would by far exceed the intention of the Discussion Draft.

The Discussion Draft further strengthens, moreover, the “independence” requirement, as its suggests removing the possibility for an agent to still be deemed independent, if it exclusively acts on behalf of one party, provided some specific requirements are complied with.

If an enterprise works exclusively or almost exclusively for associated enterprises, automatic denial of independent agent status does not take into consideration the fundamental concept of legal entities’ independence and is not justified, especially if the agent is remunerated at arm’s length, and legal and economic independence may be otherwise substantiated.

2.2. SECTION B of the Discussion Draft - Artificial avoidance of PE status through the specific activity exemptions

The key issue concerns whether such activities referred to under subparagraphs (a) to (d), Paragraph 4, should be regarded as automatic exceptions, or whether they should be subject to the condition that such activities be preparatory or auxiliary. For the purposes of restraining any potential abuse of an enterprise’s fragmentation of functions in the host country (and to limit the tax revenue loss risk) the OECD’s suggestion is to subject those exceptions included under Paragraph 4 of Article 5 to the requirement of being preparatory or auxiliary is acceptable.

Exemption of specific activities has the purpose of providing some certainty on activities that are, as a rule, preparatory and auxiliary and that do not appreciably contribute to an enterprise’s profits.

While Option E under the Discussion Draft would not delete any of the activities from the list, it would subject them all to the provision that they be of a preparatory or auxiliary nature. The said option offers some advantages as well as some disadvantages; for example, an advantage consists in recognizing that all of the items on the list may, under certain
circumstances, be of a preparatory or auxiliary nature, but expands the possibility that such items of the list be challenged.

Option F would delete delivery activities from subparagraphs a) and b) of Paragraph 4, under Article 5. Such option would be surely more suitable where countries are convinced that keeping a fixed business place through which deliveries activities flow cannot be deemed preparatory and auxiliary. For greater clarity and to prevent any further disputes or uncertainty, additional guidance and examples are required.

Option G would remove the preparatory and auxiliary exception in connection with purchasing goods. The purchasing exception should be kept. In most cases the mere purchase of goods is an aspect that is too insignificant for profit earning purposes such to justify the creation of a PE.

Option H would remove subparagraph d) of Paragraph 4, under Article 5. The proposal intends to delete the two exceptions that are respectively related to purchasing and data collection. It is VAGP's opinion that the data collection exception should be kept, given that raw data has in general no or hardly any intrinsic value.

### Fragmentation of Operations

Any abuse of artificially fragmented operations within the context of multinational groups – in order to qualify for the PE status exception related to preparatory and ancillary activities – should be restricted. All the same, any operation that involves valid commercial reasons (i.e., sound business purposes) should not give rise to any challenge, since this would be in conflict with the applicable tax treaty. Once again, more focus should be put on the arrangement’s functions and substance in order to assess whether the multinational group is actually fragmenting operations or not. Both, the current and future state of affairs demands a most careful documentary support to each and every single set of negotiations/operations to substantiate, in due time, intent and rationale of a given arrangement.

Proposals under Options I and J suggest to treat the issue of fragmentation of activities within the context of associated enterprises, rather than within the context of separate parts of the same enterprise. Our objections raised in connection with these rules actually apply to both options, given that the objections involve the basic application of the anti-fragmentation rule. Both options would considerably undermine the concept of separate entity reporting. They would also produce results that would considerably differ for enterprises dealing with related vs. unrelated parties, and which would undermine the arm’s length principle still being endorsed by the BEPS Action Plan. This would lead companies to an inefficient restructuring of their operations which would impact negatively on global investments and trade.
**Splitting-up of contracts**

The Discussion Draft also treats the subject-matter of abuse concerning the exception under Paragraph 3 of Article 5 of the OECD Model. Splitting-up of contracts raises an issue that creates some concern as to the application of service-PEs rules.

The Discussion Draft states that “(...) BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by paragraph 3 of Article 5 could be addressed either by the general anti-abuse (i.e. the “Principal Purposes Test” rule) proposed as a result of the work on Action 6 or by a more “automatic” rule that would take account of any activities performed by associated enterprises”.

In VAGP’s opinion, proposals under the Discussion Draft are not entirely balanced. Monitoring of the “automatic rule” is no simple matter and is, consequently, practically unfeasible. Conversely, the Principle Purpose Test leads to more legal uncertainty, nor should the extension of service PEs be pursued, as the same is impracticable, and would simultaneously add to legal uncertainty.

Reference to a general anti-abuse provision should be examined more in-depth, whereas the opportunity to introduce a special anti-abuse rule on the matter ought to be further explored. The general anti-abuse rule (under page 23, box L) intends to exclusively treat cases in which the splitting-up of contracts is tax-motivated, excluding therewith any instances where there are valid business purposes such to involve associated enterprises in the same project. Albeit, the suggestion is to include a (specific) example in the OECD Commentary, the expected consequence will be that Tax Authorities are most likely to be encouraged to apply the new Principle Purpose Test; this would diminish any certainty remaining in the PE rules even further.

Conversely, the Discussion Draft actually refers to the fact that the “automatic rule” (page 22, box K), which sums up the various activities performed by associated enterprises, may be excessively wide-ranging. As a matter of fact, we believe that it might “catch” cases that are in no way related to tax avoidance.

**2.3. SECTION E of the Discussion Draft - Transfer Pricing Issues**

Coordination is required between the work on PE (Action 7) and the work on Action 4 (“Limit base erosion via interest deductions and other financial payment”), Action 8 (“Intangibles”), Action 9 (“Risks and capital”). For greater clarity and consistency, further elucidations are essential on all aspects involved.
VAGP is concerned about the subjectivity that might arise as a result of the application of the attribution rules, which might continue leading to formulary apportionment approaches “through the back door”, as the only viable means to settle such kinds of disputes.

VAGP is further concerned that, in practical terms, the Discussion Draft might raise the Tax Authorities’ expectations of higher profits to be allocated to PEs.

Nevertheless, whereas it may be stated that there are cases in which the relevant profit allocation to a PE may be greater than such profits that would have been achieved by applying TP rules, in a great many cases, such result would not have been attained. What could be expected, rather, is that there would have been no difference between the profit margin that would have been attributed to a PE and the profit margin that would have been realized by applying TP rules.
AB Volvo’s comments on the Discussion Draft on Action 7: Preventing the Artificial Avoidance of PE Status

About the Volvo Group

The Volvo Group is one of the world’s leading manufacturers of trucks, buses, construction equipment and drive systems for marine and industrial applications. The Group employs about 115 000 people, has production facilities in 18 countries and sale of products in more than 190 markets. The annual net sales amounts to some 300 BSEK. AB Volvo is the ultimate parent of the Volvo Group which consists of more than 300 legal entities.

Comments

Volvo appreciates this opportunity to leave some brief comments on the discussion draft on Article 7. As stated previously, Volvo welcomes the ambition to prevent Base Erosion and Profit Shifting (BEPS) conducted through aggressive tax planning and tax avoidance practices.

One of the key challenges for the OECD is to ensure that the new rules and guidelines are designed to specifically target the kind of practices that are believed to create BEPS without impacting compliant businesses or real business activities. It is particularly important that the new rules do not drive further administration or increases the risk for disputes and double taxation.

Although Volvo understands the rationale behind this action, we are very concerned that several of the principles outlined in the draft will not appropriately meet these objectives. In particular, the current draft does not sufficiently distinguish between BEPS and the allocation of taxing rights between the source state and the residence state. Moreover, we believe that modifying the PE definition by introducing additional subjectivity and unclear PE tests will lead to an unsecure tax environment and increase risk of double taxation, disputes and undue administration.

Overall we support the comments made by BIAC particularly with respect to commissionaire arrangements. There is a strong need for clarification of the conditions under which a commissionaire has the authority to bind the principal and what is meant by similar arrangements. We consider that the proposed options are far too vague and broad and will open to multiple disputes with at the end very little profit attribution to the PE. For MNEs operating with principal transfer pricing models, we are concerned that this ambiguity could be used to arbitrarily argue for the existence of a PE when this is believed to give a more favorable result from a revenue perspective. Where a MNE carries out an activity in a country through a subsidiary, the tax analysis should in our view be founded on the arm’s length principle to secure a proper taxation in the country of the subsidiary. Where the activity is supported by an arm’s length TP-remuneration based on a proper functional analysis, there should in our view be no PE-issue.
As for the specific activity exemptions, we would furthermore like to express support to Business Europe’s comments. In particular we strongly object to option F which proposes to delete the word “delivery”. The purpose of a warehouse is to store products for later delivery. Having a warehouse with no delivery doesn’t make sense. Consequently, deleting the word “delivery” will add confusion. As long as the functions of the warehouse are limited to the storage and the delivery and the entity (if it is an affiliate) operating the warehouse receives an arm’s length remuneration for the service rendered, again this should in our view not constitute a PE.