OSLER

OECD Releases Proposed Changes to Permanent Establishment Rules

MAY 20, 2015 16 MIN READ

Related Expertise

- Tax: M&A, Reorganizations and Restructuring Transactions

On May 15, 2015, as part of its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD released its "Revised Discussion Draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status" [PDF] (the 2015 PE Draft) for comments. If adopted in tax treaties, the proposals in the 2015 PE Draft could significantly increase the range of circumstances in which business enterprises would see their profits become taxable in foreign jurisdictions.

Key changes to the definition of "permanent establishment" (PE) proposed in the 2015 PE Draft include:

- **Negotiation of material terms**: It would no longer be necessary to conclude contracts to give rise to a PE in a country, which could arise under the proposed changes if material terms of a contract are negotiated in the country and the contract is concluded abroad;
- **Standard-form contracts:** Soliciting orders in a country to be filled under standard-form contracts, or obtaining offers in the country to enter into standard-form contracts, can give rise to a PE in the country even if no negotiation or signing of the contract takes place in the country; and
- **Auxiliary/preparatory exemptions**: Certain listed exemptions from PE status would no longer be available to a foreign enterprise depending on how essential the relevant activities are to the business of the foreign enterprise, or depending on potential aggregation with other activities by the same or a "connected" enterprise.

Background

The BEPS Action Plan [PDF], published in July 2013, identifies 15 actions to address BEPS and sets deadlines to implement these actions. Visit our Osler Update of July 19, 2013 on OECD/G20 International Tax Reform for further information. Action 7 of the BEPS Action Plan calls for the development of changes to the PE definition in the OECD model tax convention to prevent the artificial avoidance of PE status in relation to BEPS.

Most tax treaties are in some way developed from the OECD model tax convention, and any changes to the PE definition in tax treaties would have significant impact on when countries can tax foreign businesses and investors. The domestic laws of most countries impose a fairly low threshold for taxing business profits of foreign enterprises, but if there is a tax treaty between the country where an enterprise is resident (the Residence State) and another country where that enterprise is doing business (the Source State), the Source State will generally only be permitted to tax the business profits of the enterprise if they are attributable to a PE of the enterprise in the Source State. Under Article 5 of the OECD model tax convention, on which the PE provision of Canada's tax treaties is based, an enterprise can

have a PE in a Source State only if it has a fixed place of business (Fixed Place PE) therein or if there is an employee or agent therein who acts on behalf of the enterprise and has, and habitually exercises, in the Source State, authority to conclude contracts in the name of the enterprise (Agency PE). Both the Fixed Place PE and Agency PE are subject to a general exemption for certain activities that could be described as being of a preparatory or auxiliary nature (the Specific Activity Exemptions). These rules, which have not changed since the 1963 version of the OECD model tax convention, generally impose a higher threshold than domestic rules for taxing the business profits of foreign enterprises.

The OECD has expressed concern that the PE definition has not kept pace with developments in the ways in which business is conducted cross-border. Advances in technology, in particular, have made it possible for considerable volumes of trade to be conducted with and in a country without giving rise to a PE. In October 2014, the OECD released an earlier discussion draft on Action 7 (the 2014 PE Draft), which addressed the following sources of BEPS concerns relating to the current PE definition:

- artificial avoidance of PE status through *commissionaire* arrangements and similar strategies
- artificial avoidance of PE status through the Specific Activity Exemptions
- splitting-up of contracts
- insurance
- profit attribution to PEs and interaction with action points on transfer pricing

For each of these topics (other than profit attribution), the 2014 PE Draft proposed multiple alternative options for changes to the OECD model tax convention and related commentaries (the OECD Commentaries). Following the review of stakeholder comments on the 2014 PE Draft, a public consultation meeting in January 2015 and internal discussion of the public input, the OECD has in the 2015 PE Draft selected its preferred option for addressing each of the first four issues listed above.

The proposed changes have the potential to significantly erode the perceived “PE protection” offered by tax treaties.

The 2015 PE Draft

Changes to Agency PE Rule

The proposed changes to the Agency PE Rule are far-reaching and would expand the range of circumstances in which a PE arises from a person acting in a Source State on behalf of a Residence State enterprise. Also, in many cases the proposed changes may lead to significant uncertainty regarding whether a PE has been established – which could significantly increase tax administration burdens and tax disputes.

The existing Agency PE rule has two components, the main rule and an exception:

- *Main Agency PE rule (Article 5(5) of OECD model tax convention)*: Where a person – other than an independent agent described in the next paragraph – acts on behalf of an enterprise and has, and habitually exercises, in a Source State authority to conclude contracts in the name of the enterprise, that enterprise is deemed to have a PE in that State (unless the activities of the person are within the Specific Activity Exemptions).

- *Independent Agent Exception (Article 5(6) of OECD model tax convention)*: An enterprise will not be deemed to have a PE in a Source 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 2015 PE Draft proposes to make changes to both the Agency PE rule in Article 5(5) and the independent agent exception in Article 5(6). The changes to the Agency PE rule in Article 5(5) were motivated in the first instance by the perceived avoidance of PE status by use of *commissionaire* arrangements – that is, arrangements created in some civil law jurisdictions whereby a person sells products in a Source State in its own name but on behalf of a foreign enterprise that is the owner of the products. The 2015 PE Draft proposes the following changes to Article 5(5):

- In addition to the habitual conclusion of contracts in a Source State, the habitual "negotiat[ion] of the material elements" of contracts in the Source State would be an activity that could give rise to an Agency PE.

- It would no longer be necessary for the person whose activities in the Source State create an Agency PE (a Dependent Agent) to have authority to conclude contracts; the focus of the revised rule is more on conduct than legal authority.A person who is not authorized to conclude contracts (or negotiate their material elements) on behalf of an enterprise could give rise to an Agency PE if the person does so habitually.

- The contracts concluded or negotiated by the Dependent Agent in the Source State need not be "in the name of" the foreign enterprise; under the proposed changes, an Agency PE could also arise if the contracts in question are for the provision of services by that enterprise or for the transfer of ownership or grant of the right to use property over which the enterprise has ownership or use rights.

The last change would ensure that typical commissionaire arrangements, or contracts where the name of the principal is simply not disclosed by the agent, would not avoid PE status for the foreign enterprise whose goods are being sold by the commissionaire or agent. The first and second changes to the Agency PE rule could have a much wider impact, as they could potentially affect all those multinational and other enterprises that use employees or other agents to solicit business and negotiate key terms of contracts (or obtain orders for goods or services to be delivered under standard form contracts, whose terms are not negotiable) in a Source State. Often such arrangements prohibit the employee or agent from concluding contracts in the Source State and require that terms be approved and contracts signed outside the Source State.

The 2015 PE Draft contains proposed changes to the OECD Commentaries that seek to clarify what it means to "conclude" and "negotiate the material elements of" a contract in a Source State. Concluding a contract can occur in a Source State even if the contract is signed elsewhere. For example, if a person acting on behalf of an enterprise in a Source State accepts an offer to enter into a contract but the actual signing of the contract by the

enterprise occurs later, in the Residence State, the contract would be "concluded" in the Source State. The "material elements of a contract" would generally include price, nature and quantity of the goods or services to which the contract applies. Somewhat surprisingly, the 2015 PE Draft expresses the view that negotiating material elements of a contract does not require any actual negotiation, but rather is meant generally to refer to activities that regularly result in the conclusion of contracts. For example, a person that solicits business and accepts orders in the Source State that are routinely approved by the enterprise in the Residence State would be considered to have negotiated the material elements of the contract even if that person did no bargaining over terms.

The proposed changes to the Agency PE rule would mean that Article 5 and the legal concept of agency would no longer be conjoined. That is, a person acting in a Source State on behalf of a foreign enterprise could cause the enterprise to have a PE under Article 5(5) even if the person lacks the authority to legally bind the foreign enterprise.

In addition to broadening the scope of the main Agency PE rule in Article 5(5), the 2015 PE Draft proposes to add greater precision to the wording of the independent agent exception in Article 5(6). The 2015 PE Draft would rephrase the conditions for the independent agent exception to apply:

- the person acting in the Source State on behalf of the foreign enterprise must carry on business in that state as an independent agent (the reference to brokers and commission agents is removed),
- the person must be acting for the foreign enterprise in the ordinary course of that business, and
- the person cannot act exclusively or almost exclusively on behalf of one or more enterprises to which it is "connected."

Enterprises will be considered to be "connected" if they satisfy either a bright-line 50 percent ownership test or a factual control test.

Changes to Specific Activity Exemptions

The 2015 PE Draft also addresses "artificial avoidance of the PE status through the specific activity exemptions." The Specific Activity Exemptions are listed in Article 5(4) of the OECD model tax convention, according to which a PE (Fixed Place PE or Agency PE) is deemed not to include:

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- 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 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;
- 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

The OECD has expressed concern that the Specific Activity Exemptions were being used by multinational enterprises to conduct a very high volume of trade in a country without becoming taxable therein.

The 2015 PE Draft recommends restricting each of the exceptions included in Article 5(4) to activities that are otherwise of a "preparatory or auxiliary" character. However, in order to address the concern about the uncertainty of the phrase "preparatory or auxiliary," the 2015 PE Draft proposes to amend the OECD Commentaries on Article 5(4) to provide more guidance and examples with regards to the meaning of that phrase. Under the proposed revisions, an activity would be considered preparatory if it is carried on in contemplation of the carrying on of the essential and significant part of the activity of the enterprise as a whole. An activity would be considered "auxiliary" if it is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. In this regard, the revised Commentaries say that an activity that requires a significant proportion of the assets or employees of the enterprise would be unlikely to be considered as having an auxiliary character.

The proposed revisions to the OECD Commentaries provide examples that are intended to clarify the scope of the existing exemptions in light of the overarching limitation of the "preparatory and auxiliary" character of the particular activity. One notable example is of a very large warehouse maintained at a Source State by an enterprise, which has many employees at the warehouse from which a large volume of orders for sale of the enterprise's goods to Source State customers are filled. The activities at the warehouse do not have a preparatory or auxiliary character because they constitute an essential part of the enterprise's sale and distribution business.

In addition to subjecting each of the Specific Activity Exemptions to an overriding "preparatory or auxiliary" requirement, the 2015 PE Draft also proposes to amend the Specific Activity Exemptions to address what the OECD considers to be the artificial fragmentation of activities so as to avoid PE status.

The 2015 PE Draft addresses fragmentation concerns by proposing to add new Article 5(4.1), which essentially prevents an enterprise from relying on the Specific Activity Exemptions where the same enterprise carries on activities in two places or two connected enterprises carry on business through the same place, and these activities constitute complementary functions that are part of a cohesive business operation. For new paragraph 4.1 to apply, at least one of the places where these activities are exercised would have to constitute a PE or, if that is not the case, the overall activity resulting from the combination of the relevant activities would have to go beyond what is merely preparatory or auxiliary.

Where one or more of the Specific Activity Exemptions are being relied on, it will become necessary to take into account the new anti-fragmentation rule in Article 5(4.1), since if a foreign enterprise has a fixed place of business that is only used for preparatory or auxiliary activities, that place of business could become a PE if the foreign enterprise (or a connected

enterprise, including potentially a Source State subsidiary) has one or more other places of business in the Source State at which the activities are more than merely preparatory or auxiliary.

Splitting-up of contracts

The OECD model tax convention includes an exception in Article 5(3) whereby a building site, construction or installation project will only be found to constitute a PE if it lasts for more than twelve months. The OECD is concerned that this exception is subject to abuse by enterprises that divide their contracts such that different enterprises owned by the same group each work for less than a twelve month period even though the collective duration for the group would have otherwise exceeded twelve months and constituted a PE.

The 2015 PE Draft opts to deal with the splitting-up of contracts outside Article 5, through the application of the “principal purpose test” (PPT) that is proposed as part of Action 6 (prevent treaty abuse) of the BEPS action plan. In general, the PPT denies treaty benefits when it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to secure a benefit under a tax treaty – unless it is established that obtaining such benefit would be in accordance with the object and purpose of the relevant treaty provision(s). The 2015 PE Draft proposes to address splitting-up of contracts by including an additional example to the OECD Commentaries that illustrates the application of the PPT to Article 5(3).

Insurance

The 2014 PE Draft contained proposals aimed at situations where a foreign insurance company conducts large-scale business operations in a Source State through a network of generally exclusive agents who sell insurance for the foreign insurer but do not formally conclude insurance contracts in that State and thus do not create an Agency PE under current Article 5(5) of the OECD model tax convention. In Canada, for instance, in each of two court cases decided in 2008 the government failed to establish that a large network of Canadian sales agents working generally for a single U.S. life insurer gave rise to Agency PEs for the insurer.

The 2015 PE Draft announces the decision to not adopt any proposals specifically targeting insurance businesses, but to rely instead on the more general changes proposed by the 2015 PE Draft to the Agency PE in Articles 5(5) and 5(6) of the OECD model tax convention.

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

The 2015 PE Draft acknowledges that additional work will be required to provide guidance on the application of existing PE profit attribution principles. Follow-up work will be carried on after September 2015 with a view to providing the necessary guidelines before the end of 2016 (to coincide with the proposed timing for a new multi-lateral instrument that could rapidly amend tax treaties without the need for separate bilateral negotiations).

Conclusion

If implemented, the 2015 PE Draft proposed changes to the PE definition have the potential to reapportion taxing rights over cross-border income between Residence States and Source States with respect to certain commonly-used arrangements in international commerce and

multinational groups. Although presented as measures to prevent the “artificial avoidance” of PE status within the context of an overall initiative aimed at curbing base erosion (and profit shifting), some of the most far-reaching proposals in the 2015 PE Draft can be considered as simply being an expansion of the tax base of Source States relative to how it had been defined in tax treaties for decades. Taxpayers should carefully review affected arrangements and structures that are intended not to result in a PE under the current rules. Taxpayers and tax authorities alike will need to consider how to deal with an increase in the number of PEs, in some cases potentially with little or no additional revenue to the Source State, but increased administrative and compliance burden.

While the proposed changes to the PE definition are of great importance to cross-border business, their impact on tax liability in Source States will not be immediate. At this point, these are draft proposals by a working party within the OECD to amend the OECD model tax convention and the related commentaries. Public comments are invited to be sent by June 12, 2015. Later that month, the working party is scheduled to finalize the changes to the OECD model tax convention that will be proposed as the result of the work on BEPS Action 7. Even if the OECD model tax convention is amended as thus finally proposed, the amendments would have to be adopted in an in-force bilateral tax treaty in order to be binding on specific countries, and that process could take considerable additional time, with some countries potentially not welcoming a lowered PE threshold. This timing could potentially be affected by the OECD’s work on developing a multi-lateral instrument to amend bilateral tax treaties more rapidly.

For further information on the BEPS Action Plan and Canada’s international tax regime, please contact any member of our Tax Group.