European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on

**BEPS ACTION 7:
PREVENTING THE ARTIFICAL AVOIDANCE OF PE STATUS**

Members of EBIT at the time of this submission: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.

EBIT Comments on the OECD's Discussion Draft on BEPS ACTION 7: Preventing the artificial avoidance of PE status

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Dear Marlies,

EBIT welcomes this opportunity to provide comments to the OECD on the Discussion Draft on "BEPS Action 7: Preventing the Artificial Avoidance of PE Status 31 October 2014 - 9 January 2015" which was issued on 31 October 2014 (hereinafter "the Discussion Draft").

General Comments

- EBIT generally supports the OECD's work to address artificial avoidance of PE status and to eliminate double non-taxation through PEs and ensure that tax is properly charged on activities that are valuable and integral to MNC's business operations.

- EBIT welcomes proposals aimed at mitigating the legitimate concerns of the G20 and OECD in this context, however, they should not give rise to more double taxation and other unintended consequences for genuine cross-border businesses. The preamble of the Discussion Draft outlines that the BEPS Action Plan intended the update of the treaty definition of PE to prevent abuses of that threshold, but did not mention the widening of the definition and the wider reconsideration of the allocation of taxing rights between source and residence countries which is now also proposed by the OECD. We believe that this approach will augment the risk of "collateral damage" in particular, double taxation in non-abusive circumstances, and may well result in a proliferation of "new PEs", the majority of which will have trivial attributable profits. There is thus a significant danger that a hugely expanded compliance burden will result for both businesses and tax authorities. The proposed solution may be worse than the current problem that is limited to those MNCs that are abusing the exceptions to PE and artificially avoid taxation, whereas MNCs not abusing PE rules currently face issues in various States due to a lack of uniformity of PE rules and interpretations (e.g.: qualification of PE by local tax authorities based on domestic law without applying treaty provisions, or interpretation of the tax treaty divergent from OCDE guidelines; in the case where a PE exists under the tax treaty, issues as regards attribution of profits and potential double taxation due to non-application or unusual interpretation of tax treaty (often linked to recent - or inexistent - local transfer pricing rules).

- EBIT therefore urges the OECD to make its proposed measures more targeted in nature, either by finding a way to limit the expansion of the PE definition to those situations which should be brought into tax; or, if it is concluded that the PE definition has to be broadened in ways similar to those outlined, then measures to "carve-out" from the extended definition of PE those PEs which would have trivial, and perhaps zero, profit attribution.

- EBIT is moreover of the opinion that it is also necessary that the OECD considers the indirect tax consequences and impacts of any changes to the definition of PEs. Not only does a PE for corporate tax purposes in many countries trigger indirect tax registration (and expensive compliance issues) but there is currently also a need for clarity between the definition of PE for corporate tax purposes and that of a fixed establishment for indirect tax purposes.

Specific comments

A. Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies

- EBIT Members note that all four alternatives have in common that they on the one hand propose a restriction of the independent agent exemption and on the other propose a broadening of the dependent agent concept. All four alternatives are aimed at defining a PE against a less objective and more subjective standard for determining whether a PE exists.

- They do so by barring the use of affiliated enterprises in commissionaire arrangements and by taking away the possibility for an independent agent to act exclusively or almost exclusively on behalf of an enterprise, combined with rewording of "an authority to conclude contracts in the name of the enterprise".

- We believe this unduly narrows the independent agent exemption and eliminates a long standing international taxation principle that an agent can be independent even if it acts exclusively for one party or one or more affiliated enterprises if appropriate criteria are met. This restriction of the independent agent exemption will bring into the scope of the PE definition almost all agency arrangements within a group, given that such agents rarely provide same services to their affiliates and to third parties.

- We are also concerned that the proposed changes to the dependent agent test will impact not only commissionaire arrangements but also other arrangements for making direct sales or providing sales support.

- EBIT considers that there are examples where an intermediary, not carrying on an independent business, carries on activities in a country which result in regular conclusion of contracts to be performed by a foreign enterprise in cases where there is no abusive intention, where the activities have been carried on in a similar manner for a long period of time without giving rise to concern and where this is the only practical way of conducting the business. The OECD should ensure that in such cases, the activities of the intermediary should continue to be regarded as preparatory or auxiliary.

- EBIT urges the OECD to propose more targeted measures, either by finding a way to limit the extension of the PE definition to those situations which should be brought into tax by considering actual conduct of the parties rather than relying on the mere absence of agreements of an agent with third parties; or allow "carve-outs" from the extended definition of PE to those PEs which would have trivial or zero profit attribution.

- To prevent a proliferation of small/trivial PEs as a result of the proposed changes, the OECD could consider introducing a fiscal threshold with regard to the physical presence of sales from an enterprise and any affiliated entities from outside the jurisdiction in which the PE might arise, below which a company would not create a PE. Sales arising from PEs and affiliated entities within the jurisdiction in which the PE might arise should not be counted for the purposes of the threshold. Such a threshold should be set at $1m.

- In this context, EBIT Members are gravely concerned about the U.K. Government's unilateral newly proposed diverted profits tax which may be introduced in April 2015 ahead of any BEPS agreement on Action 7 and outside the consensual BEPS process. The new rules will tax large MNCs at a rate of 25% on profits that the legislation deems they would have earned if they had set up a PE in the UK, and substantially weakens the distinction between "trading in" the UK (taxable in the UK) and "trading with" the UK (not taxable in the UK) and deeming non-UK based MNCs to be trading in the UK. We are concerned this will set a precedent for other jurisdictions to ignore the BEPS process and set their own definitions of a PE.

B. Artificial avoidance of PE status through the specific activity exemptions

- The Discussion Draft examines four aspects of Article 5 (4) in each case providing options to counter aspects that the Working Group sees as potentially triggering artificial avoidance of the PE threshold. However, EBIT Members strongly believe that it is changes in technology and business models that are driving the pressure on the PE definition in this instance, not artificial structures as such, and we have concerns around the proposed watering down of the specific activity exemptions.

- All four options proposed in the Discussion Draft are likely to lead to collateral damage and have unintended consequences in some areas. Inter-company arrangements that are entirely commercially driven and have no BEPS motive whatsoever are likely to be negatively impacted by the proposed changes to Article 5 (4), perhaps even to the extent that management would consider changing the preferred trading model in order to minimise double taxation risk. This is clearly not an intended consequence of Action 7 which seeks to prevent only "artificial avoidance" of PE status.

- EBIT Members would like to offer concrete examples of potentially unintended consequences:

  Example 1: In the commodities or energy trading business, typical commodities or energy trading operations will have only a few companies which enter into transactions with third parties around the world. Negotiations are carried out by employees of these companies in the jurisdiction (not a tax haven) in which they are resident and contracts are concluded by telephone or online. The trading company has no economic substance (people activity) in the majority of countries with which it trades. However, in order to satisfy the delivery of products the trading company may rent from third parties warehouses or tanks to store the products prior to delivery. The margin earned from the trading operation is taxed and should remain to be taxed in the country of residence of the trading company where all economic activity takes place.

  Example 2: In order to place spare parts closer to key customers Company A holds a stock of spares at the premises of one of its foreign subsidiaries (Company B). Spares are delivered from Company A's stock (by third party freight forwarders) to customers throughout the region. Company B is remunerated by Company A on an arm's length basis for the warehousing function. Whereas previously Article 5(4)(a) would have provided certainty that Company A had not created a PE in country B, the removal of "delivery" from Article 5(4) in accordance with Option F changes a bright line test into a subjective one and the risk that the tax authorities of country B might deem Company A to have created a PE by virtue of the Company B warehouse constituting a fixed place of business. Although the PE risk could be mitigated by Company A storing the stock in a third party warehouse in country B (which, owing to the unrelated party relationship is unlikely be considered a fixed place of business of Company A) this clearly makes no commercial sense if Company B had the requisite facilities to store Company A's stock.

  Example 3: The Option G proposal of deleting the purchasing exemption would create uncertainty for MNCs that utilise regional purchasing hubs to facilitate procurement from regional suppliers on behalf of one, or a number of, group companies.

  Example 4: The Option E requirement for all Article 5 (4) exemptions to be preparatory and auxiliary also creates PE exposure for groups employing regional purchasing models as purchasing activities of any business are unlikely to be considered preparatory or auxiliary in nature. In addition, if the regional purchasing hub is *negotiating material elements supplier contracts* then this would suggest an agency PE is created for all group entities that procure from the regional suppliers as Options A-D do not discriminate between the conclusion of customer contracts and the conclusion of supplier contracts.

- We would agree that Article 5 (4) is intended to and should only cover preparatory or auxiliary activities. EBIT advocates that any amendments to the definitions of activity within Article 5 (4) are only made where changes in business models suggest a change is needed, as in the case of warehousing, rather than qualifying the entire list.

- EBIT Members would generally prefer the approach as set out in options F-H. However, in regard to option H, in EBIT's view, whilst technology allows far more data to be collected and stored than ever before, the mere collection of data does not, of itself, create value. Where the collection of information is a core function of the enterprise, it may be appropriate to regard the activity as more than preparatory or auxiliary. A functional analysis may be required but the exemption for the maintenance of a fixed place of business for the purpose of collecting information should not be removed altogether in our view because this would greatly increase the risk of disputes and double taxation. In our view, it is not practical to seek to attribute profit to a PE represented by third parties who are providing information for free to an enterprise.

- EBIT urges the OECD to retain the reference to 'delivery' in Article 5 (4). Except for facilities used for the purpose of the display of goods, any other premises that are used for storage are also used for delivery, as goods at some point in time are shipped from the premises where they have been stored. As currently drafted, removing the reference to delivery from subparagraphs a) and b) of paragraph 4 of Article 5 as currently drafted would equally and practically mean that the use of premises for the purpose of storage would also be out of the PE exceptions, irrespective of the core business of the enterprise. Importantly, if the option to remove the exemption for the delivery of goods is adopted nevertheless, the Commentary will need to specify when storage/display ends and when delivery starts, and address the case of the use of premises for storage and delivery when delivery is not the core activity of the enterprise, thus remains auxiliary.

- Where there has been artificial fragmentation of activities in order to bring an entity within the preparatory or auxiliary exclusion there may be a valid case for doing so. However, EBIT is concerned that the Discussion Draft does not distinguish these cases from the many cases where the fragmentation reflects a genuine commercial arrangement, where, for example, activities have been divided between legal entities in order to focus the business or to manage risk from a commercial perspective. This is therefore likely to prove highly contentious in practice and might offer an opportunity for adopting a more aggressive stance by tax authorities (see also section on splitting up of contracts C below).

  As an example, Company A (resident in State A) has a PE in State C (successive construction projects), and related Company B (resident in State B) performs a preparatory or auxiliary activity (collecting information) in State C. Company A performs operational activity whereas Company B is its headquarter. Under the proposed Discussion Draft, if the activities are considered as cohesive business operation, Company B will have a PE in State C (this would assume that Tax Treaty B-C includes provision to qualify a PE based on the cumulated activities performed by related entities and not only by a given legal entity). Although such qualification should not apply here, local tax authorities may challenge this view (e.g. on the ground that collected information supports the business and conclusion of contracts). This being said, if B performs preparatory or auxiliary activity, the taxable income of the PE should be nil.

  If Company B performs an activity which is not preparatory or auxiliary (as listed in existing Article 5.4), but does not qualify as a PE on a standalone basis, it does not seem that the revised wording would apply, since it is inserted as paragraph 4 (1) and starts with “Paragraph 4 shall not apply to …”.

- EBIT considers that in general, the target and impact of the rewording should be clarified.

C. Splitting-up of contracts

- EBIT considers that the proposed PPT would ensure that in cases where contracts are split up for legitimate commercial reasons the enterprise is not inappropriately deprived of the benefit of the threshold. We note that under the first proposed approach, i.e. the automatic rule as proposed under K on page 22 of the Discussion Draft, this would not be granted. EBIT therefore does not welcome the automatic rule approach. Rather, we'd advocate that the Model Tax Convention make an exception for cases where there are genuinely separate contracts either for particular genuine commercial purposes or as a result of the history of the enterprise.

- EBIT is concerned that the options proposed in the Discussion Draft could lead tax authorities to becoming more aggressive in applying the treaty PPT anti-abuse test, which would result in more uncertainty about the application of the PE definition rules as a whole. Although the Discussion Draft does explain that the PPT would apply only to tax-motivated cases and not where there are legitimate business purposes for the involvement of associated enterprises, this distinction is likely to prove highly contentious in practice, and especially under EU Law. EBIT urges the OECD to make sure that none of its proposals breach EU Law, as otherwise 23 out of the 44 BEPS countries will be unable to adopt the recommendations.

E. Profit attribution to PEs and interaction with action points on transfer pricing

- EBIT welcomes the OECD’s acknowledgment that the work on Action 4 (interest deductions), Action 7 (PEs), Action 8 (intangibles) and Action 9 (risks and capital) are all interlinked and will all need to be considered in connection before contemplating amendments to the existing profit attribution rules. The discussion on the definition of PE and profit attribution should also be linked.

- The Discussion Draft implies that the creation of a source country PE by the principal would result in the attribution of additional taxable profit to the source country. However, to the extent that the affiliate resident in the source country is already being remunerated on arm’s length terms by the principal for routine functions performed locally, it is difficult to see what additional profit (if any) should be attributed to the PE based on the arm’s length principle. Whilst the Discussion Draft acknowledges that additions/clarifications (but not substantial changes) to the existing rules and guidance is necessary, a key concern is that tax authorities could use the amended Article 5 to deem a PE of the principal had been created but deviate from the OECD standard when it comes to apportioning profits to the said PE and disregarding the profits already being taxed locally in the hands of the affiliate.

- EBIT urges the OECD therefore to take a holistic approach with regard to the reconsideration of some aspects of the existing rules and guidance on PE profit attribution.

- EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss and remain committed to a constructive dialogue with the OECD.

Yours sincerely,

European Business Initiative on Taxation – January 2015

For further information on EBIT, please contact the EBIT Secretariat via Bob van der Made, Tel: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

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