Headline	Treaty issues on permanent establishments		
MediaTitle	The Philippine Star		
Date	30 Aug 2016	Color	Black/white
Section	Business	Circulation	305,090
Page No	B6	Readership	305,090
Language	English	ArticleSize	429 cm²

TOP OF MIND

By MARIA CECILIA V. REGALADO

Treaty issues on permanent establishments

Recent developments in the global business environment which are characterized by intense competition and rapid growth of multinational enterprises have led to new business models and structuring of business operations in order to meet the increasing demands of expansion on a global scale.

Agency arrangements, as a way for enterprises to have sales presence in local markets, have been widely-recognized as a business strategy to attain commercial efficiencies in undertaking cross-border trade and investment. The tax consequences of business models and structures involving sales agents across different jurisdictions have been the subject of attention and major concern in international taxation as it relates to problems on aggressive tax planning and base erosion and profit shifting (BEPS).

For taxation purposes, business presence in a particular state can be established even without a fixed place of business such as when an enterprise conducts its business activities through a person acting on its behalf. In such cases, allocation of taxing rights between the state of residence of the enterprise and the state of source can be determined through treaty provisions on permanent establishments, such that an agent, other than an agent of independent status, is taxable in the state of source, only where such agent meets the conditions for PE status.

The definition of agency-PE under the current OECD Model Tax Convention on Income and Capital is contained in Articles 5(5) and 5(6). The elements by which a person acting on behalf of an enterprise is deemed a PE under Article 5(5), can be broken down as follows: 1) The person has, and habitually exercises an authority to conclude contracts, and 2) Such contracts are in the name of the enterprise. Article 5(6) states that an enterprise shall not be deemed to have a PE by having a broker, general commission agent or any other agent of independent status acting on its behalf, provided that such persons are acting in the ordinary course of business.

The problem arises in the case of commissionaire arrangements where an agent sells products in its own name, but for the account and risk of a foreign enterprise who holds title to the products. Following the plain wordings of Article 5(5), these arrangements do not create a PE since the contracts are not in the name of the foreign enterprise. Much concern has been raised that such arrangements create opportunities for aggressive tax planning through avoidance of PE status.

The proposed changes to the definition of PE under Action 7 of the BEPs final report are intended to address these problems as it avoids the issue of who is bound by the contract with the third party customer and focuses rather on the fact that a sale or transfer

Headline	Treaty issues on permanent establishments		
MediaTitle	The Philippine Star		
Date	30 Aug 2016	Color	Black/white
Section	Business	Circulation	305,090
Page No	B6	Readership	305,090
Language	English	ArticleSize	429 cm²

of ownership of goods took place.

Tax planning strategies to avoid PE status, which result in shifting of profits from the state of source to the state of residence where taxation is low, is a major concern under the BEPS project. It was observed that arrangements through which subsidiaries, traditionally acting as distributors, are replaced by commissionaire arrangements lead to this result, as profits are shifted from the country where the sale was consummated without a substantive change in the functions performed in that country.

The OECD goes further and emphasizes the underlying policy behind the proposed changes to the definition of PE, which is to ensure that profits are taxed where the economic activities take place and value is created. Such policy reinforces substance requirements in existing international standards which is a pillar of the BEPS Action Plan.

When an enterprise structures its operations in the form of a commissionaire arrangement, and supported by commercial considerations, it may be argued that these facts alone cannot be equated with "abuse," rather, such arrangements resulting in a no-PE situation and low taxation in the state of residence may be considered as politically inappropriate in light of the policy considerations under BEPS against low taxation and lowering the threshold for source taxation.

Under the proposed rules, the requirements in order for a person acting on behalf of an enterpise to be deemed a PE are as follows: 1) There is a person acting in a contracting state on behalf of an enterprise; 2) In doing so, the person habitually concludes contracts, or habitually plays a principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise; and 3) These contracts are in the name of the enterprise, or for the transfer of ownership of, or of the granting of right to use, property owned by that enterprise or that the enterprise has a right to use or for the provision of services enterprise.

In the Philippines, the position of BIR on the issue is seemingly aligned with the proposed changes under the BEPS final report. The following considerations are considered material in determining whether there is a PE in the Philippines: The duration of the contract between the principal and agent which indicates regularity, the control of the principal over the products and its delivery, and the exclusivity of the dsitribution agreement.

The unintended consequences of the change would be the treatment of agency arrangements similar to a service PE. Under the UN Model Convention, there are specific thresholds to establish economic nexus for services, e.g. only if activities continue within a contracting state for a period or period aggregating more than six months within a 12-month period. The proposed rules would result in agents treated in the same way as a service PE i.e. based on performance of activities, without any sort of threshold as to duration.

The proposed rules, which give importance to the subject matter of the contract entered into, e.g. for transfer of ownership, rather than function which actually take place, may lead to an interpretation as far-reaching as deeming all sales contracts which are concluded by an agent on behalf of the principal wherein the foreign principal ultimately transfers title, as creating a PE. The treatment would be similar to a service PE without any sort of threshold as to period or duration of the activities.

The result under the BEPS project is a PE threshold that is too broad and all-encompassing that renders limitation to source taxation as a principle behind the concept of PE ineffectual. The crucial condition would be whether a contract is concluded at all, since all contracts from which the principal would derive economic benefit would be considered basis for creation of a PE. The emphasis on source taxation would seem advantageous to a developing country such as the Philippines. This however, should not lead to policy decisions that would impact legitimate commercial decisions of multinational enterprises.

As regards impact on stakeholders, the manner and burden of proof to establish when an agent plays a principal role in conclusion of contracts is a matter which may lead to problems on practicability, as detailed actions e.g. chain of events leading to conclusion of contracts and patterns of communication in negotiations, are not always documented in such a way as to allow objective evaluation. Given these uncertainties, there remains an opportunity for taxpayers to devise ways to fall outside the scope of the rules, thus, possibly leaving us with the problem of litigation between taxpayers and tax administration.

Unless the intention of the OECD is towards a policy direction, in terms of a PE threshold that focuses merely on whether the foreign enterprise derives profit from the source state, the challenge of having a threshold that is considerably objective and certain may be a task that is yet to be achieved.

Maria Cecilia V. Regalado is a director from the tax group of KPMG R.G. Manabat & Co. (KPMG RGM&Co.), the Philippine member firm of KPMG International. KPMG RGM&Co. has been recognized as a Tier 1 tax practice, Tier 1 transfer pricing practice, Tier 1 leading tax transactional firm and the 2016 National Transfer Pricing Firm of the Year in the Philippines by the International Tax Review.