

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS:

BASE EROSION AND PROFIT SHIFTING (BEPS)



SUBJECT

THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (“OECD”) ISSUES FINAL REPORT ON ACTION ITEM 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS

SUMMARY

This alert is one installment in a series of alerts on the release of the OECD/G20 Base Erosion and Profit Shifting Project (“the BEPS Project”).

On October 5, 2015, the OECD released the final report (the “Report”) of the BEPS Project. This alert discusses Action Item 7: Preventing the Artificial Avoidance of Permanent Establishment status.

The OECD, a non-governmental forum established to promote economic growth, has developed a 15-point action plan to shape “fair, effective and efficient tax systems.” The OECD’s project regarding BEPS has addressed issues arising from tax planning strategies that exploit gaps or mismatches in member countries’ tax rules.

BACKGROUND AND DETAILS

In an effort to address BEPS issues in a coordinated and comprehensive manner, the G20 finance ministers called on the OECD to develop an action plan to equip countries with instruments that will better align tax with economic activity. Generally, under tax treaties, the business profits of a foreign

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enterprise are taxable in a State only to the extent that the enterprise has a permanent establishment (“PE”) in that State to which the profits are attributable. Multinational companies often utilize certain strategies to minimize the risk of PE and taxation in a particular country in which business transactions occur. Action Item 7 of the BEPS project focuses on the prevention of artificial avoidance of PE status.

The Report includes changes that will be made to the definition of PE in Article 5 of the OECD Model Tax Convention (the “Convention”). Article 5 of the Convention is widely used as the basis of treaty negotiations relating to PE issues. Together with Action Item 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, the changes will impact the taxation of cross-border income that may otherwise go untaxed or is taxed at very low effective rate of tax.

Through the utilization of different strategies to conduct cross-border business activities, multinationals have been able to avoid PE status in particular jurisdictions. These strategies include the use of: commissionaire arrangements; specific exceptions such as preparatory and auxiliary activities to avoid PE status; and the construction site exception to avoid PE status.

Action Item 7 discusses how the use of commissionaire arrangements has been used to minimize PE status in certain jurisdictions and describes how a commissionaire arrangement has been used in global transactions. A *commissionaire* arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. The Report provides that, in using such arrangements, a foreign enterprise is able to sell its products in a jurisdiction without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). A foreign enterprise that uses a *commissionaire* arrangement does not have a PE because it is able to avoid the application of Article 5(5) of the Convention, to the extent that the contracts concluded by the person acting as a *commissionaire* are not binding on the foreign enterprise. Since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a jurisdiction. *Commissionaire* arrangements have been a major preoccupation of tax administrations in many countries, as shown by a number of cases dealing with such arrangements that were litigated in OECD countries. In many of the cases that went to court, the tax administration’s arguments were rejected, and the affected multinationals enterprise’s arguments prevailed. The Report recommends changes to Article 5 to address these types of arrangements.

Since the introduction of these treaty-defined exceptions many years ago, there have been dramatic changes in the way that business is conducted. This is outlined in detail in the report on [Action Item 1: Addressing the Tax Challenges of the Digital Economy](#). Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may now correspond to core business activities. In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) of the Convention is modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character.

The Report also addresses concerns related to Article 5(4) which arise from what is typically referred to as the “fragmentation of activities.” Multinational enterprises (MNEs) may alter their structures to obtain tax advantages by fragmenting or splitting the various activities being conducted in the same jurisdiction to avoid a PE. Action Item 7 now provides that the substance of all the activities may be considered in determining whether a PE exists.

The exception in Article 5(3), applicable to construction sites, has also given rise to abuses through the practice of splitting-up contracts between closely-related enterprises. The Principal Purposes Test (PPT) rule that will be added to the Convention as a result of the adoption of the report on Action Item 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, will address the BEPS concerns related to such abuses.

BDO INSIGHTS

Multinationals should review their activities and transactions and how the changes recommended in Action Item 7 impacts their business operations and tax liability. Some countries have taken action in advance of the final report. For instance, the United Kingdom enacted its diverted profits tax earlier in 2015 to combat some of the tax planning used to avoid a PE. Other countries have indicated that they may enact similar laws to strengthen their general anti-abuse statutes. The risk for double taxation will exist for multinationals depending on how individual countries implement any changes from Action Item 7.

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