The OECD Discussion Draft on BEPS Action 7 : A Critical Analysis

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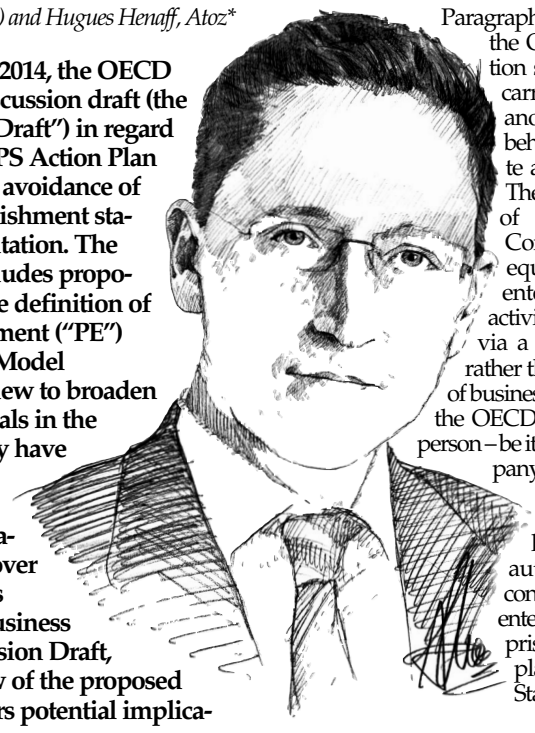

On 31 October 2014, the OECD released a discussion draft (the "Discussion Draft") in regard to Action 7 of the BEPS Action Plan (Prevent the artificial avoidance of the permanent establishment status) for public consultation. The Discussion Draft includes proposals for changes to the definition of permanent establishment ("PE") found in the OECD Model Convention with a view to broaden its scope. The proposals in the Discussion Draft may have a major impact on global business models and the allocation of taxing rights over business profits. This article outlines the business context of the Discussion Draft, provides an overview of the proposed changes and considers potential implications for Luxembourg.

I. Introduction

During the last two decades, Multinational Enterprises ("MNEs") have tended to change their business model from the "traditional business model" to the so-called "supply chain management" business model. While under the traditional business model MNEs gave each entity within the group key entrepreneurial risk taking functions ("KERT functions")[1], supply chain management structures are characterized by a centralization of business activities. Here, a company within the MNE group, acting as a principal, assumes and manages most of the business risks.

Conversely, the operating companies at the manufacturing and sales level perform reduced functions and bear limited business risks.[2] From a transfer pricing perspective, the functional and risk profile of the entities within the group result in a basic return for the operating companies, whereas the real entrepreneur (that is the principal company which is typically established in a low tax or a tax-efficient jurisdiction) is entitled to the residual profit.[3] Under the current PE definition in the OECD Model Convention, the principal company is generally not considered to have a PE in the jurisdiction in which the operating companies are established.

The main purpose of the PE concept under the Convention is to determine the right of a Contracting State to tax the profits of an enterprise which is resident in the other Contracting State. This is because according to Article 7 OECD Model Convention, a Contracting State cannot tax business profits of enterprises resident in the other Contracting State unless it carries on its business through a PE located therein.[4] Thus, the concept of PE is of major importance for the allocation of taxing rights over business profits realized by enterprises in a cross-border context. In light of the above, the BEPS (Base Erosion and Profit Shifting) Action Plan calls for developing changes to the concept of PE as defined in Article 5 of the OECD Model Convention in order to prevent perceived abuses of that threshold.

Whether or not a PE is found to exist is probably one of the most frequent tax treaty issues. Nevertheless, despite the long history of the PE concept, its practical application raises a number of issues. Therefore, the OECD released on 12 October 2011 a discussion draft on the "interpretation and application of Article 5 of the OECD Model Convention" (the "2011 Discussion Draft"). The 2011 Discussion Draft considered additional guidance to be included in the Commentary to the OECD Model Convention. However, given that some of the aspects addressed in the 2011 Discussion Draft are reconsidered as part of the work on Action 7 of the BEPS Action Plan, no additional guidance regarding the interpretation of the PE concept has been included in the 2014 Update to the OECD Model Convention.

II. Proposed amendments to the PE definition

The Discussion Draft provides for a number of options for changes in regard to the following aspects of the PE definition found in Article 5 of the OECD Model Convention:

1. Commissionaire arrangements

Under commissionaire arrangements[5], the distribution entity (that is the commissionaire) concludes sales contracts with the final customers in its own name, but relies on the commissionaire agreement with the principal entity to fulfill its obligations towards the final customer.[6] Although the principal remains generally undisclosed, the commissionaire does not, at any stage, take legal title to the inventory. Instead, goods are delivered directly from the principal entity to the customer. Therefore, the principal entity may, for practical reasons, need to maintain a stock of goods in the State where the commissionaire is located.

Paragraphs 5 and 6 of Article 5 of the OECD Model Convention specify when activities carried on by an agent or another person acting on behalf of an enterprise create a PE of that enterprise. The objective of Article 5 (5) of the OECD Model Convention is to ensure equal tax treatment of enterprises that perform activities in the source state via a separate legal person rather than an own fixed place of business. Under Article 5 (5) of the OECD Model Convention, a person – be it an individual or a company – is deemed to create a PE of the enterprise if that person has and habitually exercises authority "to conclude contracts in the name of the enterprise" even if the enterprise may not have a fixed place of business in that State.[7]

In contrast, where an enterprise carries on business in the other Contracting State through an "independent" agent (for example, a broker or general commission agent), it is not deemed to have a PE in that State provided that the agent is acting in the ordinary course of his business as an independent agent (Article 5 (6) of the OECD Model).[8] In light of these differences, MNEs have frequently restructured their business model from fully-fledged distributors to commissionaire structures that do not amount to a PE of the principal.

In recent years, several European courts had to decide whether a commissionaire arrangement constitutes a PE of the principal. The French Supreme Administrative Court (in the Zimmer Case[9]) and the Norwegian Supreme Court (in the Dell Case[10]) followed the legal relationships established by the statute and the applicable commercial agreements, pursuant to which customers entered into contracts which were enforceable against, and binding on, the commissionaire only; not the principal. As the contracts were "in the name of" the commissionaire, not the principal, the sales entities did not have and did not habitually exercise the authority to conclude contracts "in the name of" the principal for purposes of an Article 5 (5) OECD Model (deemed) dependent agent PE. In contrast, the Spanish Supreme Court decided in the Roche Case[11] that the commissionaire creates a PE of the non-resident principal in Spain. It should, however, be noted that the Spanish Supreme Court went far beyond the legal aspects in its argumentation and reasoning, taking a broad and economically-driven approach. It follows that the answer to the question as to whether a commissionaire arrangement creates a PE of the principal may vary between legal and economic views.

The Focus Group on the Artificial Avoidance of PE Status considers 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. The position of the Focus Group is that when an intermediary exercises activities in a country which 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. In this regard, the Discussion Draft proposes four alternative options that would amend the wording of Paragraph 5 and 6 of Article 5 of the OECD Model Convention in a way that commissionaires would constitute an agency PE of their foreign principals.

The language used in the four alternative options will not, however, put an end to global supply chain management. Instead, in the same way as business models evolved in light of the existing wording of the OECD Model Convention, they will continue to evolve if the PE definition is amended. Nevertheless, the language will add a new layer of complexity in the practical application of the PE concept and potentially entail that other business models will become more attractive in terms of the overall tax burden and legal certainty.

2. Specific activity exemptions according to Article 5 (4) of the OECD Model Convention

Article 5 (4) of the OECD Model Convention contains exceptions to the general rule provided under Article 5 (1) of the OECD Model Convention, listing a number of activities of preparatory or auxiliary nature which may be carried out through a fixed place of business but which nevertheless do not create a PE. Even if the conditions of Article 5 (1) of the OECD Model Convention are met and the activity is carried on through a fixed place of business, no PE is constituted.[12] The activities listed in Article 5 (4) of the OECD Model Convention share the common characteristic that the services performed are so remote from the actual realization of profits that it is difficult to allocate any profit to them. Therefore, Article 5 (4) of the OECD Model Convention is designed to prevent an enterprise of a Contracting State from being taxed in the other Contracting State.

The Discussion Draft provides for six alternative options with changes to Article 5 (4) of the OECD Model Convention that aim at limiting the scope of the specific activity exemptions. The options considered range from expressly stating that all activities listed in Article 5 (4) of the OECD Model Convention need to be of preparatory or auxiliary nature to more targeted changes that would eliminate specific activities from the PE exemption. 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. It is interesting to note that the 2011 Discussion Draft expressed a consensus that the wording of Article 5 (4) a) to d) of the OECD Model does not support the view that the application of these subparagraphs was subject to the additional condition that the relevant activity was of a "preparatory or auxiliary nature".[13]

Moreover, two options consider denying the application of the exceptions of Article 5 (4) of the OECD Model Convention where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or by associated enterprises at different locations. Such provision would clearly increase uncertainty and cause significant complexity in regard to the attribution of profits to such a PE.

3. Splitting up of contracts

According to Article 5 (3) of the OECD Model Convention building sites, constructions and installation projects constitute a PE provided that they last more than twelve months. Once the twelve month period is exceeded, a PE is deemed to exist (from the first day of activity) even if the general conditions laid down in Article 5 (1) of the OECD Model Convention are not met.

The twelve-month test applies separately to each individual site or project; time spent on totally unconnected activities is, therefore, disregarded. However, a series of contracts or projects by a contractor that are interdependent both commercially and geographically are to be treated as a single project for the purposes of applying the twelve-month threshold test.[14] According to paragraph 18 of the Commentary on Article 5 of the OECD Model Convention, the twelve-month threshold has given rise to abuses and it has sometimes been found that enterprises divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company of the same group.

In order to address the potential circumvention of the restrictions imposed by Article 5 (3) of the OECD Model Convention, the Discussion Draft considers two alternative options. The first option is an "automatic" rule to be included in Article 5 of the OECD Model Convention according to which periods of time spend by associated enterprises at a place that constitutes a building site or construction or installation project shall be added for the (sole) purpose of the twelve-month test. This option is fairly similar to an alternative that can already be found in paragraph 42.45 of the Commentary on Article 5 of the OECD Model Convention and which may be included by Contracting States in their bilateral tax treaties. The second option would rely on the Principal Purposes Test (a general anti-abuse rule proposed in regard to BEPS Action 6 relating to Preventing Treaty Abuse) through the addition of an example in the Commentary. This alternative would only address cases where the splitting-up of contracts is tax-motivated and exclude situations where there are legitimate business purposes for the involvement of associated enterprises in the same project.

4. Insurance

Insurance companies operating in a cross-border context may be taxed in another State if they either have a fixed place of business within the meaning of Article 5 (1) of the OECD Model or if they carry on business through a dependent agent[15] in that State. In some cases, however, the agencies of foreign insurance companies do not meet any of the aforementioned requirements. Thus, profits arising from such business may not be taxed in the other State.[16] In this regard, the Discussion Draft provides for an option that would deal with the situation of dependent agents who sell insurance for a foreign insurer but do not formally conclude insurance contracts.[17] Alternatively, it is considered to rely on the changes proposed to Article 5 (5) and (6) of the OECD Model Convention in regard to agency PEs. Notably, this aspect has already been considered in the 2011 Discussion Draft where the working group agreed that no changes should be made to the Commentary since only a few countries have included a special PE provision dealing with insurance agents in their tax treaties.[18]

5. Profit attribution to PEs

According to the Discussion Draft, BEPS concerns regarding the PE rules relate primarily to situations where one member of a group clearly has a physical presence and tax nexus with a jurisdiction, whereas another member of the MNE group is shielded from tax in the absence of a PE, and the first-mentioned entity is allocated limited profits (because of low risk) while the foreign entity is allocated a large share of the income. Nevertheless, this outcome is in line with the arm's length principle according to which associated enterprises should price controlled transactions as comparable transactions on the open market.

The Discussion Draft states that no substantial changes would be needed to the existing guidance concerning the attribution of profits to a PE. This statement is positive as the Authorized OECD Approach regarding the attribution of profits to a PE was adopted only on 22 July 2010 after a more than 10 year negotiation process. According to the Authorized OECD Approach, the OECD Transfer Pricing Guidelines (regarding the application of the arm's length principle) should apply "by analogy" to internal dealings between a head office and a PE (and other parts of the same enterprise). Hence, the potential amendment of Article 5 of the OECD Model Convention will not prevent MNEs to allocate functions, risks and assets in a way that optimizes the allocation of profits among different companies and (potential) PEs.

III. Conclusion and outlook

The Discussion Draft sets out a number of proposals for changes to Article 5 of the OECD Model Convention that aim at broadening the definition of PEs in a tax treaty context. The proposals regarding commissionaire arrangements seem overbroad and would undermine the current rules for dependent agents. The vague language that is proposed to be added in this respect to Article 5 is open to interpretation by local tax administrations. In this context, structures involving Luxembourg principal companies and local commissionaires may be challenged by foreign tax authorities. Similar uncertainty would occur if the "auxiliary and preparatory" requirement were to be added to Article 5 (4) of the OECD Model Convention. As a consequence, an enterprise may be considered to have a PE in every country in which it has sales.

Once a PE is created, the attribution of profits in accordance with the Authorized OECD Approach is one of the main challenges for taxpayers and there exists a serious risk that tax administrations may try to attribute more than an arm's length profit to a new PE. This may result in double taxation and long-lasting disputes. Overall, it may be questioned whether the (limited) additional tax revenue that may be expected (under arm's length conditions) for the host states may justify the administrative burden for businesses and tax administrations. In addition, some of the proposed changes may have a negative effect on international trade and commerce.

Ultimately, the Discussion Draft urges multinational enterprises to review their distribution models and to analyse whether existing business models may give rise to unintentional PEs. In some cases, business restructurings may be needed for efficiency purposes.

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1) Examples of this organizational model are the full-fledged distributor and the full-fledged manufacturer.
2) Examples of this organizational model are commissionaires and toll manufacturers.
3) See Oliver R. Hoor, "Multinational business restructuring and supply chain management: An analysis of global business models and related transfer pricing aspects", Les cahiers du droit luxembourgeois No. 20, Legitech, Luxembourg 2014, p. 27, 36.
4) See Article 5 Paragraph 1 of the Commentary on the OECD Model Convention; see Oliver R. Hoor, "The OECD Model Tax Convention – A comprehensive technical analysis", Legitech, Luxembourg 2010, p. 104.
5) A commissionaire agreement is a form of contractual arrangement that exists under civil law.
6) The sales contracts entered into by the commissionaire are for the benefit of the principal entity, but do not legally bind it.
7) See Article 5 Paragraphs 31 and 35 of the Commentary on the OECD Model Convention; Article 5 (5) OECD-MC deems a PE to exist with respect to activities on an enterprise that would not otherwise be attributed to a PE as defined under the basic rule provided in Article 5 (1) OECD-MC; see Oliver R. Hoor "The OECD Model Tax Convention – A comprehensive technical analysis", Legitech, Luxembourg 2010, p. 109.
8) See Oliver R. Hoor, "The OECD Model Tax Convention – A comprehensive technical analysis", Legitech, Luxembourg 2010, p. 110.
9) CE 31 mars 2010 n° 304715, 308525, 10e et 9e s.-s., Sté Zimmer limited.
10) Dell Products v. Staten v/Skatt øst, Case HR-2011-02245-A, 2 December 2011.
11) Roche case, Sentencia de 12 enero 2012, JUR\2012\41054.
12) The application of Article 5 (4) of the OECD Model further requires that no activities other than those listed in Article 5 (4) subparagraphs a) to d) are carried on at such fixed place of business; see Oliver R. Hoor, "The OECD Model Tax Convention – A comprehensive technical analysis", Legitech, Luxembourg 2010, p. 108.
13) Since Article 5 (4) e) and f) of the OECD Model deals with other unspecified activities, it is a necessary requirement of the activities being of a preparatory or auxiliary nature. In contrast, the activities listed in Article 5 (4) a) to d) of the OECD Model share that they have a preparatory or auxiliary character; see No. 74 of the 2011 Discussion Draft.
14) For example, the construction of a housing development would be considered as a single project even if each house were constructed for a different purchaser.
15) Article 5 (5) of the OECD Model.
16) See Paragraph 39 of the Commentary on Article 5 of the OECD Model.
17) According to this special provision, insurance companies would be deemed to have a PE in the other State if they either collect premiums in that other State or insure risks situated in the territory of the other State through an agent established therein.
18) See No. 135 of the 2011 Discussion Draft.