

# **PERMANENT ESTABLISHMENTS: EMERGING ISSUES WITH OUR TREATY PARTNERS**

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Tax Treaties – Recent Developments and Emerging Issues  
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# AGENDA

- Overview of PE concepts
- Service PEs
- Limited-risk operators
- Digital enterprises
- Other emerging issues
  - OECD papers
  - Hidden PEs



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# PE CONCEPTS

# OVERVIEW

## Treaty basics

- Typically bilateral agreements *override, modify* or *supplement* each party's local tax law
  - Allocation of taxing rights / jurisdiction
  - Aspire to resolve issues / certainty
- Article 5 – minimum connections necessary to essentially assert residence basis taxation

## Dynamic / evolving – many influences

- US model (2006) – starting point for US negotiations
- OECD
  - OCED model (2014) and influential commentaries
  - Proposed changes to Article 5 – October 2012
  - BEPS Action Plan 7 (*Prevent Artificial Avoidance of PE Status*) – 31 Oct. 2014 discussion draft
- UN model (2011)
- G20 / NGOs / public

# OECD vs. UN

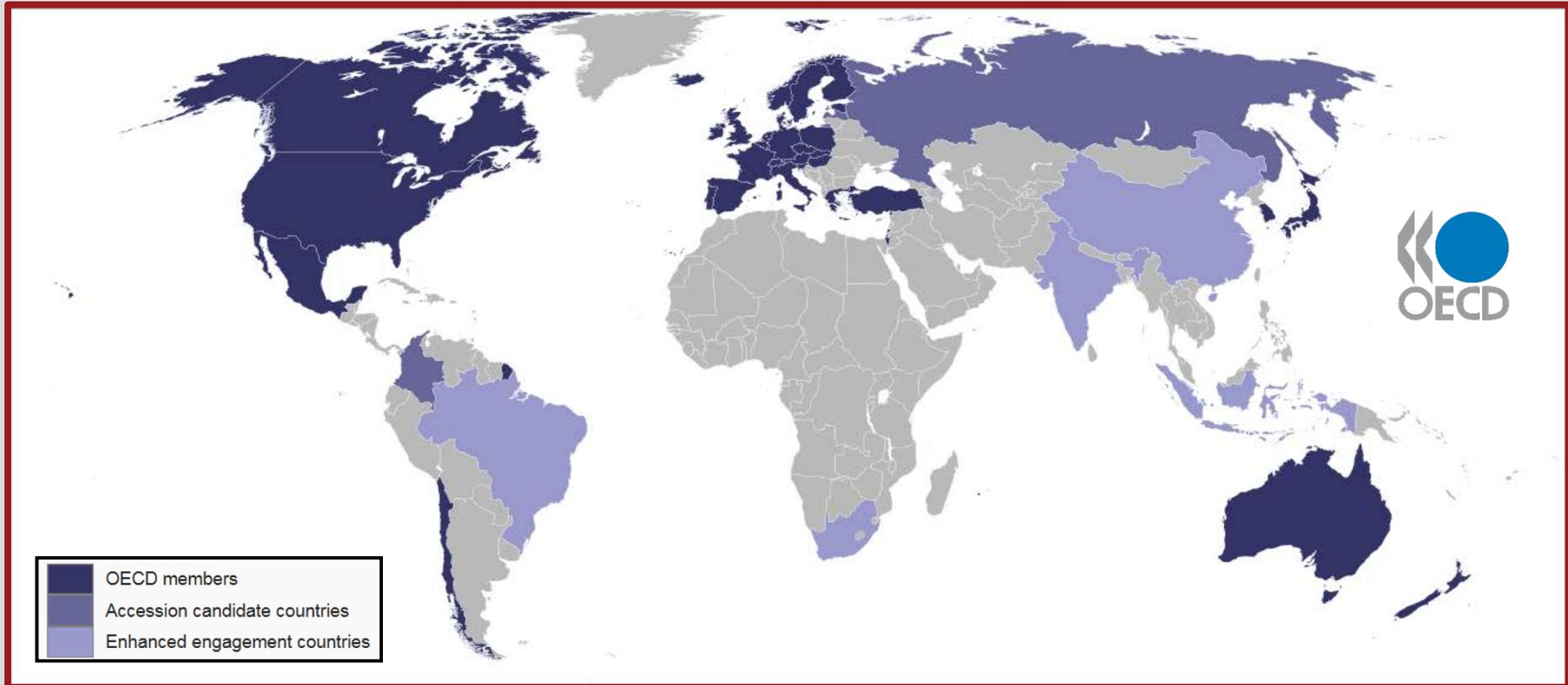
## OECD tax work

- 34 member countries
- “Observers” – Argentina, China, India, Russia, South Africa
- Increasing engagement with non-OECD economies – Brazil, Colombia, Indonesia and others
- Working parties of country delegates study and develop proposals
- Tax work supported by OECD Centre for Tax Policy and Administration
  - Secretariat of approx. 100

## United Nations tax work

- 193 member countries (including all OECD members)
- UN Committee of Experts on Int’l Cooperation in Tax Matters (UN Tax Committee)
  - Supported by International Tax Cooperation Section within Financing for Development Office
    - Secretariat of approx. 3

# SUPRANATIONAL IMPACT



United Nations

## UN Tax Committee Members - 2013 to 2017

- |                  |           |                   |                |               |                |
|------------------|-----------|-------------------|----------------|---------------|----------------|
| • Mexico*        | • Brazil  | • Germany*        | • South Africa | • Morocco     | • China        |
| • Chile*         | • Sweden* | • Switzerland*    | • Senegal      | • Qatar       | • India        |
| • Bahamas        | • Italy*  | • Norway*         | • Ghana        | • Azerbaijan  | • New Zealand* |
| • United States* | • Poland* | • United Kingdom* | • Zambia       | • Philippines |                |
|                  |           |                   |                | • Malaysia    |                |
|                  |           |                   |                | • Japan*      |                |

\* Denotes OECD member

# GENERAL PE APPROACH

**OECD model and commentaries** – are the default

## **Business profits – Article 7(I)**

*“Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a **permanent establishment** situated therein.”*

## **Permanent establishment generally**

- Two distinct tests to determine whether a PE exists:
  - Fixed place of business (FPB) test
  - Agency test

## **Fixed place of business PE – Article 5(I)**

*“For the purposes of this Convention, the term ‘permanent establishment’ means a **fixed place of business** through which the business of an enterprise is wholly or partly carried on.”*

# FIXED PLACE OF BUSINESS

## Specific examples of FPB

- place of management
- branch
- office
- factory
- workshop
- place of natural resource extraction (e.g., oil/gas well, mine, quarry)

Article 5(2)

Project site PE – a building site or construction or installation project constitutes a PE only if it lasts more than 12 months

Article 5(3)

## Some specific exemptions from PE

- The use of facilities solely for the purpose of **storage, display or delivery of goods** or merchandise belonging to the enterprise
- The maintenance of a FPB solely for the purpose of **purchasing goods** or merchandise or of **collecting information**, for the enterprise
- The maintenance of a FPB solely for the purpose of carrying on, for the enterprise, **any other activity of a preparatory or auxiliary character**

Article 5(4)

# FIXED PLACE OF BUSINESS (CONT.)

## Review of key FPB components

- **Place** – there must be a *physical* presence at a location; the place is a low threshold item, as it can be any premises, facility or location whether or not used exclusively for the specific purpose; machinery or equipment can qualify in certain cases
- **Fixed (some degree of permanence)** – there must be a fixed situs for some duration of time; no minimum time thresholds set – e.g., can qualify even if duration is short, if the nature of the business suggests that short periods are all that are normally needed; some countries apply 6-month threshold; aggregation concepts apply (e.g., disregard temporary interruptions)
- **At the disposal** – the foreign enterprise must have a certain amount of space under its *effective control* (whether or not it has the legal/formal right to use the space); mere presence is not enough; does not matter whether the space is owned, rented or simply used; it may be situated in the business facilities of another enterprise
- **Through which activities carried on**

# AGENCY PE

## Dependent agents – Article 5(5)

*“[W]here a person ... is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”*

## Independent agents | Parent / subsidiaries

Independent Agents – a PE is **not** established if an enterprise carries on business in the other country through a broker, general commission agent or **any other agent of indept. status, provided** that such person is acting in the ordinary course of its business

Article 5(6)

Related Companies – the fact that one company is related to another company does **not, of itself**, constitute a PE for either company

Article 5(7)

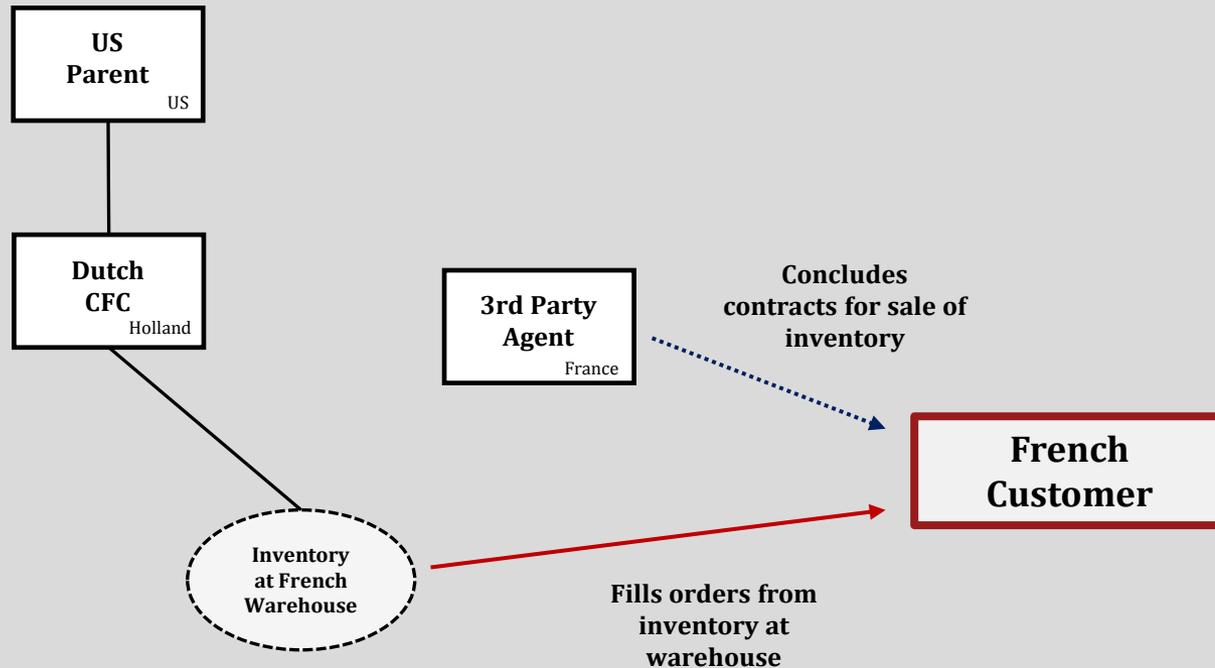
**Big fight is whether independent** – factual analysis (risk, operational/financial control)

# AGENCY PE (CONT.)

## Review of key agency PE components

- **Authority to conclude contracts** – critical aspects are *negotiation* and *conclusion* of binding contracts; this amounts to more than mere participation in negotiations; however, signing a contract is not necessary or sufficient
  - Not necessary that contracts *literally* in the name of principal, if binding on enterprise
- **Habitually exercises authority in country** – no bright lines; however, activities must be performed in the country under consideration
- **Independent status** – to be independent, and agent must satisfy a two-part test: (1) legally independent (free from control), and (2) economically independent (bearing business risk)
  - Number of principals an agent represents may have bearing, but is not by itself determinative
- **More than preparatory / auxiliary activities** – if activities of agent are limited solely to those that would qualify for a specific exemption under Art. 5(4) (e.g., purchasing goods on behalf of a non-resident enterprise) then it is fine

# PE CONCEPT – EXAMPLE



- **What are the PE consequences?**
- **How would it change under a UN approach?** (discussed below)

# COMPARE THE UN APPROACH

## United Nation's focus

- Resource constraints results in OECD as starting point for modifications
- UN and OECD have significantly different membership profiles
  - UN has significant source state and developing nations representation
    - Treaties as shield, not sword
  - UN concerned with administerability and resource constraints
  - Larger membership means UN focused less on consensus than OECD

## UN divergence on certain Article 5 matters

<u>Item</u>	<u>OECD Model</u>	<u>UN Model</u>
• Project Site PE	12 months duration	6 months duration
• FPB for Delivery of Goods	Art. 5(4) kicks-out	No similar kick-out
• Dependent Agent	Must sign/bind	Need not sign/bind if maintains stock of goods for delivery for non-resident
• Service PE	Atypical (option only)	Typical



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# SERVICE PEs

# SERVICE PE OVERVIEW

## Historic approach

- **Developed nations (OECD)**
  - Effect of Arts. 5 and 7 of OECD model is that profits from services performed in country by non-resident are **not** taxable if not attributable to PE in the country
  - US historically has resisted “service PE” provisions, except for treaties with *developing* countries (e.g., US-China treaty)
- **Developing nations (UN)**
  - UN model standard language provides for a “service PE” at Art. 5(3)(b):

*“The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose [shall result in a PE], but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.”*

## Evolution – concern that physical presence may no longer make sense today

- Increasingly globalized, high-tech world

# TREND – DEVELOPED COUNTRIES

## US experience

- **Developing countries** – service PE provisions tolerated
- **US-Canada treaty Art. 5(9) – inserted via 5<sup>th</sup> protocol (2007)**
  - Service PE – even if foreign business does not otherwise have PE, it will be deemed to have one if:
    - 1) **Key Person Test** – The individual performing services is present for aggregate of 183 days or more in any 12-month period **and** for that period more than 50% of gross active business revenues of enterprise derived from services performed by individual in other state; or
    - 2) **Enterprise Test** – Services are performed for aggregate of 183 days or more in any 12-month period with respect to the same or connected project for customers who are resident in the country (or have a PE there in respect of which the services are provided)
      - Are related parties “customers”? What is “connected”?
  - Belief is that inserted at behest of Canada, due to Canadian case law – Dudney (FCA 2000)
- **Other recent treaties**
  - Bulgaria (2007) – Art. 5(8)
  - Chile (signed 2010) – Art. 5(3)(c)

# TREND (CONT.)

## OECD activity

- Service PE option
  - In 2008 update, OECD included service PE option in commentaries – see Art. 5 commentary, ¶ 42.23
    - Significant range of valuable services can be performed within a territory that do not require the support of PE
    - Acknowledges that some member states wish to retain source-based taxation for certain levels of service
  - Virtually same as provision adopted via 5<sup>th</sup> protocol to US-Canada treaty

## Compliance / planning considerations

## Digital business?

- Character disagreements?
- Potential expansion beyond individuals?



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# LIMITED-RISK OPERATORS

# LIMITED-RISK MODELS

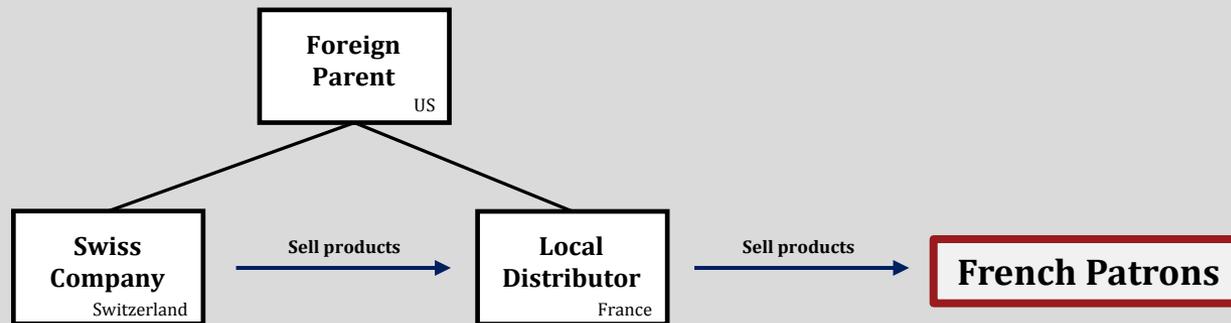
## Overview

- Cross-border enterprises often establish business models utilizing limited-risk service providers
- Aside from transfer pricing, a key issue in these models is determining whether the principal has a PE as a result of affiliate's activities
  - **Cross-border sales**
    - Spectrum of distribution models, including:
      - *Buy/Sell Distributor*
      - *Commissionaire*
    - **Contract manufacturing** – not covered in this presentation
  - Art. 5 issues in this area often arise as a result of business restructurings that strip risk out of a jurisdiction (e.g., restructuring from full-fledged distributor to limited-risk distributor)
    - From local jurisdiction's perspective, the restructuring may effectuate no net change on the ground other than profit (and possibly employment) leaving the jurisdiction for a more favorable climate
    - Incentivizes authorities / judiciary to challenge consequences using innovative legal theories

# CROSS-BORDER SALES

## Distributor vs. commissionaire

- **Buy-sell distributor**

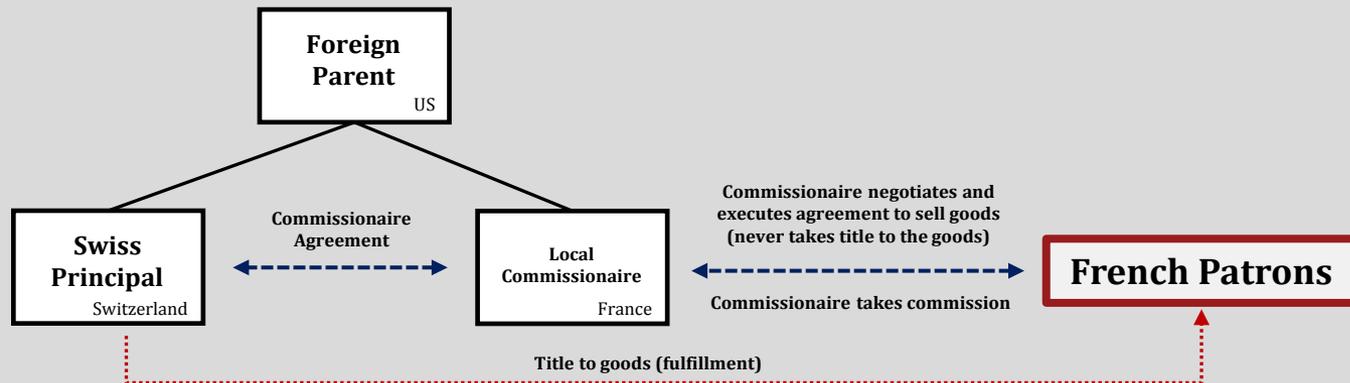


- Typically buy-sell distributors do not give rise to PE issues for the supply company
  - Products sold to distributor at arm's length
  - Distributor takes title to inventory, sells product on own account and realizes gross sales revenue
    - Significant risk equates to higher local remuneration for distributor

# CROSS-BORDER SALES (CONT.)

## Distributor vs. commissionaire (cont.)

- The commissionaire



- Commissionaire structures are creatures of civil law jurisdictions
- The “commissionaire” is authorized to enter into contracts for the sale of goods *in its own name*, but for the account of the principal
- Commissionaire does *not* take title to goods – earns commission income from the principal
  - Diminished risk equates to lower local remuneration for commissionaire

# THE COMMISSIONAIRE

## Focused attention

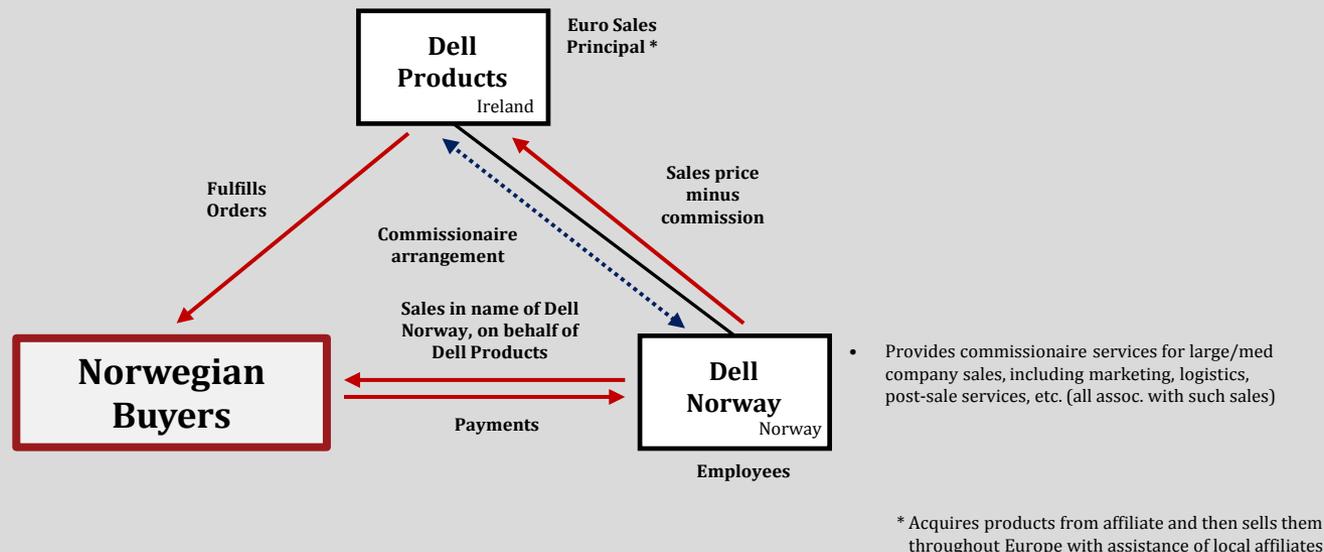
- Recent trend of tax authorities is to challenge commissioner structures under Art. 5, as if the commissioner is a potential **dependent agent** of the principal
- OECD Art. 5(5)

*“[W]here a person ... is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an **authority to conclude contracts in the name of the enterprise**, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise....”*

- OECD Art. 5 commentary, ¶ 32.1:

*“Also, the phrase ‘**authority to conclude contracts in the name of the enterprise**’ does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph **applies equally** to an agent who **concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.**”*

# NORWAY – COMMISSIONAIRE



## Commissionaire is not dependent agent PE

- *Dell*, Supreme Court of Norway, Dec. 2, 2011
- **Background** – Dell Products (“Parent”) is European sales company for Dell. It engaged Dell Norway (“DN”) to act as a commissionaire and make sales to large corporate accounts and government bodies in exchange for commission on sales. Parent never considered itself to have a PE in Norway, but Norway tax authorities asserted that DN was a dependent agent PE under Art. 5(5). The lower court agreed with the Norway tax authority, finding that DN was able to *enter into contracts that were in reality legally binding on Parent*. The relevant cited authority was OECD Art. 5 commentary, ¶ 32.1 (applies even if contracts not actually in name of enterprise, if binding on the enterprise). Parent appealed, arguing that even if DN was dependent agent it wasn’t a PE. (Note: in 1995, there was a restructuring whereby DN went from a *full-fledged distributor* to merely a commissionaire for large/med company sales.)
- **Ruling** – The Supreme Court overturned lower court decision that held that DN constituted a PE of Parent. Instead, SC agreed with taxpayer, noting that a PE via dependent agent exists only if the principal in legal terms is bound to third parties by the agent’s action. Thus, OECD Art. 5 commentary, ¶ 32.1 not truly applicable here b/c under Norwegian commercial law, any contract entered into by a company in the position of commissionaire and entered into in the name of the commissionaire (and not the principal) = the contract is enforceable by the customer *only against the commissionaire* (not the principal) if the goods are not delivered. In other words, that commentary applies to general agency law under common law but is *not* applicable to *civil law* commissionaire structures.

# COMMISSIONAIRE TRENDS

## Other cases involving commissionaires

- Zimmer (France 2010) – French commissionaire not a dependent agent PE of UK principal under UK-France treaty; restructuring from full-fledged distributor to commissionaire
- Dell (Spain 2012) – Spanish commissionaire WAS a dependent agent PE of Irish principal under Ireland-Spain treaty; restructuring from full-fledged distributor to commissionaire; essentially the same facts as *Dell* (Norway), except in respect of Spain
- Boston Scientific (Italy 2012) – Italian commissionaire not a dependent agent PE of Dutch principal under Italy-Netherlands treaty
- **Takeaway** – normal operation of commissionaire typically should not give rise to dependent agent PE, but the status of a commissionaire vis-à-vis a principal does seem to turn on the particular country involved and local interpretations (e.g., Spain will always try to find a PE)

## BEPS Action 7

- Takes aim at commissionaire structures
- See discussion, *infra*.

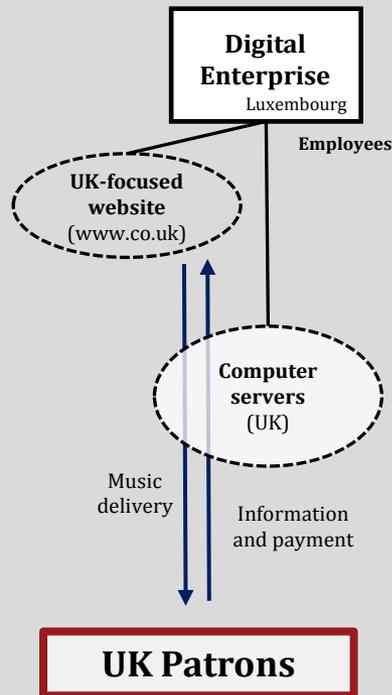


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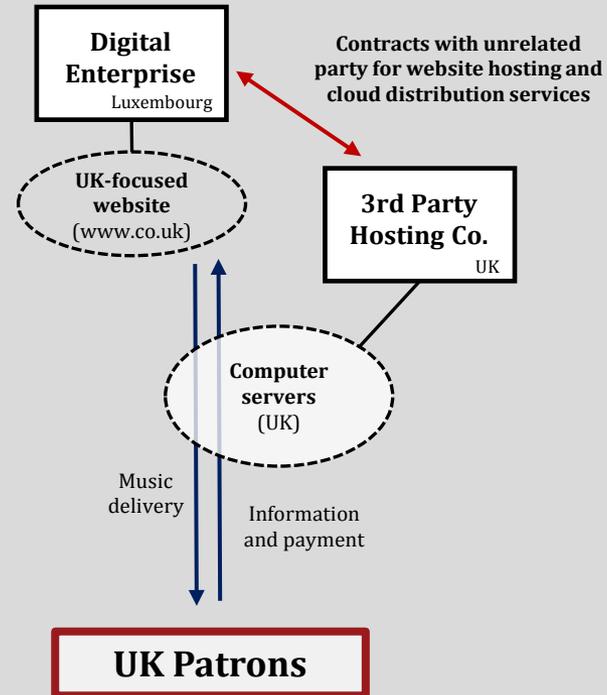
# DIGITAL ENTERPRISES

# DIGITAL BUSINESS PE ISSUES – OVERVIEW

## Direct server operation



## Third-party server operation



- **Query – Should Digital Enterprise be considered to have a PE in the UK in either of these situations?**

# EXISTING OECD POSITION

## Existing OECD commentary

- Long-established that FPB can arise via automatic equipment – Art 5. commentary, ¶ 10:

*“[A] permanent establishment may ... exist if the business of the enterprise is carried on mainly through **automatic equipment**, ... [particularly] ... if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.”*

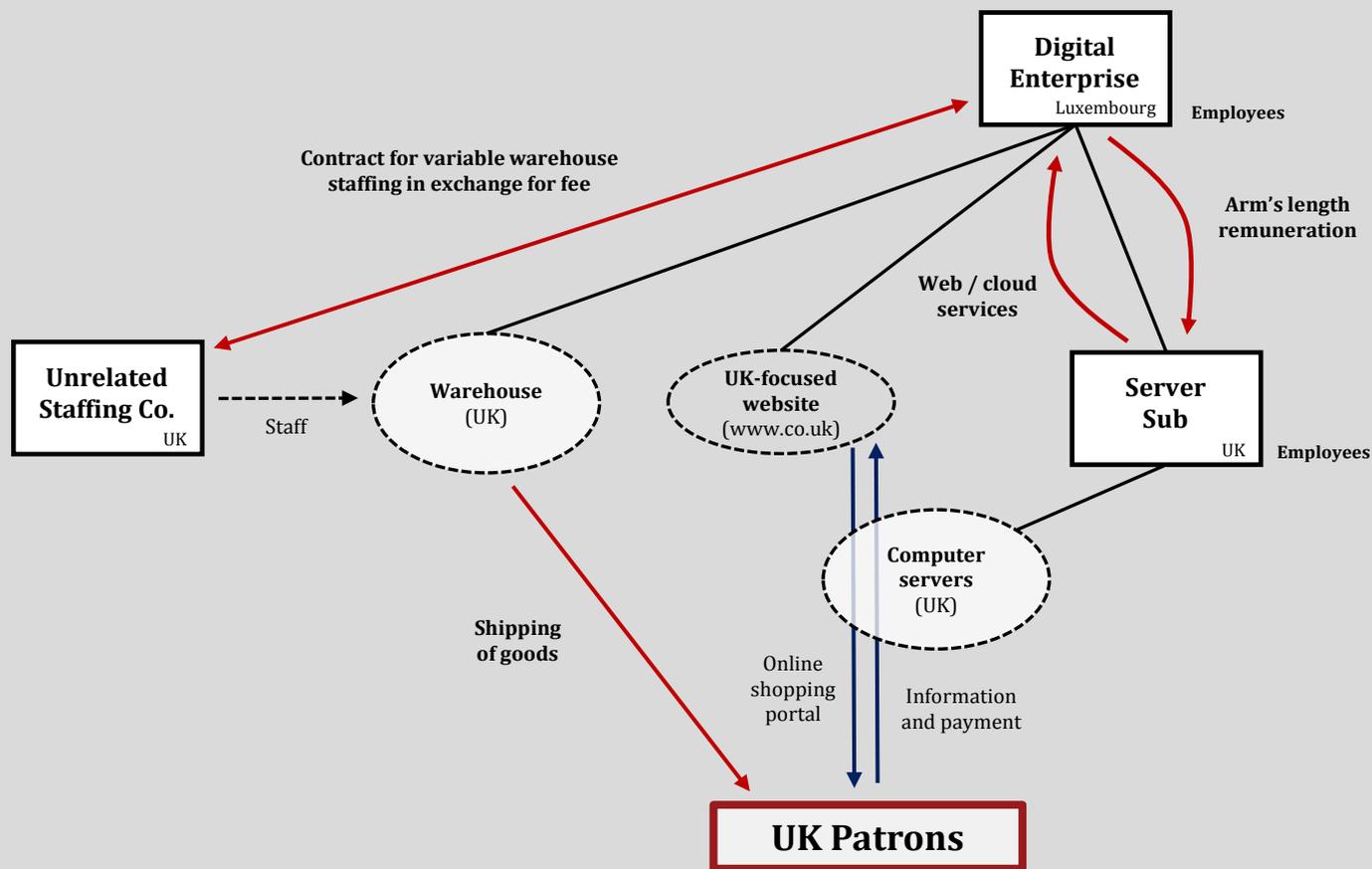
- In 2003, OECD adopted PE commentary relating to digital business – clarifying that digital operations in a country will not automatically establish a PE for the foreign enterprise. See Art. 5 commentary, ¶¶ 42.1 – 42.10
  - **Distinguish physical from intangible** – the commentaries distinguish *physical facilities* that are owned / leased (e.g., server creates potential for a PE) versus *intangible online presence* (website is not tangible, and thus not a place of business and generally not a PE).
  - **Servers at one’s disposal** – must distinguish between having server dedicated and at one’s disposal versus a more general hosting arrangement.
  - **Core vs. preparatory / auxiliary** – distinguishes “core” business activities from prep / aux activity, noting that essential activities may fail prep / aux status even if listed as such.
  - **Website cannot be agent** – is not a “person” and thus cannot be dependent agent.

# EXISTING OECD POSITION (CONT.)

## Summary of existing OECD commentary's salient points

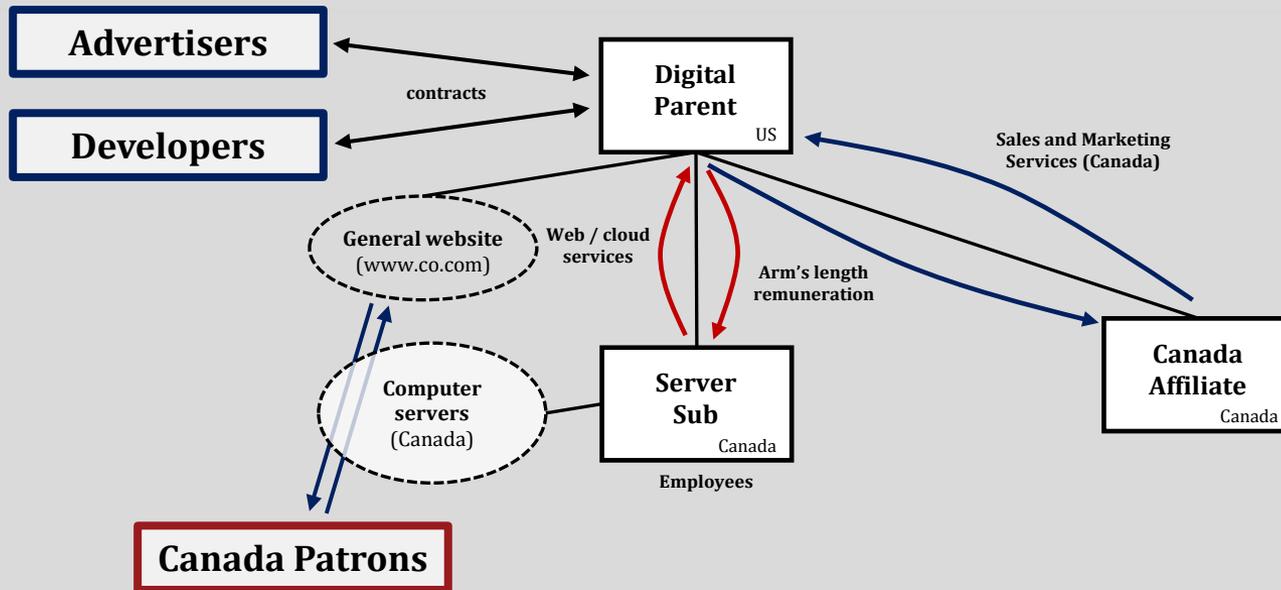
- **Servers may be PEs** – if foreign enterprise owns, leases or has at its disposal servers or computer equipment at a fixed location, then such equipment *may* be PE under normal rules
- **Core functionality**
  - **Servers performing non-core activities**– even if a foreign enterprise might own a server located in a country, a PE will not be created if the server is merely performing *preparatory or auxiliary* functions (generally thought to include advertising, supplying or gathering info, data backup, etc.)
  - **Servers performing core activities**– equipment and/or personnel that performs “core” functions of the foreign enterprise – such as a server owned or considered to be at the disposal of the enterprise (e.g., because isolated / sequestered in a locked cage for security reasons) may create a PE
  - **What are “core” activities?** – may be factually intensive inquiry due to multi-sided digital business models, but is critical to identify core activities. For instance, query whether an e-tailer’s “core” activities might include *concluding contracts, processing payments and shipping goods for delivery?*
- **Website is not a *place of business nor an agent***

# APPLYING EXISTING OECD COMMENTARY



- **Query – Taking into account existing OECD model and commentary, does Digital Enterprise have a PE in the UK?**

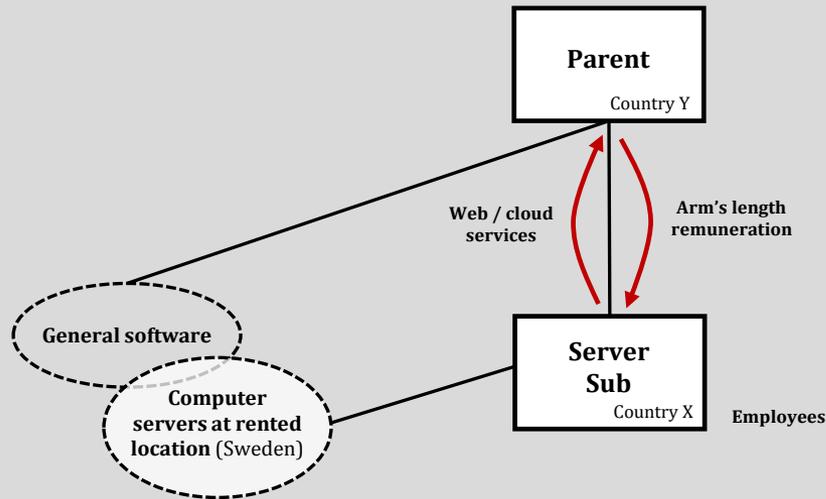
# CANADA – WEB HOSTING



## No PE due to subsidiary's web-hosting services

- CRA Ruling 2012-0423141R3 (2012) – advance ruling
- **Background** – Digital Parent (“USP”) appears to be in the online app or media store business, but does not operate country-specific sites. Advertisers and developers contract with USP to advertise content (demographically directed to users) and to sell digital content (e.g., a developer will sell apps directly to a user via USP’s platform). USP hosts its website using cloud-based technology, meaning all server farms are potentially available to host all data even though optimal performance dictates that users typically served by local servers. The Canadian Affiliate provides marketing / sales support activities to USP so it can expand its Canadian base of users / advertisers / developers. USP’s website historically hosted on data centers owned or leased by USP in the US; but USP proposes to help finance Server Sub (“SS”) so that SS can construct, own and operate a server farm in Canadian province. ...*(cont’d)*
- *(cont’d)*... SS will provide USP with website and data hosting capacity for arm’s length fees. The server farm will host all website and data, and servers provide automatic services (e.g., data storage and processing, transaction processing, etc.) and will host advertising content. In essence, a fully-functional app / media store website. To retain integrity of data control, SS cannot use/process the data that USP has in the server farm, except as a service provider under USP’s instructions. SS is not a party to any agreement to provide services to users, advertisers or developers, and it cannot legally or economically bind USP. The server farm will be maintained by SS and access to it is restricted to SS’s employees (although USP’s employees may visit from time-to-time). The applications/data hosted at the servers will be *managed by USP employees from outside of Canada*. The purpose of the server farm is to reduce latency and provide redundancy.
- **Ruled** – USP will not have a PE in Canada as a result of the arrangement.

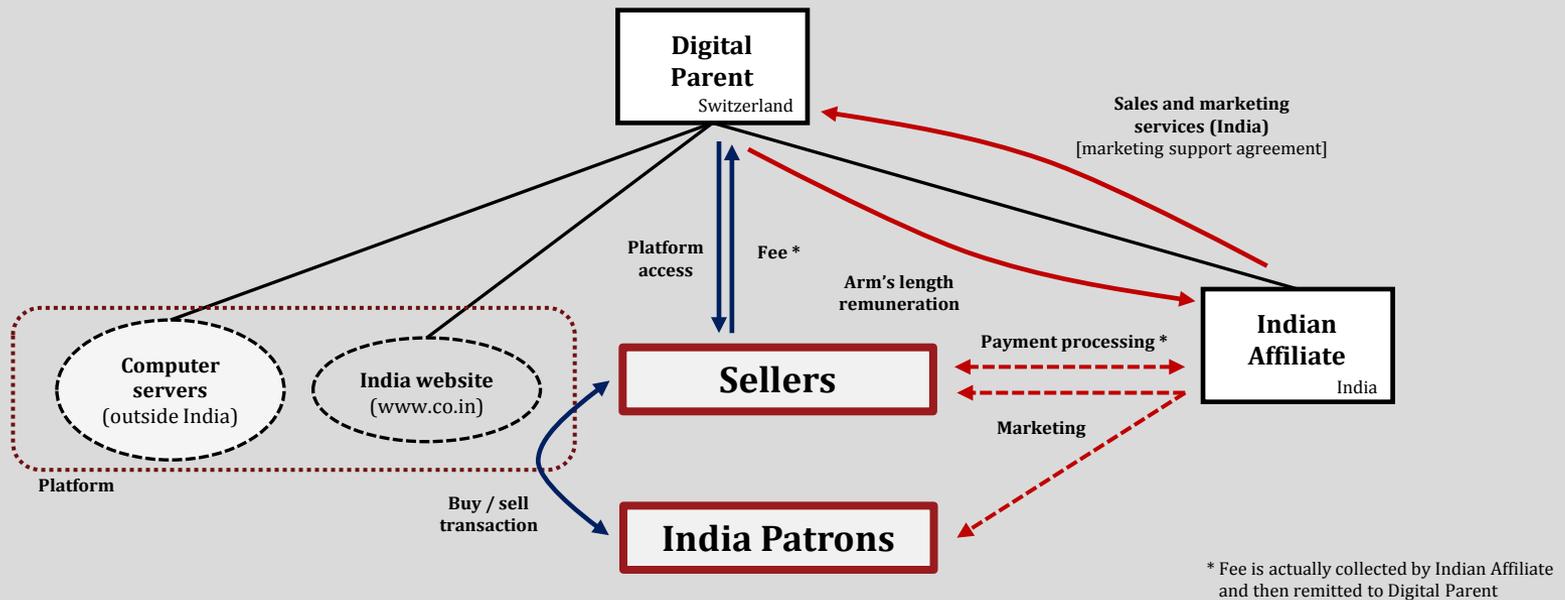
# SWEDEN – WEB HOSTING



## Uncertain PE due to subsidiary's web-hosting

- Swedish Council for Advance Rulings (June 12, 2013) – advance ruling
- **Background** – Parent and Server Sub are both foreign enterprises, thinking about setting up cloud facilities in Sweden to support the supply of software within the MNE group. Server Sub would buy a server and place it in a rented location in Sweden, and make space available on the server to Parent. Parent would use the server space to store its wholly-owned software. The only real business of Server Sub would be to manage the server and software stored on the server. All other activities by Parent and Server Sub would take place in their country of residence. The group came in for advance ruling that setting up this arrangement would not create a PE in Sweden.
- **Issue** – Does the establishment of server and operating software constitute a PE in Sweden, or is it solely preparatory / auxiliary activity?
- **Ruled** – Parent merely owned intangible asset (software) stored on a server in Sweden, and thus not a PE in Sweden. However, Server Sub's "core" activity is letting space on a server situated in Sweden; accordingly, Server Sub's activities are its "core" business and cannot be preparatory or auxiliary and thus Server Sub has a PE in Sweden.
- **Follow on information** – Following the ruling, the Swedish Tax Agency (!) appealed the case to the Swedish Supreme Administrative Court ("SAC") arguing that **no PE** should arise in this case. It appears that the SAC has actually removed the advance ruling due to a lack of sufficiently detailed information
- **Now what?** – No clarity in Sweden on the status of servers and PEs!

# INDIA – MARKETING SUPPORT



## No PE due to subsidiary's marketing support

- *eBay International AG, Mumbai ITAT (Oct. 2012) – ruling by Indian tribunal*
- **Background** – Digital Parent (“Swissco”) operated the eBay India platform (from outside India), and engaged an Indian subsidiary (“Indian Affiliate”) to provide support services (pursuant to a “marketing support agreement”) in respect of the Indian website. These services included (1) providing market data, (2) providing marketing / promotional services in India as directed by Swissco, (3) perform payment processing and collection activities, (4) at the direction of Swissco prepare and discuss India-business related budgets and provide relevant market data, (5) furnish reports and information regarding its activities as necessary, (6) suggest what Indian legal requirements must be satisfied for the business, and (7) other admin / support activities requested. On the payment processing / collection side, Swissco raises invoices to the sellers and instructs to remit to Indian Affiliate (not Switzerland)...(cont'd)
- (cont'd)...Indian Affiliate does not participate in getting sellers to list on eBay (only markets possibility of doing so), and does not get involved in transactions between sellers and India patrons. Swissco compensates Indian Affiliate on a cost + 8% basis. All transactions between sellers and India patrons, and between sellers and Swissco, take place online through websites managed outside of India. Indian Affiliate does not negotiate or conclude contracts, participate in establishing sellers on the platform or otherwise manage, maintain or operate the revenue-generating websites.
- **Ruled** – Swissco has no PE in India, and thus no business profits taxable in India. Indian Affiliate was dependent agent because legally / economically dependent on Swissco, but had no authority to conclude contracts. Indian Affiliate also did not create a PE under the *place of management* listing b/c it only provided market support services and had no role to play in the online business between (1) sellers and buyers, or (2) Swissco and sellers.

# TRENDING

## Spain – Dell (2012)

- “Virtual” PE in Spain – foreign enterprise maintained website *dedicated to Spanish market* but had no hardware (e.g., servers) or employees in Spain; merely utilized services of Spanish affiliate for limited scope work. Court nonetheless found foreign enterprise has Spanish PE

## France – digital business report (January 2013)

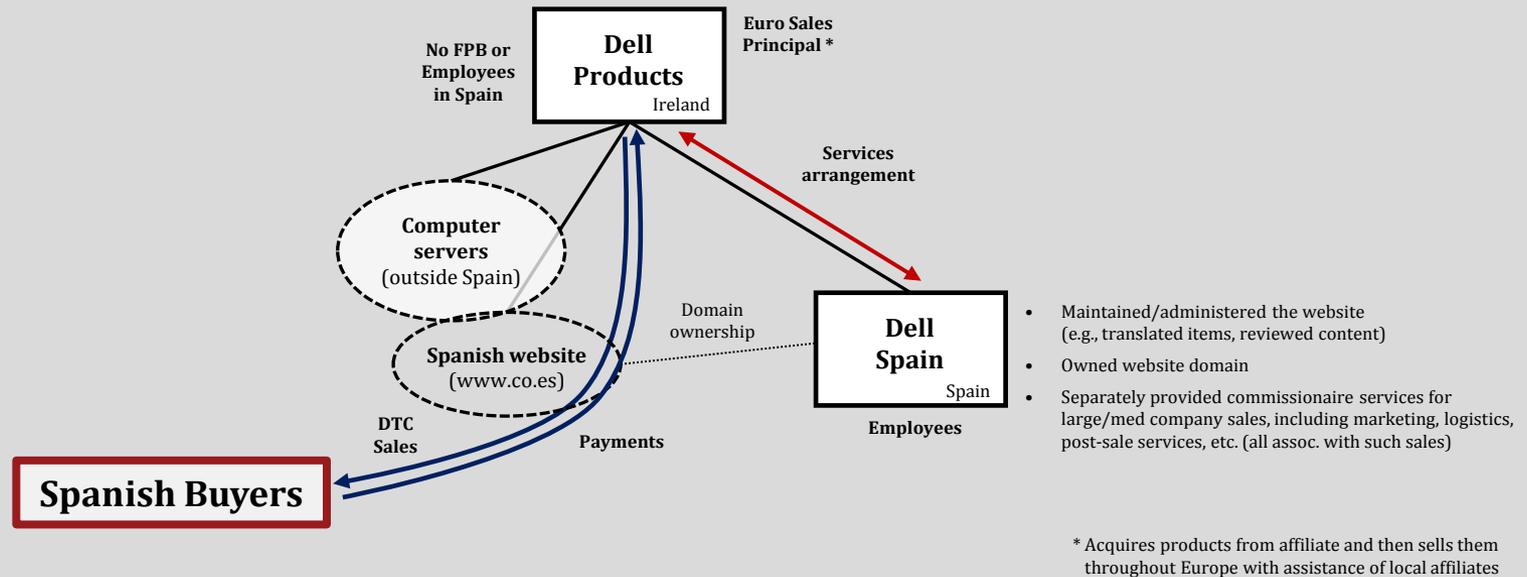
- Proposes controversial new PE standard for digital era; seeks to tax foreign digital enterprises
- Asserts that data collection (i.e., collection of personal data from internet users) is a central component of value creation in a digital economy; thus, harvesting that info should trigger tax
  - Suggests internet users working for free, providing info useful for selling targeted advertising
- Questions the validity of current PE definition – says is outdated, but recognizes need for international cooperation to effectuate change

*“[T]he goal should be to have a permanent establishment **each time data is collected** on a domestic market to fuel a business targeted on that same market.”*

*– Nicolas Colin (report co-author), Forbes (Jan. 28, 2013)*

- Also proposes VAT changes for digital business

# SPAIN – VIRTUAL PE



## Virtual PE due to site and subsidiary's support

- *Dell*, Spanish Central Economic Administrative Court (TEAC), Mar. 15, 2012
- **Background** – Dell Products (“Parent”) is European sales company for Dell. It owned Spain-targeted website and servers (all outside Spain), and engaged in direct sales to consumers (e.g., through the website or call center). Parent had no employees or facilities in Spain. Dell Spain (“Sub”) had employees in Spain, which provided assistance (in addition to other services it provided as noted below) and helped with logistics, marketing, post-sale activities and *maintenance / admin.* of the website (translation, reviewing content, etc.). It also had legal ownership of the domain name.
  - **Note:** Sub was a commissionaire as to other sales. In 1995, there was a restructuring whereby it went from a *full-fledged distributor* in Spain to merely a commissionaire for large/med company sales.

- **Ruling** – The court (aside from the commissionaire basis for finding a PE), found that Parent had a “virtual” PE in Spain as a result of (1) owning a *Spain-targeted* website through which it sold goods into Spain, and (2) Sub employees in Spain provided services associated with the site (e.g., web page translation, content review, maintenance/admin), and (3) Sub owned the domain (though not clear what significance here). Found that online PE justified b/c Parent’s activities *economically significant* in Spain (e.g., selling and delivery) and *Sub’s employees* helped maintain the online store. The court seemingly rejected OECD commentary notion that web site doesn’t generate PE unless server physically present there. Also said that Spain had put in an observation into the e-commerce commentaries in 2003 and 2005 that it may not necessarily take the commentary into account until OECD has concluded on these items. (Incidentally, Spain removed that observation in 2010, but the court didn’t state that.) Court misreads commentaries to come up w/ what many believe is a “substantialist” tact when dealing with post-restructuring scenarios.

# BEPS AND DIGITAL BUSINESS

## OECD / G20 BEPS project

- **BEPS Action 1** (*Address the Tax Challenges of the Digital Economy*)
  - **16 September 2014** – 202-page report released
  - **Key takeaways**
    - **No ring-fencing** – the “digital economy” is in fact “the economy” so no sense in isolating it and creating special tax rules for it; however, VAT should be carefully considered. The digital economy issues should be addressed through other efforts, including those relating to PE, CFC rules and transfer pricing; regardless, the task force on the digital economy will continue work
    - **PE approach** – the report proposes to leave Action 7 to deal with the fragmentation possible in the digital economy – e.g., through changes to Art. 5(4) specific exemptions
      - **Original PE proposals** – included (1) modifying Art. 5(4) exemptions (e.g., eliminating “delivery,” reconfirming that “core” activities cannot get a pass, etc.), (2) creating a new PE standard of “significant digital presence,” or (3) creating a “virtual” PE standard
    - **Views** – there remain certain areas of continued disagreement (e.g., importance of data in driving value for tax purposes), but consensus seems to exist that action is needed to clarify PE (presumably via Action 7)
- **BEPS Action 7** (*Preventing the Artificial Avoidance of PE Status*) – see discussion, *infra*.
  - **31 October 2014** – 26-page discussion draft released



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## **OTHER EMERGING PE ISSUES**

# BEPS ACTION 7 – “ARTIFICIAL” PE AVOIDANCE

## Overview

- BEPS Action 7 (*Preventing the Artificial Avoidance of PE Status*) discussion draft on 31 Oct. 2014
- Seemingly reflects digital business (BEPS Action 1) concerns
- Offers alternative approaches, and proposals do not represent consensus views of OECD
- All focused on making PE more likely – very wide potential impact and significant for MNEs

## Proposal #1 – modify agency rules

- Seeks to broaden Art. 5(5) (dependent agent) and narrow Art. 5(6) (independent agent)
  - Targeting commissionaire structures, but potentially hits other limited-risk distributors
  - Increased possibility that agent’s office viewed as “at the disposal” of foreign enterprise?
- Art. 5(5) – modify the “conclude contracts” wording to broaden dependent agent capture
- Art. 5(6) – modify to indicate that independence generally requires work done for various persons *and* not (almost) exclusively for one / associated person

# BEPS ACTION 7 (CONT.)

## Proposal #2 – modify specific exemptions to PE in Art. 5(4)

- All seem to target the digital economy
- **Key proposal** – *all* listed exemption activities must be independently preparatory / auxiliary
  - Assuming this is not adopted, discussion draft proposes alternatives to key proposal
  - *Alternative #1*: remove exemption for use of facility for delivery of goods (a UN-styled approach)
  - *Alternative #2*: remove exemption for purchasing goods or collecting information (a French favorite!)
    - Here, suggestion is to either (a) delete both activities, or (b) delete only purchasing activity from passage
- **Anti-fragmentation proposal** – **expand** existing OECD commentary that prohibits the fragmentation by a (single) enterprise of a “**cohesive operating business**” into *multiple* small operations for the purpose of arguing that each is of a preparatory / auxiliary activity
  - Focuses on whether **complementary business activities** are carried on (1) either (a) at the same location by associated enterprises or (b) at different locations by the same or associated enterprises, and (2) there is at least one FPB or the combination of activities goes beyond what is prep / aux
    - **Very subjective and likely to generate uncertainty / veil piercing / disputes** – What is “cohesive operating business”? What is “complementary”? Where does storage / display end if *delivery* exemption gone?

# BEPS ACTION 7 (CONT.)

## Other miscellanea

- Discussion draft also addresses a few other points
  - **Splitting-up contracts** – the discussion draft contemplates options to avoid splitting up of contracts to avoid PE status under the Article 5 *durational tests* (e.g., project site PE, service PEs)
    - Propose to automatically aggregate activities of associated enterprises, or apply the BEPS proposed treaty-abuse “principle purpose test” to attack “tax motivated” situations
  - **Insurance sector PE issue** – issues involving insurance agents
  - **Profit attribution to PEs** – seemingly suggests that preliminarily no real changes needed to existing Art. 7 attribution rules, although later BEPS action items may still have influence

## Parting thoughts

- How genuine is the claim of “restoring” vs. changing? (source vs. residence tax rights)
- Query whether changes will really result in materially greater attribution of profits
- 100% guaranteed to generate greater subjectivity / uncertainty / controversy; palatable level of attention-deficit regarding dispute resolution / prevention

# HIDDEN PEs

## Compliance issues

- Expansive / interpretative articulation of PE may result in “hidden PE” compliance failures
  - Italy Supreme Court of Cassation decision no. 16106/2011 – PE is autonomous taxpayer and different from head office; therefore, profits of Italian PE of non-resident company to be assessed in the hands of Italian subsidiary (the undisclosed PE) rather than in the hands of the non-resident company
    - Notice of assessment must go to, and be challenged in court only by, the undisclosed PE
  - How to satisfy compliance obligations if PE not anticipated at outset?
    - For instance, “connected” standard (e.g., service PE test) not clearly articulated; taxation of employees relying on “business visitor exception”
    - Disagreement as to characterization of activity/item?
- Will hidden PE assertions in audit intensify if State Aid inquiries fail?

## PEs within boxes – the new normal?

- OECD Art. 5(7) appears ripe for leverage by gov’t in audit given profit attribution oppty
- Philip Morris (Italy 2002) and similar



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**THANK YOU...**

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**BRIAN DAVIS** is a partner in the Washington, D.C. office of Ivins, Phillips & Barker. He has practiced in all areas of U.S. federal income taxation, with considerable experience assisting public and private businesses with U.S. and global tax planning matters. He regularly serves as a trusted tax adviser to Fortune 200 companies and high net worth individuals, and has also worked in industry as Director of International Tax for a publicly-traded global media conglomerate. Brian is regularly engaged by corporate and tax executives seeking proficient and pragmatic advice regarding cross-border transactional design and implementation, as well as general troubleshooting of domestic and international tax matters.

Brian regularly speaks at events sponsored by TEI (where he previously served as Vice Chair of the International Tax Committee), the International Fiscal Association and the American Bar Association. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

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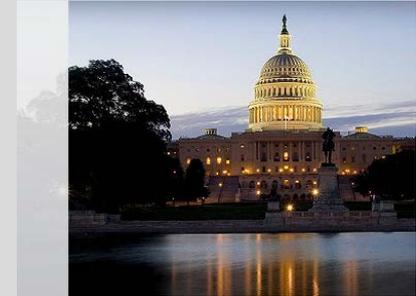
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