



PERMANENT ESTABLISHMENT AND ITS ROLE IN BEPS

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Panel

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CONCEPT OF PE

OECD approach to PE

- **Longstanding concept** (derived from economic allegiance and supply theory) allocating taxing rights to source state only if a sufficient threshold of physical presence (by use of physical means of production) is met
- Based on the “**bricks and mortar**” economy
- **Types of PE in Article 5:**
 - main/ basic rule PE (para 1): fixed place of business concept
 - construction project PE (para 3)
 - deemed agency PE (para 5)
 - (optional) deemed services PE (Commentary para 42.23)
 - specific activities exception
 - separate entity approach (no) Group PE

Many unclarities and flaws

- Unclarities or flaws, **for example: at the disposal, degree of permanence time threshold, signing / binding principal, automatic equipment, digital economy**
- Many BEPS issues already addressed in case law [for example: **Philip Morris 2002 (Group PE), Stock of Goods 2007 (specific activity exceptions), Morgan Stanley 2007 (outsourcing), Fugro 2008 (permanence / nature of projects), Zimmer 2010, Dell 2011, Roche 2012 (binding a principal)**]
- OECD approach to blurred concept: guidance on interpretation via commentaries (**for example: painter example, recurrent activities, nature of activity, automated equipment, e-commerce, services - latter optional text**)
- Draft reports on (25!) PE problems 2011 / 2012

Triggers for change / BEPS PE approach

- **Business restructuring, splitting up manufacturing and distribution supply chains;** obvious tax planning *via* avoidance of PE
- **Public discussion** on tax avoidance by MNE's, **budgetary needs**
- BEPS outcome still based on **traditional economy physical presence concept**, no fundamental change to allocation between residence-source state intended (exploration of, but no agreement on, treatment of digital economy)
- OECD focus on PE limited to repairs of most urgent problems related to base erosion, but this time by **changing the Model text and MLI!**

BEPS PE proposals

- **No agreement on minimum standards**
- **5 specific elements:** agency amendments (no authority to sign contracts required but principal role leading to contracts), all activity exceptions (subject to auxiliary/ preparatory test), anti-fragmentation (denying activity exception if complementary cohesive business activities), anti-splitting (GAAR or SAAR)
- **No review regarding other fundamental issues of the current PE concept** (residence source allocation)
- **Digital economy to be further studied**, although maybe leading to base erosion / distortion of residence-source allocation as perceived by, for example: Developing countries?



UN APPROACH

UN approach

- **UN MTC and Commentary 2011 – main differences to OECD MC PE notion:**
 - Lower time thresholds for construction sites
 - Lower activity thresholds for PE exemptions catalogue
 - Service PE concept in the Model (rather than as optional provision in the Commentary)
 - Agency PE – more restrictive view on independent agents
- UN Tax Committee meeting deliberations (Geneva, October 2015) on “virtual service PE” and invited changes to the UN Commentary on this issue (“majority” and “minority” view on interpretation of the “physical presence test”)
- **UN Handbook “Protecting Tax Base for developing countries” (2015)** publication goes beyond BEPS Action 7 Recommendations, for example:
 - Focus on commissioners as dependent agents is not sufficient to address the issue of base erosion
 - Other weaknesses noted within the anti-fragmentation rule and splitting of contracts rule
- UN Tax Committee adopted a **new article on fees for technical services** which is proposed to be included in the UN Model in 2017



SOURCE COUNTRY PERSPECTIVE

Source country perspective

- While the OECD approach is seen as allocating taxing rights largely to residence state, the developing countries canvass source-based taxing rights and have expressed concerns about number of provisions in the OECD commentary on Article 5
- BEPS Action 7 recommendations seem to have shifted the needle from residence-based tax system to source to ensure that profits are taxed where economic activities take place and value is created
- The proposed changes would impact structures that avoid having a taxable presence or a PE in the source country

Significant concerns of developing countries

- Non-inclusion of sales outlet, warehouse, farm, plantation in Paragraph 2
- The time threshold for Service PE to be reduced to 90 days, factoring in advancement of technology in modern era
- Creation of PE in case of Agency; where Agent secures orders wholly or almost wholly for the enterprise
- Agent dealing at arm's length considered as agent of independent status; case of subsidiaries
- Restricting the scope of exemption to activities that are purely in the nature of preparatory and auxiliary activities

BEPS PE approach

- The proposed changes in BEPS Action 7 vindicates virtually every stand India has taken on taxation for the past 20 years; from being a minority view to a majority voice
- With the tremendous growth of e-commerce in India, functions such as warehousing, display, delivery and its impact of the entire supply chain model to be analysed in the context of preparatory and auxiliary activities
- Activities such as scientific research cannot be an activity of preparatory or auxiliary nature
- Specific tax issues that deal with exploration and exploitation of natural resources, supervisory activities about building site or a construction assembly or installation project remain areas of divergent views



OTHER COUNTRY DEVELOPMENTS

PE development across countries

- **Israel – digital PE:**
 - New Circular of Israeli Tax Authority (published on April 16, 2016) claims that a significant digital presence of a non-resident in Israel creates a PE therein
 - Entirely domestic law concept applying to non-treaty situations
- **UK – diverted profit tax**
 - A penal tax targeting artificial profit diversion strategies involving low tax / low substance companies
 - Arguably overrides the provisions of the existing UK tax treaties
- **Australia – Multinational Anti-avoidance Law (MAAL)**
 - Applying to “schemes” with a principal purpose to obtain a tax benefit and target foreign MNCs generating profits earned from Australia without a PE
- **Saudi Arabia/ Kuwait – virtual service PE**
 - “Minority” and “majority” positions for the requirement of physical presence for the 183-day threshold condition
 - In practice, tax treaty exemption/refund applications under Article 7 being denied



CASE STUDIES ON BEPS PROPOSALS

Case study 1: Agency PE- Principal role leading to conclusion of contracts

Ten shades of principal role -

Person acting in host country :

- Takes final agreed document for signatures
- Attends document signing ceremony
- Merely acts as spokes person seeking specific direction
- Acts to reach agreement within defined limits
- Coordinates with multiple group functions overseas to prepare response to bid

Case study 1: Agency PE- Principal role leading to conclusion of contracts

Ten shades of principal role -

Person acting in host country :

- Takes decision on agreeing to scope variation
- Takes decision on material but not significant terms
- Takes decision on significant but not substantial terms
- Only tele presence in host country
- Only video presence in host country

Proposed Article 5(5)

5. Notwithstanding the provisions of paragraphs 1 and 2 **but subject to the provisions of paragraph 6**, where a person is acting **in a Contracting State** on behalf of an enterprise and, **in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are**
- 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 or that the enterprise has the right to use, or
 - c) for the provision of services by that enterprise

Proposed Article 5(6)

- a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise
- b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one 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 of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise

Case study 2: Preparatory and auxiliary condition

- R Co is a company resident of State R that is a large buyer of a particular agricultural product produced in State S, which R Co sells from State R to distributors situated in different countries
- R Co maintains a purchasing office in State S
- The employees who work at that office are experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type / quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products by R Co

Case study 2: Preparatory and auxiliary condition



Proposed Article 5(4)

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;

Proposed Article 5(4)

- 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,

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character

Proposed Article 5(4) – New anti-fragmentation rule

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

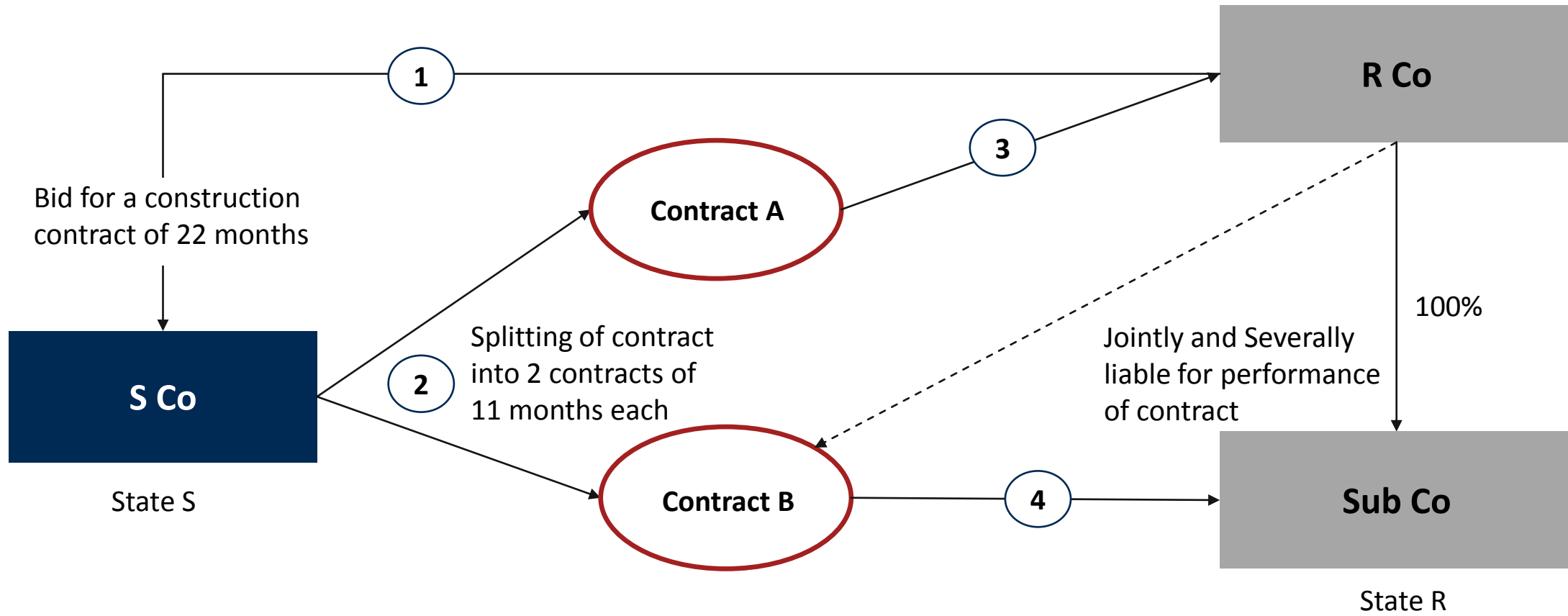
- a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or**
- b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,**

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation

Case study 3: Splitting-up of contracts

- R Co is a company resident of State R
- It has successfully submitted a bid for the construction of a power plant for S Co, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months.
- The first contract is concluded with R Co and the second contract is concluded with Sub Co, a recently incorporated wholly-owned subsidiary of R Co resident of State R
- At the request of S Co, which wanted to ensure that R Co would be contractually liable for the performance of the two contracts, the contractual arrangements are such that R Co is jointly and severally liable with Sub Co for the performance of Sub Co's contractual obligations under the Sub Co-S Co contract

Case study 3: Splitting-up of contracts





RESIDENCE COUNTRY PERSPECTIVE

Residence country perspective on new PE thresholds

- Various views between OECD countries on PE recommendations. Many opt-outs in MLI?
- Subjectivity in interpreting new notions / more reliance on unclear economic notions: auxiliary / preparatory in various business models, principal role in negotiations, complementary activities of a cohesive business process
- Multiplication of PEs? Related difficult profit allocation (assessment of budgetary impact relief/ is it all worth it, also for developing countries?)
- Increase in international disputes
- No doubt part of future evaluation of BEPS
- Potential issues with foreign tax relief (for PE tax) and economic double taxation



UNCONCLUDED ACTION ON ATTRIBUTION OF PROFITS

Attribution of profits to PE – Additional guidance

- Additional Guidance from OECD – Discussion draft (4 July – 5 Sept)
 - Guidance for cases where AOA is not adopted?
 - Simplicity of examples – No attribution of profits to DAPE?
 - Changes to Article 5(5) and (6) theoretical?



ATTRIBUTION OF PROFITS – UN APPROACH

Attribution of profits to PE – UN approach

- **Pre-2010 Article 7 OECD MC vs / UN MC** found in most existing tax treaties with inherent tension between para 2 and 3 of Article 7, for example:
 - Only compensation of actual expenditure
 - No mark-up allowed on cost allocations
 - This is not consistent with new OECD AoA
- **Force-of-attraction principle**
 - Not consistent with AoA
 - Allocation of total revenues and total costs based on books of accounts
 - Conflicts between the residence and source country's views on the quantum of profits to be attributable to the PE
 - Potentially leads to economic double taxation
- UN MTC Commentary to Article 7 ***explicitly rejects*** the OECD AoA



CONCERN AREAS

Concern areas

- Whether BEPS concerns adequately addressed?
- Bilateral resolution under MAP – Effective remedy?
- Economic double taxation – difficulty in obtaining foreign tax credit relief
- Unilateral / summary approach of countries



QUESTIONS AND CONCLUSION