Preventing Artificial Avoidance of PE - An Insight to BEPS Action Plan 7

Organisation for Economic Co-operation and Development (OECD) and the G20 countries adopted a 15-point action plan to address base erosion and profit shifting (BEPS) in a comprehensive manner. One of the 15-point action plans deals with "Preventing the artificial avoidance of permanent establishment status". This article discusses the significant amendments proposed to be brought out in Article 5 of the OECD Model Tax Convention which intend to prevent artificial avoidance of PE status in relation to BEPS. Read on…

1. Background

The OECD Focus Group initially released a discussion draft on BEPS Action 7[1] on 31st October 2014 and subsequently, a revised discussion draft on 15th May 2015 that proposed changes to the definition of Permanent Establishment (PE) under Article 5 of the OECD Model Tax Convention ('Convention').

OECD, in its Final Report on Action Plan 7 (hereafter referred to as 'Report'), recommends changes to the definition of permanent establishment (PE) and the associated Commentary. This Report includes changes that will be made to the definition of PE in Article 5 of the Convention, *inter alia*, to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition.

The ambiguity in relation to a PE being formed or perceived avoidance of PE has revolved mostly around the following important aspects:

- The extent to which Article 5(5) may apply where contracts are substantially negotiated in a State but are finalised or authorised abroad.

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[1] 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 exception of Article 5(6) for 'independent agents' and its applicability in case of closely related enterprises.
- The exception as stated in Article 5(4) with respect to the applicability of preparatory and auxiliary services and clarification regarding its meaning.
- Fragmentation of activities of a cohesive business operation between related parties classifying the same as preparatory or auxiliary in order to avoid PE.
- Splitting of contracts in order to circumvent formation of PE in terms of provisions of Article 5(3).

The BEPS Action 7 intends to acknowledge these concerns as well as provide guidance to address such issues by bringing out amendments in Article 5 as well as explaining the same by way of changes in the Commentary. Work on these issues will also address related profit attribution issues.

2. Dependent Agency PE- Amendments in Article 5(5)

Under the current Article 5(5) of the Convention, a person other than an agent of independent status, acting on behalf of a foreign enterprise having 'authority to conclude contract in the name of the enterprise' forms a PE of the foreign enterprise. The PE shall be determined in respect of activities undertaken by the enterprise, unless the activities can be limited to activities mentioned in Paragraph 4 of the Article.

OECD, in its Report, proposes to change Paragraph 5 of Article 5. It states that dependent agent PE shall exists where a person on behalf of an enterprise habitually concludes a contract or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

The pivotal aspects which are recommended in the Report, to change the Commentary on Article 5, are being briefly discussed in the ensuing paragraphs:

- The phrase 'concludes contracts' focuses on situations where a contract is legally concluded. A contract may be concluded in a State even if the same is signed outside that State. In addition, a person who negotiates in a State all elements and details of a contract in a way binding on the enterprise can be said to conclude the contract in that State even if that contract is signed by another person outside that State.
- The phrase "or habitually plays the principal role leading to the conclusion of contracts" is aimed at situations where the conclusion of a contract directly results from the actions that the person performs in a Contracting State on behalf of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State. The said expression will typically be associated with the actions of the persons who convince the third party to enter into contract with the foreign enterprise.
- The phrase does not apply, however, where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts.
- Paragraph 5 shall also apply to contracts that create obligations that will effectively be performed by such enterprise rather than by the person contractually obliged to do so.
- The presence which an enterprise maintains should be more than merely transitory if the enterprise is to be regarded as maintaining PE in the source State. The extent and frequency of the activities required to be carried out would depend upon the nature of contracts and the business as well. However, it is not possible to lay any precise frequency test for determination of PE.
- Where the requirements set out in Article 5(5) are met, a PE of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts.
- The provisions of Article 5(5) are not intended to apply to arrangements where a person concludes contracts on its own behalf and in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises. The entire profits arising from such contracts shall not be attributed to the PE. The determination of the profits, in cases where a PE, is formed shall be governed by Article 7.
- In many cases 'commissionnaire arrangements' and similar strategies were put in place primarily in order to erode the taxable base of the State where sales took place. Accordingly, a typical case covered by Article 5(5) and 5(6) would be the contracts that a "commissionnaire" would conclude with third

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parties under a 'commissionnaire arrangement' with a foreign enterprise pursuant to which that commissionnaire would act on behalf of the enterprise but in doing so, would conclude in its own name contracts that do not create rights and obligations that are legally enforceable between the foreign enterprise and the third parties even though the results of the arrangement between the commissionnaire and the foreign enterprise would be such that the foreign enterprise would directly transfer to these third parties the ownership or use of property that it owns or has the right to use.

3. Independent Agent PE- Amendments in Article 5(6)

The existing Article 5(6) of the Model Convention specifies that an enterprise shall not be deemed to have a PE merely because it carries business in the Contracting State through a broker, general commission agent or any other agent of an independent status, provided such persons act in the ordinary course of their business.

The amendments to Paragraph 6 of Article 5 acclaims that where a person acts *exclusively or almost exclusively* on behalf of one or more enterprise to which it is closely related, the person shall not be deemed to be an independent agent. The pivotal aspects which are recommended in the Report with respect to Article 5(6) to change the Commentary on Article 5 are being mentioned below:

- Article 6(a) would limit the scope of independent agent exception if a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related.
- The exception of Paragraph 6 would not apply where a person acts on behalf of an enterprise in a different capacity, such as where an employee acts on behalf of his employer.
- Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.
- Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise.
- Article 5(6) will not automatically apply where a person acts for one or more enterprise to which that person is not closely related. For Article 5(6) to apply, a person must carry on business as an independent agent and be acting in the ordinary course of that business.
- Independent status is less likely if the activities of the person are performed almost wholly on behalf of only one enterprise/group over a long period of time. All facts and circumstances would have to be taken into consideration to determine whether the activities of the agent can be considered as an independent agent or otherwise.
- The concept of 'closely related' needs to be distinguished from the concept of 'associated enterprises' as used in Article 9. It is stated that although the two concepts overlap to a certain extent, they are not intended to be equivalent.
- In terms of the second limb of sub Paragraph (b) of Article 6, a person is considered to be closely related to an enterprise if either one possesses directly or indirectly more than 50 per cent of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50 per cent of the beneficial interests in both the person and the enterprise. In the case of a company, this condition is satisfied where a person holds directly or indirectly more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company.
- In respect of a subsidiary and a parent company, the Report recommends altering the Commentary to clarify that the fact the enterprise and its subsidiary are closely related does not affect the operation of Article 5(7). It implies that Article 5(5) and 5(6) shall still apply to a holding subsidiary relationship to determine whether the activities of the subsidiary on behalf of the holding gives rise to a PE.

4. Specific Activity Exemption-Amendments to Article 5(4)

The current OECD Model includes specific activity exemptions from the PE definition. While the

activities listed in sub Paragraphs a) to d) were exempted from being classified as PE even if the activities were carried on at a fixed place and the same did not confirm the preparatory or auxiliary condition.

The Report suggests modification to Article 5(4) of the Convention so that each of the exceptions included in that provision is restricted to activities that are otherwise of a preparatory or auxiliary character.

The pivotal aspects, which are recommended in the Report to replace the existing Commentary on Article 5(4), are being discussed in the ensuing paragraphs of this section.

- Paragraph 4 lists a number of business activities which are treated as exceptions to the general definition laid down in Paragraph 1 and which when carried on through fixed places of business, are not sufficient for these places to constitute PE. These exceptions only apply if the listed activities have a preparatory or auxiliary character. Similar restriction applies to sub-Paragraph (e) which considers any activity that is not otherwise listed in the paragraph and sub-Paragraph (f) which considers combinations of activities mentioned in sub-Paragraphs (a) to (e).
- The preparatory or auxiliary activities must be viewed in light of other activities that constitute complementary functions that are a part of the cohesive business which the enterprise or the closely related enterprise carries on in the same State.
- A fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.
- An activity of preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. Similarly, an activity is classified to be of auxiliary character if it generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole.
- It is stated that PE would be formed if activities a) to e) are performed on behalf of other enterprises and not for the enterprise itself.
- Whether the activity carried on at a place of business (as mentioned in Para 4) has a preparatory or auxiliary character will have to be determined in the light of factors that include the overall business activity of the enterprise.
- Where a fixed place of business is used by an enterprise both for activities that are listed as exceptions of (Paragraph 4) and for other activities that go beyond what is preparatory or auxiliary, that place of business constitutes a single PE of the enterprise and the profits attributable to the PE with respect to as regards both types of activities may be taxed in the State where that PE is situated. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

In order to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity, Paragraph 4.1 to Article 5, in the form of anti-fragmentation rule, has been introduced in the Convention.

It is suggested that for the anti-fragmentation rule to apply, at least one of the places where the activities are carried out must constitute a PE *or* the overall activity resulting from the combination of activity goes beyond preparatory or auxiliary activity.

5. Splitting up of Contracts -Amendments to Article 5(3)

The existing Article 5(3) provides that a building site or construction or installation project constitutes a PE only if it lasts for more than 12 months. It may be noted that the Report on Action Plan 7 does not suggest any change in the existing Article 5(3). The practice of splitting up the contracts amongst the related parties in order to circumvent the threshold

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period (generally 12 months) has given rise to abuses. In order to address the concerns related to abusive splitting up of contracts, the Principle Purposes Test (PPT) rule shall be added to the Convention as a result of adoption of the Action Plan 6 (Preventing the Granting of Treaty benefits in inappropriate circumstances). In order to make this clear, certain examples have been added to the Commentary on the PPT rule.

The Report by way of amendment in the Commentary states that these abuses could also be addressed through the application of the anti-abuse rule in the Convention. Some States may nevertheless deal expressly with such abuses through domestic legislation.

Further, the determination of whether the specific activities are connected will depend upon the facts and circumstances of each case. Factors that may especially be relevant for that purpose include: a) whether the contracts are concluded with same or related persons? b) whether conclusion of additional contracts is a logical consequence of the previous contract? c) whether the activities would have been covered by a single contract absent tax planning considerations? d) whether the nature of work involved is same or different? e) whether same employees are performing the activities under different contracts?

6. Parting Thoughts

The commissionaire structures, fragmentation of activities, splitting up of contracts and similar other arrangements intended to circumvent PE, have generally elicited to erode the tax base of the Source State. This situation, more particularly, leads to abuse of treaty provisions and thereby shifting the profits from high-tax jurisdiction to low-tax jurisdiction. Existence of perennial problems and associated risks, in terms of interpretation of the expressions as provided in existing Article 5, requires a policy re-evaluation of the existing PE definition to address such strategies. The BEPS Action Plan 7 intends to modify the definition of PE as specified in Article 5 of the Model Convention to address such issues. Overall, the BEPS Report on Action Plan 7 is a welcome step, yet the success would entirely depend upon its implementation. The implementation is foreseen to have many challenges, some of which are illustrated as under:

- **Amendment in Treaties-** The changes discussed above would almost amount to complete overhaul the current PE concept as prevalent in the existing treaties. The implementation of the amendments suggested in the Report would need to be carried out via changes in the domestic laws and practices and also via amendment in the existing treaty provisions. Since there are over 3,000 treaties worldwide, making individual negotiation would be immensely time consuming, impracticable and a burdensome process. This is intended to be met through a multilateral instrument which would help in streamlining the implementation of the suggested amendments in the tax treaties. Unanimity of opinion amongst the countries discussing the multilateral instrument may also be a foreseeable challenge.
- **Expanded Scope-** The paradigm shift from 'concludes contracts' to 'principal role leading to conclusion of contracts' is a highly subjective matter prone to litigation. There are numerous activities which are routinely carried out by a person on behalf of an enterprise in view of certain contractual obligations. The risk of inadvertently creating a number of PEs would be further compounded by greater element of subjectivity in the proposed amendments. Further, since the scope of 'principal role' has not been defined, even routine and allied activities may be alleged as PE by the Revenue authorities.
- **Profit Attribution-** The idea of holding existence of PE is to attribute profits to the said PE which would be taxable in that jurisdiction. Once a PE is triggered, the next issue is how profits attributable to such PE are to be calculated. The changes as recommended in the Report do not provide guidance on the inevitable issue of profit attribution. The Report states that follow-up work on the attribution of profits will be carried out after September 2015 with a view of providing guidance before the end of 2016.
- **Increased Litigation-** The amendments to the definition of PE as proposed in the Action Plan 7 may be subject to varied interpretations. Different tax authorities may reach to different conclusions on whether a PE has been created. Besides, the risk of prolonged litigation on account of creation of more PEs in case of low-value, routine and low-risk activities cannot be ignored. ■