LEGAL INFORMATIVE NEWSLETTER

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We are pleased to provide you with the new issue of our legal information newsletter.

Topical legal questions are discussed and those related to issues that you might encounter.

We hope that you will find it of interest. We would welcome any comment you might have.

OECD ACTION 7 OF THE BASE EROSION AND PROFIT SHIFTING – B.E.P.S. ACTION PLAN – ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (Public Discussion Draft)

INTRODUCTION - Action 7 of the BEPS Action Plan mandated the development of changes to the definition of "permanent establishment" ("PE") to prevent the artificial avoidance of PE status, including through the use of commissionnaire arrangements and the specific activity exemptions.

It also mandated that the work should address related profit attribution issues. The conclusions reached are found in the 2015 BEPS Report on Action 7 "Preventing the Artificial Avoidance of Permanent Establishment Status" (the Report on Action 7).

THE REPORT - The Report on Action 7 provides for changes to be made to Article 5 of the Model Tax Convention ("MTC") for the following reasons:

In order to prevent the avoidance of PE status through commissionnaire arrangements and similar strategies, the Report concludes 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 taxable presence in that country unless the intermediary is performing these activities in the course of an independent business.

This has resulted in changes to Articles 5(5) and 5(6) and to the Commentary.

In order to prevent the avoidance of PE status through the specific activity exemptions, the Report concludes that it should not be possible to avoid permanent establishment status by using the exceptions of paragraph 4 of Article 5 of the MTC in the case of activities that are not preparatory or auxiliary.

Likewise, by fragmenting a cohesive operating business into several small operations in order to argue that each party is merely engaged in preparatory or auxiliary activities that benefit from these exceptions.

This has resulted in changes to Article 5(4) and to the Commentary to include: a) a "preparatory or auxiliary" condition applicable to all the subparagraphs of Article 5(4) of the MTC; and, b) a new anti-fragmentation rule.

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In order to prevent the avoidance of PE status through the splitting up of contracts to take advantage of the exception of paragraph 3 of Article 5, the Report concludes that the Principal Purposes Test rule ("PPT rule") should address the BEPS concerns related to the abusive splitting up of contracts for purposes of that exception.

In addition to the changes to the MTC under the Report on BEPS Action 6, this work has resulted in: a) the inclusion in the Commentary on the PPT rule of an example regarding the splitting-up of a contract for work on a construction site; and, b) the inclusion in the Commentary on paragraph 3 of Article 5 of the MTC of an alternative provision that States may use to address such splitting-up of a contract.

PRELIMINARY WORK - The preliminary work on attribution of profit issues that was carried out under the Report on Action 7 focused on whether the existing rules of Article 7 of the MTC would be appropriate for determining the profits that would be allocated to PEs resulting from the changes included in that Report.

The conclusion in the Report on Action 7 is that these changes do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 but that there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in that Report.

There is also a need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital under the 2015 BEPS Report on Actions 8-10 "Aligning Transfer Pricing Outcomes with Value Creation" ("Report on Actions 8-10").

Realistically, however, work on attribution of profits related to Action 7 could not be undertaken before the work on Action 7 and Actions 8-10 were completed. For that reason, and based on the many comments received from public commentators that have stressed the need for additional guidance on the issue of attribution of profits to PEs, follow-up work on attribution of profit issues related to Action 7 is necessary.

OBJECTIVE AND SCOPE OF THE WORK - In order to determine which aspects of the BEPS work require additional guidance concerning the issue of attribution of profits to PEs, it is necessary to understand the exact scope of the changes made to the definition of PE by the Report on Action 7.

First, while the changes made to Article 5(5) and 5(6) by the Report on Action 7 have modified the threshold for the existence of a deemed permanent establishment under Article 5(5), they have not modified what is deemed to constitute that deemed PE. Both the pre-BEPS and post-BEPS versions of Article 5(5) apply only to the extent that a person is "acting on behalf of an enterprise" and provide that the PE that is deemed to exist if the threshold is met is constituted by "any activities which that person undertakes for the enterprise".

The Commentary on both the pre-BEPS2 and post-BEPS3 versions clarify that where the conditions of Article 5(5) are met, the permanent establishment exists "to the extent that person acts for the enterprise, i.e. not only to the extent that such a person [pre-BEPS version: exercises the authority to conclude contracts in the name of the enterprise] [post-BEPS version: concludes contracts or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise]".

While the Report on Action 7 has modified the threshold (which may now be met even if a person does not habitually concludes

contracts in the name of the enterprise), it has not modified what is the nature of the deemed PE. Any guidance on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5).
An important issue that now needs to be taken into account is the effect of the transfer pricing work under BEPS Actions 8-10 on the determination of the amount of profits attributable to an Article 5(5) PE where the person that acts on behalf of the non-resident enterprise is an associated enterprise that performs control functions related to risks contractually assumed by the non-resident enterprise.

It is important to note, however, that that issue arises regardless of whether one is dealing with a deemed PE arising from the post-BEPS version of Article 5(5) or from its pre-BEPS equivalent. It is also important to note that the issue does not arise where the person, although not being entitled to the independent agent exception of Article 5(6), does not constitute an associated enterprise (e.g. where the person is an employee, director, partner or other representative).

Second, the only practical effect of the changes made to Article 5(4) and of the addition of the anti-fragmentation rule of Article 5(4.1) is to restrict the scope of the exceptions currently found in Article 5(4).

As explained in the revised Commentary on Article 5(4) included in the Report on Action 7 (see in particular paragraphs 22.3. and 22.4), a pre-requisite for the application of these exceptions is that an enterprise has a fixed place of business through which its business is wholly or partly carried on and which would otherwise constitute a permanent establishment under Article 5(1).

To take one example, under the pre-BEPS version of Article 5, an enterprise of one State that operates, through its own employees, a warehouse situated in another State for the purposes of the storage and delivery of goods or merchandise belonging to third parties is not entitled to the exception of Article 5(4) unless that activity is merely preparatory or auxiliary. As a result of the changes included in the Report on Action 7, the same will now be true if the enterprise carries on identical storage and delivery functions at a similar location with respect to its own goods or merchandise.

It is not clear what is the difference between these two cases that would require additional guidance in relation to the issue of attribution of profits. It is true that the question of attribution of profits might be more complicated if all or part of the storage or activities carried on by the enterprise at the warehouse are subcontracted to another enterprise but that complication (which is addressed in Scenario C of Example 5) is not related to the changes made to Article 5(4) by the Report on Action 7.

The same can be said with respect to the changes to the Commentary related to the splitting-up of contracts. These changes do not create a new type of PE; they merely deny, in certain limited cases, the application of the exception of Article 5(3), which applies to an Article 5(1) permanent establishment that is a "building site or construction or installation project" provided that this permanent establishment does not meet the time threshold provided in Article 5(3).

In other words, where the exception of Article 5(3) does not apply as a result of the new guidance on the splitting-up of contracts (or as a result of the alternative provision on the splitting-up of contracts that is now included in the Commentary), the enterprise has a permanent establishment under Article 5(1), i.e. a fixed place of business through which its business is wholly or partly carried on.

The only difference between such a PE and a construction site that constitutes a PE under the pre-BEPS version of Article 5 has to do with the duration of the activities carried on at the construction site by the enterprise itself pursuant to specific contracts. That difference does not appear to raise particular issues related to the attribution of profits.

According to the Public Draft, this is not to say that there is no need for additional guidance on attribution of profit issues.

As indicated in paragraph 3 above (which reflects paragraph 19 of the Report on Action 7), the follow-up work on attribution of profit issues is not restricted to issues related to PEs that will result from the changes made by the Report on Action 7 but should also "take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital."

The aim of the additional guidance covered is, therefore, to illustrate how the rules for the attribution of profits to PEs apply, taking into account both the changes made by the Report on Action 7 and the changes made to the Transfer Pricing Guidelines.

Based on discussions that took place during the development of the Report on Action 7, the fact-patterns that would particularly benefit from additional guidance concerning attribution of profits to PEs are:

Dependent agent PEs ("DAPEs"), in particular under the form of commissionnaire and similar arrangements.
Permanent establishments arising under Article 5(1) to which the exemptions in Article 5(4) do not apply (e.g. warehouses as fixed place of business PE).

EXISTING GUIDANCE ON ATTRIBUTION OF PROFITS TO PES -

For purposes of the Discussion Draft, the analysis of the different fact patterns is performed by reference to Article 7 in the 2010 version of the MTC, and under the principles set out in the 2010 Commentary to the MTC, and the 2010 Report on the Attribution of Profit to Permanent Establishments ("the 2010 Attribution of Profits Report"), which endorse and attribute profits to the PE under the Authorised OECD Approach (the "AOA").

It is important to note that:

(i) relatively few treaties currently include the new version of Article 7 which was included in the OECD Model in 2010;
(ii) (ii) through reservations and positions included in the OECD Model, a number of OECD and non-OECD countries have expressly stated their intention not to include the new version of Article 7 in their treaties5; and,
(iii) the inclusion of the new version of the Article in the UN Model (and, therefore, the implementation of the full AOA with respect to Article 7 of the UN Model) has been expressly rejected by the UN Committee of Experts on International Cooperation in Tax Matters.

Apart from differences in the Article itself, the most important differences between the AOA and the interpretation of Article 7 of the OECD Model Tax Convention prior to the adoption of the AOA relate to the issue of the recognition of "dealings", in particular with regards to the use or transfer of intangibles or rights in intangibles, that would require a country to take account of such "notional" payments.

Other parts of the AOA, such as the part dealing with the allocation of "free" capital

to a permanent establishment, are not viewed as problematic by most countries.

This is confirmed by the fact that the part of the AOA that deals with the allocation of "free" capital to a permanent establishment was expressly included in the 2008 Commentary
and was incorporated in the Commentary on the UN Model in 2011.8

GUIDANCE ON PARTICULAR FACT PATTERNS RELATED TO DEPENDENT AGENT PERMANENT ESTABLISHMENTS ("DAPE") - Paragraphs 5 and 6 of Article 5 of the MTC set out the circumstances in which an enterprise is treated as having a permanent establishment in respect of activities undertaken for that enterprise, even though the enterprise may not have a fixed place of business.

Where a DAPE arises from the activities of a dependent agent, the host country may have taxing rights over two different legal entities: the dependent agent, if it is a resident of the PE jurisdiction; and the DAPE, which is a PE of a non-resident enterprise (2010 Attribution of Profits Report, Part I paragraph 230).

For purposes of determining the profits attributable to the DAPE, Article 7 of the MTC is applicable together with the guidance in Section D.5 of Part I of the 2010 Attribution of Profits Report.

According to paragraph 234 of Part I of the 2010 Attribution of Profits Report, "in calculating the profits attributable to the dependent agent PE, it would be necessary to determine and deduct an arm's length reward to the dependent agent for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any)."

There are cases where the dependent agent that performs activities that give rise to a DAPE under Article 5(5) is also, for transfer pricing purposes, an associated enterprise of the non-resident enterprise acting as the principal and is resident in the PE jurisdiction. In those cases, in addition to the attribution of profits to the DAPE, it will also be necessary to determine the arm's length remuneration of the dependent agent enterprise ("DAE").

In determining the profits of the DAPE under the AOA, it would be logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the DAE and to determine the resulting arm's length profits.

This process would provide the arm's length fee deductible in the DAPE in respect of the functions performed by the DAE, as required by paragraph 234 of Part I of the 2010 Attribution of Profits Report.

In addition to an associated enterprise (under Article 9 of the MTC), an employee or a separate non-associated enterprise (for transfer pricing purposes) may also act as a dependent agent of the principal, meeting the conditions to create a PE for the non-resident enterprise/principal under paragraphs 5 and 6 of Article of the MTC.

In these two additional situations, the remuneration paid to the dependent agent for its services (considering the functions performed, assets used and risks assumed) is generally considered to be arm's length (provided the employment relationship is not subject to the transfer pricing rules under specific domestic legislation).

Accordingly, the compensation to the dependent agent in these circumstances would not be subject to scrutiny under Article 9 of the MTC and only Article 7 of the MTC would be applicable.