



TAX FLASH NEWS

OECD BEPS Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status

Background

Gaps and mismatches in the current international tax rules create opportunities for Base Erosion and Profit Shifting (BEPS), requiring bold moves by policymakers to restore confidence in the system and ensure that profits are taxed wherever economic activities take place and value is created. Accordingly, the Organisation for Economic Co-operation and Development (OECD) launched an Action on Base Erosion and Profit Shifting (BEPS) in July 2013. The OECD identified 15 specific actions, along three key pillars: introducing coherence in the domestic rules that affect cross-border activities; reinforcing substance requirements in the existing international standards, and improving transparency as well as uncertainty. The BEPS Action aims to address BEPS in a comprehensive manner and sets deadlines to implement the same.

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a source state only to the extent that the enterprise has in that state a Permanent Establishment (PE) to which the profits are attributable, and therefore, the definition of a PE included in tax treaties is crucial. Accordingly, one of the actions launched by the OECD is 'Preventing the Artificial Avoidance of Permanent Establishment Status' which calls for a review of that definition to prevent the usage of certain tax avoidance strategies that are currently used.

On 5 October 2015, the OECD released the final reports on Action 7 which includes changes to be made to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties.

Commissionnaire arrangement

A 'commissionnaire arrangement' may be loosely defined as an arrangement through which a person sells products in a state in its own name but on behalf of a foreign enterprise that is the owner of these products. Since the person that concludes the sales does not own the products that it sells, that person 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).

A foreign enterprise that uses a commissionnaire arrangement does not have a PE because it is able to avoid the application of Article 5(5) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a commissionnaire are not binding on the foreign enterprise, though there is no material change in the functions performed in a state. Similar strategies that seek to avoid the application of Article 5(5) involve situations where contracts which are substantially negotiated in a state are not formally concluded in that state because they are either finalised or authorised abroad.

As a matter of policy, where the activities that intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, such enterprises should be considered to have a taxable presence in that country. 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 and therefore, changes to the wording of Article 5(5) and 5(6) are needed in order to address such strategies.

The final report, as compared to the revised discussion draft, reflects some refinements to the proposed amendments to Article 5(5) as well as 5(6). Currently, Article 5(5) requires a person (other than an independent agent) acting on behalf of a foreign enterprise to have the 'authority to conclude contracts in the name of the enterprise' in order to create a PE. The final report on Action 7 refers to persons that habitually conclude contracts or 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'. Further, the report also states that contracts mentioned in Article 5(5) are the 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, etc. or (c) for the provision of services by that enterprise.

The revised discussion draft proposed that the concept of 'associated enterprises' should be replaced by a narrower concept by replacing the wording 'one or more enterprises to which it is connected' in place of 'one enterprise or associated enterprises'.

As per the final report, a person shall not be considered as an independent agent if such a person acts almost exclusively on behalf of one or more enterprises to which it is closely related. Further, a person is closely related to an enterprise if, one has control of the other or both are under the control of the same enterprise.

The final report includes for this purpose cases where a person possesses directly or indirectly more than 50 per cent of the beneficial interest in the other or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or the beneficial equity interests.

Important aspects which are recommended in the report, to change the Commentary on Article 5, are as follows:

- The phrase 'concludes contracts' focuses on situations where a contract is legally concluded. A contract may be concluded in a state though the same is signed outside that state. Also, a person who negotiates in a state all elements of a contract in a way binding on the foreign 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 a 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 a 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 the 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.

Artificial avoidance of PE status through the Specific Activity Exemptions

The current OECD Model Tax Convention includes specific activity carved out as exemptions under Article 5(4)¹ from the PE definition. The activities listed in subparagraphs a) to d) therein, 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.

¹ Article 5(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

Since the introduction of these exceptions, however, there have been dramatic changes in the way that business is conducted. Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities.

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

The important aspects recommended in the report to replace the existing Commentary on Article 5(4), are summarised as follows:

- 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 that 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 an 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 a PE would be formed if the activities mentioned in Article 5(4) are performed on behalf of other enterprises and not for the enterprise itself.
- Whether the activity carried on at a place of business 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 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.

Fragmentation of activities between related parties

The OECD Commentary on Article 5 (Paragraph 27.1), currently deals with the application of Article 5(4)(f) in the case of what has been referred to as the 'fragmentation of activities'. The commentary provides that Article 5(4)(f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of Article 5(4)(a) to (e) provided that they are separated from each other locally and organisationally. In such a case, each place of business has to be viewed separately and in isolation for deciding whether a PE exists. Places of business are not 'separated organisationally' where they each perform complementary functions in a contracting state such as those of receiving and storing goods in one place, distributing those goods through another, etc. An 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. This 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 these places of business belong to related parties.

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

Such an anti-fragmentation rule seeks to deny the benefit to a foreign enterprise of the exception of 'preparatory and auxiliary' activity mentioned in Paragraph 4 of Article 5. The anti-fragmentation rule shall deny the exception benefit to a fixed place of business that is used or maintained by an enterprise, if the place of a same or closely related enterprise carries on business activities in the same contracting state and such place constitutes a PE, or the overall activity is not of a 'preparatory or auxiliary' character, provided that the business activities constitute complementary functions that are a part of a cohesive business operation.

The final report has proposed changes to the Commentary on Article 5, wherein the Commentary to Article 5(4) shall be subject to the Commentary mentioned in Article 5(4.1) i.e. anti-fragmentation rules. Further, the new paragraph added to the Commentary states that the purpose of Paragraph 4.1 is 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.

Splitting-up of contracts

The splitting-up of contracts in order to abuse the exception in Article 5(3) i.e. Building Site PE, Construction PE, Installation Project PE, etc. is discussed in Paragraph 18 of the OECD Commentary on Article 5. Paragraph 18, inter alia, provides that the twelve month threshold given in Article 5(3) has given rise to abuses; it has sometimes been found that certain enterprises divided their contracts into several parts, each covering a period less than twelve months and attributed the same to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

The Principal Purposes Test (PPT) rule that will be added to the Convention in relation to Action 6 will address the BEPS concerns related to the abusive splitting-up of contracts, and a certain example will be added to the Commentary on the PPT rule. For states that are unable to address the issue through domestic anti-abuse rules, a more automatic rule will also be included in the Commentary as a provision that should be used in treaties that would not include the PPT or as an alternative provision to be used by countries specifically concerned with the splitting-up of contracts issue.

As per the current Convention, such abuses may fall under the application of legislative or judicial anti-avoidance rules. Apart from this, it gives an option that the concerned countries with this issue can adopt solutions in the framework of bilateral negotiations. The final report suggests that these abuses could also be addressed through the application of the anti-abuse rule of the relevant tax treaty. Moreover, states that do not include the anti-abuse rule in their treaties should include an additional provision to address contract splitting, which can be drafted along the following lines:

For the sole purpose of determining whether such a twelve month period has been exceeded, where an enterprise carries on activities at a place for not more than twelve months and connected activities are carried on at the same place during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.

Insurance

According to the definition of the term PE, an insurance company of one state may be taxed in the other state on its insurance business, if it has a fixed place of business or if it carries on business through a person. Paragraph 39 of the OECD Commentary on Article 5 suggests that insurance companies may carry out large scale business in a state without having a PE in that state.

Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a state, without being taxed in that state on their profits arising from such business.

In line with the proposal of the revised discussion draft, the final report mentions that as part of the work on Action 7, BEPS concerns also related to situations where a large network of exclusive agents is used to sell insurance for a foreign insurer were also examined. It was ultimately concluded, however, that it would be inappropriate to try to address these concerns through a PE rule that would treat insurance differently from other types of businesses and that BEPS concerns that may arise in such cases should be addressed through the more general changes to Article 5(5) and 5(6) in section A of this report.

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

The first discussion draft indicated that the preliminary work on Action 7 that was done with respect to attribution of profit issues had 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 under the various options included in the discussion draft and on interactions between the work on the PE threshold and ongoing work on other parts of the Action dealing with transfer pricing, in particular the work related to risk and capital referred to in Action 9.

The first discussion draft acknowledged that, although the existing rules of Article 7 would be appropriate for determining the profits of any additional PE arising under the options included in the discussion draft, there was a need for additional guidance on how these rules would apply to such PEs, in particular outside the financial sector. The discussion draft also stressed that there was a need to take account of the results of the work on other parts of the Action dealing with transfer pricing, in particular, the work related to intangibles, risk and capital.

The final report states that the work on Action 7 that was done with respect to attribution of profit issues focused on whether the existing rules of Article 7 of the Convention would be appropriate for determining the profits that would be allocated to PEs resulting from the changes included in this report. The conclusion of that work 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 this report, in particular for PEs outside the financial sector. There is also a need to take account of the results of the work on other parts of the BEPS Action dealing with transfer pricing, in particular, the work related to intangibles, risk and capital.

The final report mentions that due to certain reasons, the follow-up work on attribution of profits issues related to Action 7 will be carried on after September 2015 with a view to provide the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action.

The aforesaid conclusions of the final report are on lines of the revised discussion draft.

Our comments

The changes suggested in Action 7 with respect to Artificial Avoidance of a PE represent a significant overhaul of the existing regime and could require businesses to revisit many aspects of their cross-border business structures. In the Indian context, Action 7 is likely to have a significant impact on cross-border investment, digital and e-commerce businesses, etc. and certain aspects of them are also dealt with in other Actions. Certain terms such as 'habitually' have not been clearly defined in this report, which may create uncertainty.

The Indian judiciary has already dealt with various aspects on this subject matter which have been echoed in this report, namely the principal purposes for the conclusion of a separate contract is to obtain the benefit of Article 5(3), would be treated as an abuse of the PE Article.

India has already given its observations/reservations to the OECD Commentary 2014 with respect to PE related issues. Some of the key observations/reservations are as follows:

- A person, who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements and details of the

contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts. Similarly, the BEPS Report provides that if an intermediary habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, it would result into a PE of the foreign enterprise.

- A series of consecutive short-term sites or projects operated by a contractor could give rise to the existence of a PE in the country concerned. Similarly, the BEPS Report takes into account the abuse of Article 5(3) by splitting up of a contract and provides that the PPT rule that will be added to the OECD Model Tax Convention, which is expected to address the BEPS concerns related to the abusive splitting-up of contracts.
- It is suggested that a sales outlet should be added to Article 5(2) to be treated as a PE. The BEPS report also recommends to expand the scope of an agency PE to cover such outlets.

These proposed changes to the PE definition will be implemented as part of the multilateral instrument adopted under the work on Action 15. However, follow-up work on profit attribution rules in relation to PEs still has to be concluded before the end of 2016, which is the deadline for negotiation of the multilateral instrument.



Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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