

Grant Thornton discussion draft response

BEPS Action 7: Preventing the Artificial Avoidance of PE Status



Grant Thornton International Ltd,
with input from certain of its
member firms, welcomes the
opportunity to comment on the
OECD Public Discussion Draft
entitled BEPS Action 7: Preventing
the Artificial Avoidance of PE
Status, issued on 31 October 2014.



Artificial avoidance of PE status through commissionaire arrangements and similar strategies - preliminary observations

Wider economic and fiscal impact of the proposals

We believe lowering the permanent establishment (PE) threshold will almost certainly lead to a shift towards source-based taxation in OECD member countries. This may mean greater subjectivity in the interpretation of the proposals by individual member countries so that their application would not be consistent.

This in turn could lead to significant uncertainty for many multinationals around the tax treatment of their established business structures and projected operating models which may have wider business and economic consequences.

We appreciate that it is not the intention to change the balance of taxing rights in this way in cases where income is being taxed, but only to restore the position 'where cross border income would otherwise go untaxed or would be taxed at very low rates'.¹ For this reason we would caution against very widely drawn and vague drafting, as in several of the options currently presented in the draft.

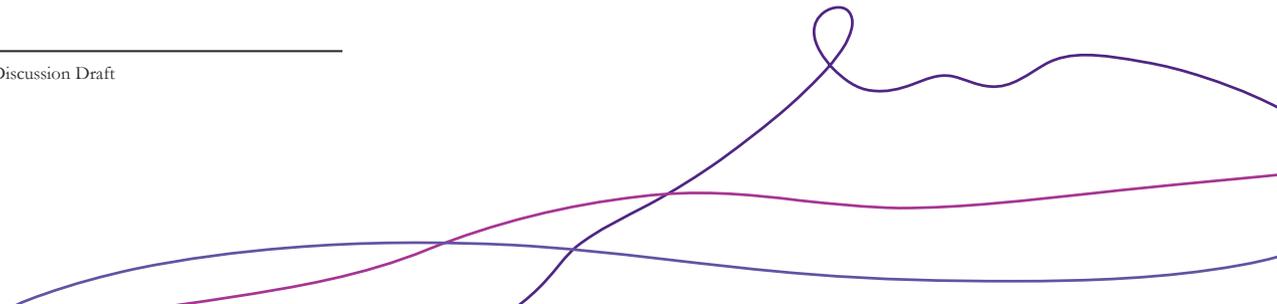
Impact on normal commercial structures

The discussion draft states that 'it is clear that in many cases commissionaire structure and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place'.

We note that in many cases, commissionaire arrangements are widely accepted legal structures (originally based on German civil law concepts) that have been put in place for commercial reasons. For example, such structures are acknowledged to permit the integration of sales operations over a number of European territories through economies of scale or to allow weak or new markets to be supported through revenue flows from stronger markets.

Therefore, any change to deem the attribution of (a) additional activities to such agents or (b) further profits would be likely to counteract many long-standing commercial arrangements including such arrangements that have so far been considered to be independent. This could lead to significant disruption to business where contracts may need to be renegotiated as a result or possibly even put out to tender.

1. paragraph 3, p10 of the Discussion Draft



Double taxation

There is a real risk of effective double taxation particularly where the arrangements are with third parties. This is because the proposals may result in the same profits potentially becoming taxable in the same jurisdiction if a commissionaire structure in one territory now gives rise to a PE of a company which is tax resident in another jurisdiction¹.

In particular, one effect of the proposals appears to be that some of the profits earned by the commissionaire on an arm's length basis may now also be included in the taxable income of the principal's proposed PE particularly on transition to any new regime.

This would not be double taxation in the usual sense, ie the same profits becoming taxable in more than one territory but instead different persons potentially being taxable on the same profits in the same territory. Hence, on the face of things, this situation may not be fully contemplated by normal double tax treaty principles for the relief of double taxation.

Therefore, it is requested that the OECD should if necessary propose appropriate mechanisms to relieve such double taxation including clarification that fees paid to the commissionaire would be deductible in computing the local taxable profits of any PE resulting from the proposals.

In this respect, the comments at page 8 of the discussion draft that no substantive changes are needed as to how the proposals interact with the attribution of profits to PEs may therefore be unrealistic, and this point is discussed in further detail below.

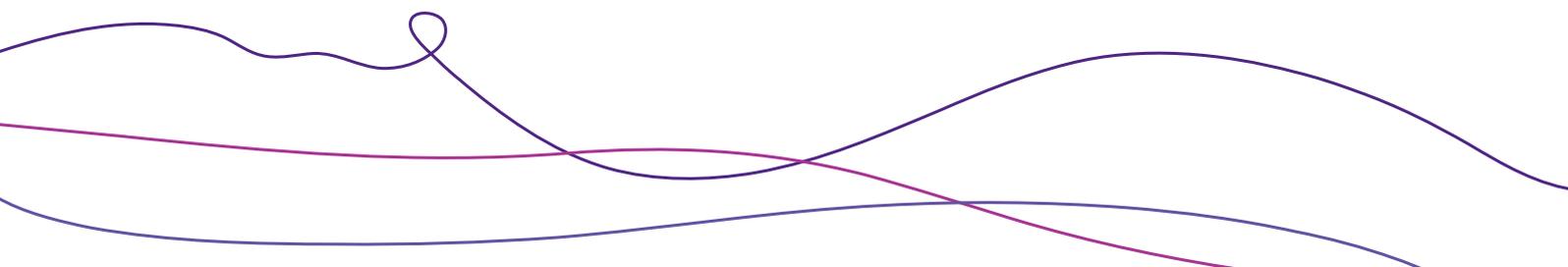
Administration and collection of taxes

The mechanics of enforcing and collecting additional taxes under the proposals also need to be reviewed by the OECD. In particular, some territories may under their domestic rules governing such matters, hold the commissionaire to account for any tax liabilities of the principal. Again, this could lead to commercial issues surrounding the existing terms of commissionaire agreements where there is an increased possibility of the principal becoming subject to tax in the other state.

Specifically, existing commercial agreements may need to be renegotiated to include clauses which provide additional protection to the commissionaire in this situation in terms of recovery of taxes and penalties from the principal. Commissionaires may also now seek increased levels of commission income to reflect the potential consequences of this additional risk.

Compatibility of the proposals with the commercial law of OECD member countries

The proposals appear to be aimed mainly at territories with a civil law legal system which permits the usual type of commissionaire structure whereby the commissionaire can enter into sales contracts in its own name, but on behalf of the principal, and where the commissionaire does not usually bind the principal. In this situation the principal remains the owner of the goods until they pass to the third party customer. Structuring sales arrangements in this way has meant that a PE of the principal generally does not arise as the commissionaire does not conclude contracts on behalf of the principal.



However, arrangements of this type are not possible in some jurisdictions such as the UK, for example, which has a common law legal system. Commissionaire arrangements are not generally found at arm's length in the UK and so they are not a traditional way of selling goods. Instead, businesses that sell finished goods will often do so by buying products, holding those products as stock, promoting and selling them to customers.

In this situation, the distributor buys the products from the manufacturer (which may be based overseas) before selling them to third party customers. The distributor may bear all or at least some of the risks associated with buying, holding and selling stock along with any additional financial costs of carrying the stock. The distributor may typically also incur costs of transporting goods to the customers and promoting, marketing and selling the products.

The original manufacturer no longer owns the goods once acquired by the UK distributor and hence profits from sales to third party customers are fully taxable in the UK in the hands of the distributor.

Some multinational enterprises have used limited risk distributor structures in the UK (or other common law territories) whereby a distribution company in the UK buys goods from an overseas manufacturer or supplier and then markets and sells them to customers. Under such structures, there is usually a contract between the distributor and principal under which the principal will indemnify certain costs such as bad debts and obsolescent stock while other functions and risks may also be transferred to the principal. However, unlike commissionaire structures in civil law countries, the arm's length profit from the ultimate sale to the third party is fully taxable in the UK.

Given the above facts, it would appear that such structures are not within the ambit of the proposals in the discussion draft as there is no sales contract between the overseas supplier and the third party customer. Additionally, the contract between the supplier and the distributor would not usually constitute an agency agreement under English law. Therefore, the sale should not be regarded as being on the account of the overseas supplier. It would therefore be helpful if the commentary could confirm that such structures are not the target of the proposals.

There are likely to be other structures where the application of the proposals is unclear, eg because of the nature of the business structures which are permitted by local law which do not correspond to the typical civil law concept of a commissionaire.

Compliance and administrative burden

There is also a real risk that the compliance and administrative burden for business from the proposals will be substantially increased, eg through the need for the principal to file tax returns in the sales territory, but without any significant benefits being generated in terms of increased tax revenues or for the wider economy as far as facilitating cross-border business is concerned.

In many cases, the commission earned by a commissionaire may in reality be equal to or even exceed the amount of profits that would be taxed in a jurisdiction through amending the definition of a permanent establishment, particularly bearing in mind the requirement to attribute expenses to in computing the profits of a PE under article 7 of a double tax treaty.

Moreover, a commissionaire typically receives a guaranteed taxable profit stream in its territory of residence even when the principal is incurring losses, eg due to difficult market conditions or start-up situations. Therefore, provided countries are consistent in applying guidance to losses as well as profits (unfortunately, often they are not) it is not entirely clear if the latest proposals for Action 7 would necessarily increase the tax burden in that territory. Where the principal incurs tax losses the tax base may be eroded where these can be utilised against other profits of the group arising in that territory, eg in a subsidiary carrying on separate operations.

Attribution of profits to PEs

Given that there may be a significantly greater number of foreign PEs generated by the OECD's proposals, it would seem appropriate for the OECD to devote technical resources to improving its existing guidance on the attribution of profits to PEs found in its July 2010 report on the 'Attribution of Profits to Permanent Establishments'. We therefore do not agree with the OECD's views at pages 8 and 26 of the discussion draft that substantial changes are not needed to existing rules and OECD commentary on the attribution of profits to PEs. In our experience, disagreements over attribution of profits are all too common, with some tax authorities apparently adopting a force of attraction methodology such that if a PE exists it must then attract a lot of the profits, irrespective of the activity, risk, and intangibles that may or may not exist locally.

Employment tax issues

Consideration must also be given as to the employment tax implications of foreign employees travelling to overseas offices to negotiate contracts if such negotiation results in the creation of a PE under the latest proposal, of the employer, in that jurisdiction.

Here, the taxation of the remuneration of such employees will be dependent upon double taxation agreements. Typically, the mere fact that part of the salary of an employee is charged to a foreign PE is often sufficient to bring that amount within the foreign employment tax regime as permitted by the wording of the employment income article of many double tax treaties.

It therefore appears that the increased incidence of foreign PEs as result of the proposals is likely to have an equivalent impact on the cross-border taxation of employees leading to significant administrative complexity and potential cash-flow implications for employers and employees in terms of complying with multiple employment tax regimes. Such issues could in turn lead to wider restrictions on the global economy if they limit the natural flow of cross-border business.

Investment fund structures

We note investment fund structures rely extensively on contracts being negotiated in one country to a certain extent by an appropriate agent (dependent or independent). These agents may or may not be authorised to conclude contracts and payment to such agents is appropriate to the work they carry out and their levels of responsibility.

Some jurisdictions contain specific domestic exemptions for such agents from PE status. Any proposed changes in such rules are likely to have widespread ramifications for the funds industry as a whole, with increased costs being passed on to investors which would distort the market.

Pension holders some of whom may already on a fixed income may also find their returns reduced where in increased costs are absorbed by institutional investors in funds.

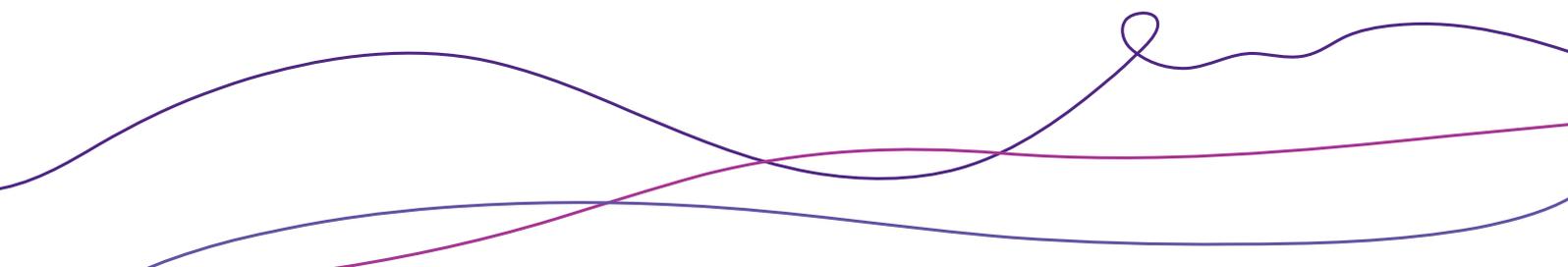
Interaction with domestic law initiatives

A number of OECD member countries are already contemplating the introduction of domestic law provisions to counter some of the structures which are the target of Action 7. For example, the UK Government has included in the 2015 Finance Bill a proposed Diverted Profits Tax (DPT), one of the key aims of which is to tax profits which it considers are diverted from the UK through the artificial avoidance of the creation of a UK PE of a foreign enterprise. Other countries like Australia have also indicated already that they are considering similar measures.

We would ask the OECD to urge its member countries including the UK to await the conclusion of Action 7 before introducing new tax rules dealing with areas which are part of the BEPS project.

For example, one issue identified with the UK's proposals for a DPT is whether it could be challenged under normal double tax treaty principles because some countries may regard the new tax as being 'substantially similar' to UK corporation tax. In addition, treaty partners of OECD member countries contemplating such proposals may have objections to such new assertions over basic long-held taxing rights.

Where there is not a co-ordinated approach amongst OECD member countries to the introduction of domestic rules, considerable uncertainty together with administrative problems for multinational businesses could ensue, with the potential for disputes between tax authorities over primary taxing rights.



The interaction of domestic measure measures stemming from Action 7 such as the proposed UK DPT with other anti-avoidance rules such as Controlled Foreign Company (CFC) legislation, including in other jurisdictions which may already apply CFC rules to the profits which are the target of Action 7 also needs to be reviewed to ensure there is no possibility of double taxation. Appropriate mechanisms to relieve potential double taxation in these situations should therefore be considered and put forward by the OECD.

Alternative wording for Articles 5(5) and 5(6)

Option A

We note that the four different options for revised wording for Articles 5(5) and 5(6) of the OECD model tax convention are each intended to make a person a dependent agent at a level of activity below the current 'concluding contracts' test.

Option A suggests replacing 'conclude contracts' with 'engages with specific persons in a way that results in the conclusion of contracts'. Under this option, even if contracts are not concluded in the foreign principal's name, the principal would still be deemed to have a PE if such contracts are for the provision of products or services by the foreign enterprise.

We believe this option would create significant uncertainty for many companies as it widens the scope and concept of a PE to an extent which is unacceptable. Specifically, it would potentially appear to encompass all sales contracts entered into by a foreign enterprise with any involved by a local agent (unless the latter is independent and non-exclusive as described in the revised paragraph 6 under this option).

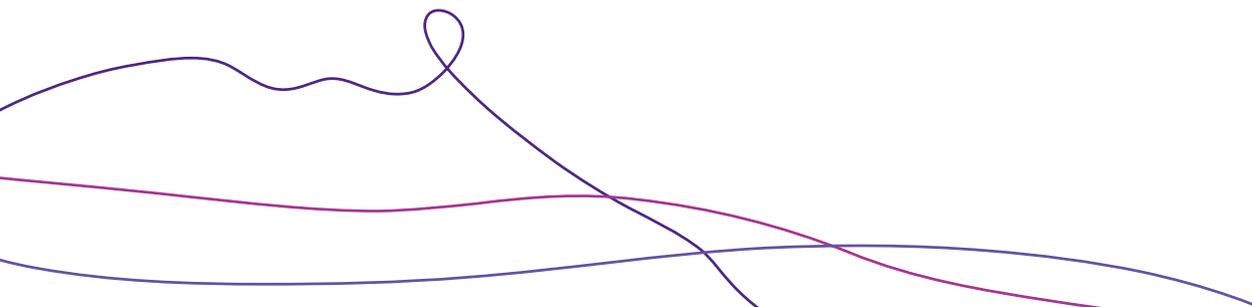
Such a wide approach to the problem could also lead to inconsistency amongst OECD member countries as to the precise application of the definition which we assume is contrary to the overall aims of the proposals.

The phrase 'in a way' is particularly vague as it does not specify the features of the agent's activities that are considered to contribute to the conclusion of contracts which would give rise to a PE. Therefore, Option A is unlikely to be the preferred option for revised wording for this part of the OECD model tax convention.

Option B

Option B is similar to Option A except it addresses persons who habitually conclude contracts or negotiate the material elements of contracts in the name of the enterprise. We believe adding '...negotiate the material elements of contracts...' may also lead to significant uncertainty, particularly in situations where the board of directors of the non-resident company has considered large parts of contracts and then asked an agent to communicate on its behalf. In this situation, it is not clear if a PE would be created as the discussion draft does not elaborate any further of what 'material' means here.

However, Option B appears to be preferable to Option A on the basis that the concept of 'negotiates material elements of contracts' may be easier to define than the concept of 'in a way that results in the conclusion of contracts' under Option A. Specifically, the material elements of contracts for this purpose could be prescribed in the revised article although further work would be needed on this point to make sure any definitions of the material elements of a contract are appropriate.



Option C

Under Option C, it appears irrelevant whether the contract is in the name of the enterprise. Rather, the emphasis is on whether the contracts are on the account and risk of the enterprise as a result of the commissionaire's legal relationship with the enterprise.

There is very little explanation of what is meant by 'on the account and risk of' and 'legal relationship' here. It is suggested by the discussion draft that it would be necessary for there to be a specific type of legal relationship between a person and an intermediary, such as a commissionaire agreement or agency contract, for this suggested revised wording to apply.

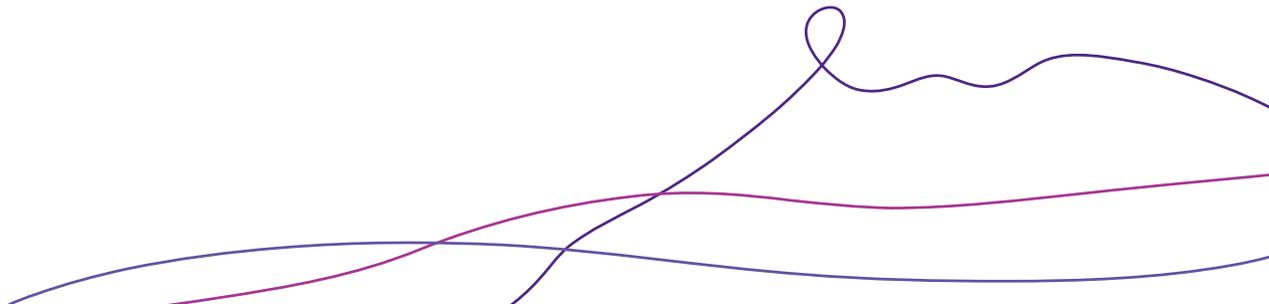
However, there may be situations where, for example a distribution-type arrangement is used as opposed to an agency or commissionaire contract so that the sale is not necessarily 'on the account of' the 'principal', ie the overseas supplier or manufacturer even though the latter is in substance on risk of the sales transactions, eg through guaranteeing bad debts or buying back obsolete stock. For the same reasons as Option A above, we do not favour Option C, with the additional complexity and subjectivity making this option even less helpful.

In the meantime, it would be useful for the OECD to provide further details of the concepts used by Option C and how it envisages they would apply.

Option D

Option D is a combination of Options B and C. This involves a person who 'habitually concludes contracts, or negotiates the material elements of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of' the foreign principal.

Again, we do not consider the potential for complexity and confusion resulting from additional subjective wording will be helpful.



Artificial avoidance of PE status through the specific activity exemptions

We understand tax administrations are concerned that some of the specific activity exemptions listed in Article 5(4) do not expressly refer to preparatory or auxiliary activities, as they consider the original purpose of paragraph 4 was to cover only preparatory or auxiliary activities and not activities which make a major contribution to the profitability of an enterprise.

The options set out in the discussion draft for addressing this are:

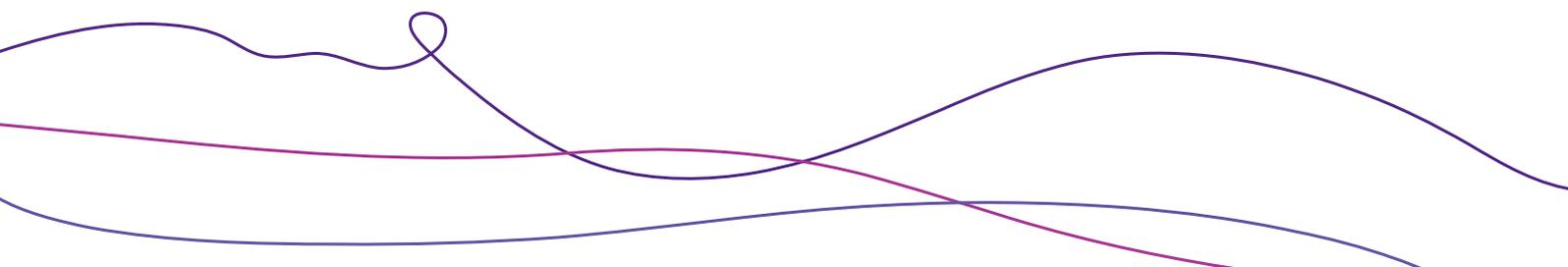
- amend Article 5(4) so that all the exception activities currently listed are subject to the condition of being preparatory or auxiliary (Option E)
- make more targeted changes to/ deletions of individual words and phrases in the sub-paragraphs, specifically the exceptions related to 'delivery' and 'purchasing goods' (Option F).

We believe the options set out in the discussion draft will need to be clarified further by the OECD model commentary to bring certainty rather than controversy. For example, if the option to remove the exemption for the delivery of goods is adopted, there will need to be clear guidance as to when storage ends and delivery begins. In addition, it is likely that companies may find it difficult in practice to distinguish between stock which is stored for delivery and stock which is stored for other purposes.

Removal of the exemption for the delivery of goods may result in entities avoiding the definition of a PE through adjustment to their supply chain so that customers come to storage warehouses to collect ordered goods, at a reduced price. Furthermore, some taxpayers may consider reducing the number of warehouses in a region if the exemption for warehouses was removed. This would reduce the level of activity and jobs in those locations.

Additionally, there may be situations where a taxpayer resident in Country A locates a warehouse in Country B because this is close to its markets in Countries C, D and E but there are few if any sales with customers in Country B. It would be helpful to understand how the OECD considers such an arrangement should be treated.

On balance, Option E may be preferable to Option F as it would appear to create less uncertainty dependent on how businesses are structured, although more specific definitions of the concepts of 'preparatory' and 'auxiliary' would be needed. For example, if the condition of preparatory or auxiliary is to apply to all exception activities listed in Article 5(4), taxpayers will wish to understand, eg when a warehouse should be considered as fundamental to a business.



Care is again needed here to ensure that actions designed to 'catch' very particular situations do not result in a significant increase in disputes and double taxation. We agree with the sentiment in paragraph 21 of the draft that 'tax authorities might be led into attributing too much profit to this activity (ie delivery)'.

Purchasing and information collection are key preparatory or auxiliary activities and the removal of these exemptions would affect a large number of start-up companies with little taxable income. Again, this could potentially restrict new business and hence economic growth in OECD member countries. Therefore, we suggest that Options G and H are reviewed and amended as necessary to provide for a more appropriate approach to new business.

Further, the option G alternative (paragraph 28) to delete all wording in relation to 'collecting information' seems to us to be another example of a potentially wide ranging change being suggested in order to counter some very specific concerns, with the attendant risk of yet more arguments and disputes. Nowadays almost all businesses will collect information about local customers; if all such situations gave rise to a potential PE argument, that would be an undesirable result.

The proposals may result indirectly in erosion of the tax base in the territory of the PE should the principal become loss-making as the latter would need to be granted access to tax relief for losses in the PE jurisdiction. In this respect, some jurisdictions allow such losses to be offset against other types of profit or profits of associated enterprises that are resident for tax purposes in the territory where the PE is located.

The interaction with the separate BEPS initiative concerning the digital economy also needs to be considered further in re-evaluating the definition of a PE here.

We note the suggestion in the paper published by the OECD in September 2014 that the level of an enterprise's digital presence could be used to determine whether and the extent to which it should be taxable there. This might involve replacing the PE concept with a 'significant presence' test.

The paper of September 2014 also refers to previous work carried out by the OECD on the digital economy including at page 163 the 'Ottawa principles' which are reproduced below. We think that there could be merit in applying these principles to the BEPS initiative so that sight is not lost of the need for fair and simple rules that do not produce unnecessary compliance and administrative burdens.

Ottawa principles:

Neutrality: Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency: Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and Simplicity: The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Here, a 'significant presence' based approach may also be worth considering in respect of other types of business for the sake of a consistent and equitable approach.

Fragmentation of activities between related parties

We note the proposed change is to address situations where a single enterprise may divide a cohesive operating business into several smaller operations with a view to arguing each of the latter is merely engaged in a preparatory or auxiliary activity.

We are in agreement that a draft anti-fragmentation rule would deny the specific activity exemptions where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or an associated enterprises at different locations. It should however be noted that separation of certain activities may be appropriate from a legal perspective in some jurisdictions.

With regard to the options listed in the discussion draft, the approach of combining activity not just of a given legal entity but also of related parties to assert that a PE is created may lead to a material increase in uncertainty and leave considerable room for conflicting interpretation by the tax authorities of individual jurisdictions regarding what is to count as a 'cohesive operating business'.

It would also give source countries an ability to pierce or ignore the separate legal personality of substantive legal entities.

For these reasons, and specifically the effective abandonment of the separate entity approach and undermining of the arm's length standard, we do not favour either option I or J. If anti avoidance rules are needed for egregious cases, they should be narrow and targeted.

By way of example, in the Real Estate Fund industry it is common to have 'Opco/Propco' structures whereby Opco typically has a PE in a Contracting State whilst Propco does not. This commercial separation of activities for instance should be carved out where Propco genuinely does not have a PE so as to avoid situations whereby an internal Opco/Propco structure is taxed differently from an external one.

Splitting up of contracts

We note there are concerns over abuse of the exception in Article 5(3): 'A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months', whereby enterprises are dividing contracts into several parts, each covering a period of less than twelve months and attributed to a different company (though owned by the same group).

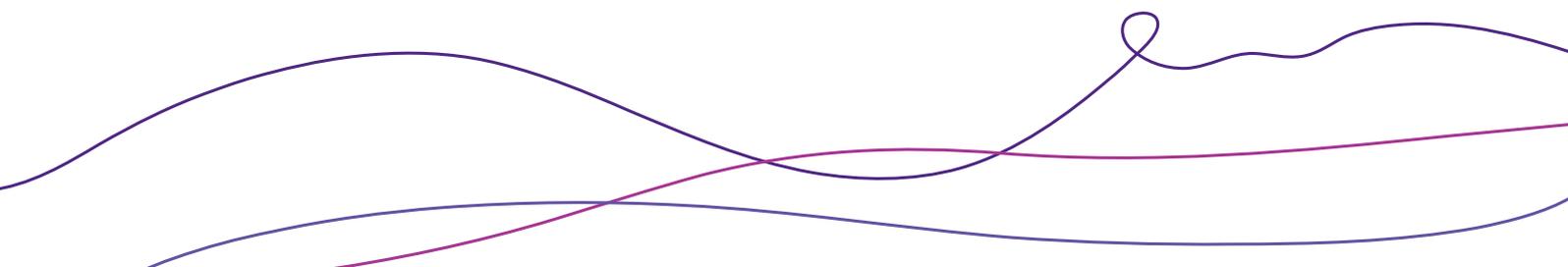
Proposed options for addressing this practice are as follows:

- implementation of an 'automatic' rule that would take account of any activities performed by associated enterprises
- addition of a new example in the Commentary on the general anti-abuse rule (ie the 'Principal Purposes Test' rule) proposed as a result of the work on Action 6.

We broadly agree with the suggestions in Options K and L set out in the discussion draft. It should however be noted that the separation of certain activities may be appropriate from a commercial perspective to manage financial risk. In this regard, the proposal in Option L that any new rules should only apply to tax motivated cases, and not where there are legitimate business purposes for the involvement of associated enterprises, is likely to be preferable to the approach which involves the automatic creation of a PE under Option K.

Additionally, a key benefit of a 'principle purposes test' approach is that protection should be given for tax payers through access to mutual agreement procedures to help ensure they can resolve cases with the relevant tax authorities where they feel they have not been taxed in accordance with existing treaties. A clear and detailed definition of what is meant by 'legitimate business purposes' will of course be necessary here.

Suitable protection will also need to be given to organisations with a large number of employees on short-term (less than 12 months) overseas contracts, eg oil companies and telecommunication businesses. The proposal for a minimum period of presence of up to thirty days in any twelve month period may help to address this point.



Insurance

Paragraph 39 of the Commentary on Article 5 suggests that insurance companies may undertake large-scale business in a state without having a PE in that state.

Proposed options for addressing this are as follows:

- A provision that would deem a PE to exist with respect to certain insurance activities (Option M). Such a provision would address cases where a large network of exclusive agents sell insurance for a foreign insurer; or
- Relying on the proposed changes to the wording to Article 5(5) and 5(6) under Options A-D set out above (Option N).

We note the inclusion of the specific proposals for insurance companies which conduct business through agents would seem to be a separate matter to the specific PE concerns raised in the original BEPS Action Plan and as such was unexpected.

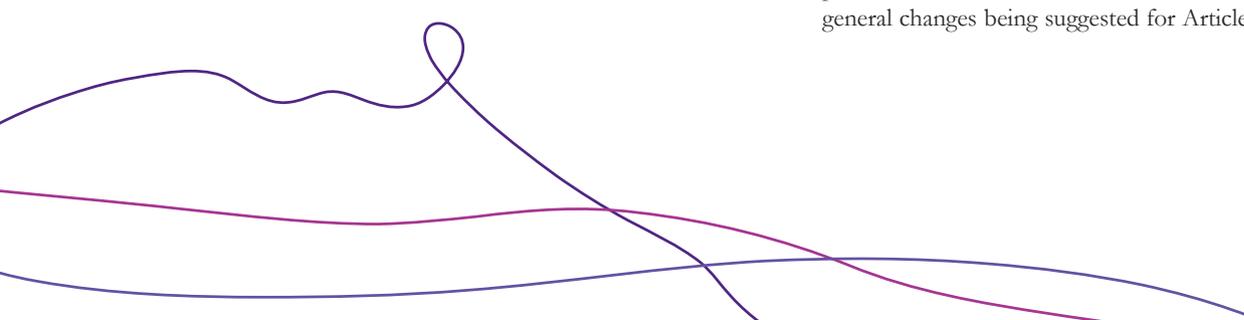
We believe insurance also raises difficult issues around where profits that represent the remuneration of risk should be taxed. Typically, it has been the location of the underwriting function where the profits of an insurance enterprise are taxable as discussed in the OECD's Report on the Attribution of Profits to Permanent Establishments of July 2010.

In this respect, the OECD acknowledges that it might be more appropriate to address the BEPS concerns related to such cases through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted, using measures contemplated under Actions 4 and 9 and this approach seems appropriate to us.

Option M has the effect of extending the scope of the agency PE rules for insurance operations to include premiums collected and risks insured through agents (other than independent agents) even though the contracts are not concluded in that country (this is included in some double tax treaties already where they are modelled on the UN treaty) and will be attractive to some tax authorities as it will have the effect of widening the tax base for businesses structured in such a way.

However, this approach may well give rise to additional compliance costs for taxpayers and there is likely to be significant uncertainty over the extent of the PE, for example with respect to the amount of investment return allocable to the PE given the business 'written' in a particular country.

It is not clear why special provisions under Option M are being proposed for the insurance sector and not for other sectors, particularly as the alternative Option N makes no specific provisions for the insurance sector, instead relying on the more general changes being suggested for Article 5 (5) and (6).



The inclusion of Option N seems to compromise the notion of there being a need for a special rule at M.

We believe the proposed modification of the PE threshold will have little impact on the relatively common commercial situation whereby risk and the associated reward is transferred through the use of (re)insurance to an associated company which does not undertake any functions in the country in question. However, this would typically be examined via transfer pricing and the Action 9 proposals will be of greater relevance here.

Conclusion

We believe that the proposed changes will create extensive work for many multinational businesses in seeking to establish where a permanent establishment exists, even in the absence of structures that involve commissionaires or similar arrangements. The proposals may also create barriers to cross-border business particularly in start-up situations as companies seek to avoid creating accidental PE's, which may have wider economic consequences for business in general.

There will also be a substantial increase in compliance, audit costs and enquiries carried out by tax authorities as they seek to understand the operations of multinationals, possibly without a commensurate increase in tax revenues or redistribution of material profit between territories.

We appreciate the opportunity to contribute our comments. If you would like to discuss any of these points in more detail then please contact your usual Grant Thornton contact or Martin Lambert, Partner for Grant Thornton LLP at martin.lambert@uk.gt.com.





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