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11 June 2015

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Via Email: taxtreaties@oecd.org

RE: Revised Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status

Dear Ms. de Ruiter:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to Action 7 of the Plan, "Prevent the artificial avoidance of PE status," the OECD issued a public discussion draft on 31 October 2014 (hereinafter the October Draft). After receiving comments and holding a public consultation on the October Draft in January 2015, on 15 May 2015 the OECD released a revised discussion draft entitled *BEPS Action 7: Preventing the Artificial Avoidance of PE Status* (hereinafter the Revised Discussion Draft or Revised Draft). The OECD requested comments on the Revised Draft no later than 12 June 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,

at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.[1]

TEI Comments

TEI commends the OECD for the substantial improvements of the proposed modifications to the definition of a permanent establishment (PE) in Article 5 of the OECD's model tax convention, as reflected in the Revised Discussion Draft. In particular, limiting the application of paragraph 6 of Article 5, regarding independent agents, to cases where the agent is "connected" to an enterprise ensures that there is a proper basis to impute the actions of the agent to the enterprise for purposes of creating a PE of the enterprise. Leaving in place the specific activity exceptions of paragraph 4, regarding activities that are generally of a preparatory or auxiliary nature, instead of eliminating one or more of them, is also welcome.

Even with these improvements, many of the changes proposed in the Revised Draft will regrettably lead to an increase in uncertainty and controversy over the tax consequences of entering new markets. The uncertainty will discourage cross-border business operations, whether they are conducted by a multi-national enterprise (MNE) entering a new market or a local company expanding internationally for the first time. As we discussed in our comments on the October Draft,[2] the tax consequences of inadvertently creating a PE are drastic and therefore any uncertainty regarding whether a PE exists is amplified and will result in a concomitant reduction in international business activity.

Revised Option B – Paragraph 5

Paragraph 5 of Article 5 of the OECD model convention addresses the circumstances when the use of a dependent agent by an enterprise within a state will give rise to a PE of that enterprise in that state. The Revised Discussion Draft sets forth "Option B" as the preferred option to address concerns arising from the use of *commissionaire* arrangements by MNEs to conduct business in a jurisdiction without creating a PE. While paragraph 5 of Option B is unchanged from the October Draft, TEI commends the OECD for recognising in the Revised Draft that "the changes to Art. 5(5) were not intended to address BEPS concerns related to the transfer of risks between related parties through low-risk distributor arrangements . . . ."[3] Thus, the Revised Draft proposes to include a paragraph in a revised official commentary to Article 5

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[1] TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

[2] *See* letter dated 23 December 2014, regarding *Public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status*, available at http://www.tei.org/news/Pages/TEI-Comments-on-BEPS-Action-7-Preventing-the-Artificial-Avoidance-of-PE-Status.aspx.

[3] Revised Discussion Draft, p.12

providing that the changes from the previous definition of a PE in the OECD model convention are not intended to reach a "so-called 'low-risk distributor' as long as the transfer of the title to property sold by that distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold)."[4] This is a welcome clarification.

Nevertheless, portions of the proposed revisions to the official commentary in the Revised Discussion Draft raise significant concerns. First, the expansion of "habitually concludes contracts" to "habitually concludes contracts or negotiates the material elements of contracts" is so broadly worded that it will be applicable to some of the most basic business practices of MNEs, will capture much more than the targeted *commissionaire* arrangements, and will apply to many transactions that do not raise BEPS-related concerns. For example, many businesses require goods and services to be delivered in multiple locations around the world. To ensure that the goods and services are always provided under the same terms and conditions, to meet the same standard, and to save time in negotiation and administration of contracts, a global master service agreement is often negotiated by a lead service provider (*e.g.*, the parent company). The master service agreement terms are then incorporated by reference into local agreements with local subsidiaries. The local agreement is reviewed, approved and signed by the local subsidiary; however, to keep each local subsidiary from re-negotiating the contract, modifications are generally limited to changes that are necessary because of specific local business needs or to satisfy local legal, tax and other regulatory requirements. The local agreement will generally arrange for the provision of the local goods and services and for taxes to be paid on the local activities by the local subsidiary.

Given the relationship between the entity negotiating the master service agreement and the local affiliates, the independent agent carve-out as proposed in new paragraph 6 of Article 5 will not apply. Thus, it seems under the Revised Draft the parent company likely will have a PE in each location that a local agreement is executed based on the master services agreement. Given that the local subsidiary is already paying tax for its local activities, the lead service provider (*i.e.*, the parent) that negotiated the global master agreement should not also have a PE in the local jurisdiction merely by virtue of the agreement. Moreover, no additional taxes would likely be assessable if there is no material change to the profit attribution rules. However, the creation of a PE of the parent company would add complexity and administrative burden if having a PE means that the lead service provider would be required to register and file tax returns. In addition, the number of disputes and potential double taxation will likely increase due to different interpretations of what constitutes "negotiating material elements of contracts" or in the application of modified profit attribution rules that are still to be determined.

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[4] *Id*. at 16.

The proposed commentary of the Discussion Draft also stretches the interpretation of the phrase "concludes contracts" beyond any reasonable definition. Specifically, paragraph 32.4 indicates that a contract may be considered to be concluded in a state (i) even without any active negotiation of the terms of that contract, or (ii) if a person accepts, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise even if the contract is signed outside of that state. MNEs often create standard legal templates to save time and resources relating to negotiation and administration of contracts that are unrelated to any perceived attempt to engage in base erosion or profit shifting. The above new interpretation of concluding contracts as proposed is overly broad and would create unintended PEs where no BEPS activities are evident.

TEI recommends that the "habitually negotiates the material elements of contracts" only be applied where there is an actual abuse of a treaty's provisions and where the applicable tax is not otherwise being paid by the local subsidiary. Although *commissionaire* structures have been targeted by the OECD, they remain acceptable from a legal and commercial standpoint and tax authorities should not automatically consider a business' choice of such a structure to be abusive. The Member States' primary concern seems to be that profits from the sale of goods and services are not being taxed to the same extent as they would be if the sales were made by a distributor. TEI understands that the OECD fears that profits from the transaction would otherwise be untaxed or taxed at very low rates, but that remains a factual interpretation and should not *per se* be ruled as abusive by employing the broad language proposed in the Revised Draft. A more concise rule would serve taxpayers better. If the OECD refuses to make concise recommendations, it should use broad definitions sparingly. Thus, the new interpretation on concluding contracts under paragraph 32.4 should be abandoned and the years of case law and interpretation on concluding contracts should be left in place.

Proposed changes to the specific activity exemption

The Revised Discussion Draft proposes changing paragraph 4 of Article 5 by requiring that each of the specific activity exemptions to PE status be of a preparatory or auxiliary character. The Revised Draft also includes substantial revisions to the commentary on this paragraph of Article 5, including examples set forth in paragraph 22.5 of the Revised Draft that raise concerns. In particular, in Example 1 the only activity being performed in State S is the purchasing function, which is performed through an office and staffed by "experienced and well-paid buyers."[5] From the example, it is not clear what the offending BEPS activity is and what deeming RCO (the out of state purchaser) to have a PE in State S would achieve other than increasing RCO's registration and administrative filing requirements. Assuming there are no sales to customers in State S and there is no material change to the profit attribution rules, if the purchasing office is deemed to be a State S branch (PE) of RCO, it will merely have continuing

5 *Id*. at 26.

branch losses. However, the above deemed PE may have a tax impact if the profit attribution rules substantially change (*e.g.*, to global apportionment of income). Is that the OECD's intention?

Would the deemed PE arise if instead of being part of RCO, there is a separate legal entity whose only function is purchasing or research and development activities or any of the specific activity exemptions, or would the separate legal entity be respected? If respected, presumably the separate legal entity would enter into related party transactions with its various affiliates; therefore, it is more appropriate to apply the transfer pricing rules to ensure that each entity pays the proper amount of tax.

Anti-Fragmentation Rule

The Revised Discussion Draft proposes a new paragraph 4.1 to Article 5 addressing the fragmentation of cohesive business activities into constituent elements, all of which are of a preparatory or auxiliary nature even though the activities taken as a whole would constitute a PE. The Revised Draft adopts "Option J" from the October Draft (with minor changes) and would allow aggregation of activities that together rise to the level of a PE to attribute a PE to the enterprise carrying on the activities. This new paragraph would apply if, for example, an enterprise had an established business line within a country that constituted a PE and then a second business line of the enterprise began operations within the same country. The operations of the second business line would thus be considered part of the PE of the first business line, even if the second business line was wholly separate from the first and was conducted via a separate legal entity (as long as that legal entity was "connected" to the first). The only limitation on combining activities is that they must "constitute complementary functions that are part of a cohesive business operation."

This is a form of a force of attraction rule that does not comport with modern business practices in MNEs. As noted in our prior comments, many MNEs are divided functionally on a worldwide basis so that, *e.g.*, the purchasing function is separated from the manufacturing operation, which is separated from the sales function. Each of these functions would have its own management, reporting lines, and financial statements. Commercial advantage is the primary driver behind utilising the specialisation, expertise, economies of scale, and flexibility that accompanies this manner of conducting worldwide operations. These separate organisations may then enter particular markets to carry out their specialised functions in the most tax efficient manner, which may include avoiding PE status. TEI therefore recommends that no such paragraph be included in a revised Article 5.

In addition, the approach in the Revised Draft to combine separate functions of an enterprise to create a PE seems to be inconsistent with the approach taken in the 22 May 2015 revised discussion draft under BEPS Action 6: Prevent Treaty Abuse. The Action 6 draft

proposes adding a limitation on benefits (LOB) provision to the OECD model that can be satisfied where an enterprise carries on an "active business" within a jurisdiction (see Paragraphs 70-72 of the Action 6 draft). The proposed revisions to the LOB provision in that draft, however, only permit aggregation of business activities conducted by different related persons if such "persons are in the same or a similar line of business." Obviously, this language differs from the "complementary functions that are part of a cohesive business operations" in the Revised Draft. TEI recommends that the OECD conform these approaches or further explain the reasons for the differing language.

Splitting-up of contracts

The Revised Discussion Draft also includes recommendations that would address enterprises splitting-up related contracts to avoid the 12 month PE threshold in paragraph 3 of Article 5. The Revised Draft includes an example illustrating the issue being addressed, along with an alternative provision that might be included in paragraph 3 listing factors that may be relevant in determining whether "connected" activities were split-up to avoid the paragraph 3 time threshold. These factors include "whether the conclusion of additional contracts with a person is a logical consequence of a previous contract with that person or related persons."[6]

The example is of little use in explaining the issues raised by MNEs splitting up contracts because it presents a simple case of a 22 month construction contract being broken up into two 11 month contracts, each with a separate entity of the contracting enterprise. Moreover, the contracts are negotiated and executed simultaneously (it appears) and provide for joint and several liability. The Revised Draft concludes these separate contracts can be aggregated under a revised OECD model treaty. Beyond this simple example and the optional factors listed, however, taxpayers are left with little guidance on when separate contracts will be aggregated for purposes of the 12 month period in paragraph 3 of Article 5. TEI submits that the factor addressing whether the additional contract was a "logical consequence" of a prior contract is overbroad and misleading. For example, a purchaser may put out for bid a contract to build, *e.g.*, a system prototype and award that contract to Company A, which then builds the prototype over a nine month period. Sometime later, perhaps months or longer, the purchaser then awards the contract for full production of the product based on another solicitation of bids to unrelated Company B. Obviously in that case Company A should not have a PE because it does not satisfy the 12 month threshold. However, if Company A was awarded the subsequent full production contract, under the proposed rule it runs the risk that the production contract will be aggregated with the contract for the prototype and retroactively cause Company A to have PE back to the beginning of the prototype contract. This would appear to be the case even if there was no guarantee that Company A would be awarded the production contract and even if a substantial period of time had passed between the prototype and full production contract

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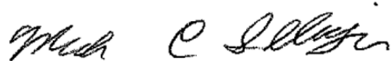
[6] *Id*. at 35-36.

periods – because the awarding of the production contract could be interpreted as a "logical consequence" of awarding the prototype contract. TEI recommends that the OECD include an example in the final guidance under Action 7 along these lines and also specify that if the awarding of a subsequent contract was a later event contingent on actions outside of the contractor's control, then that should be a factor in deciding whether to aggregate contracts for purposes of the 12 month rule.

Conclusion

TEI appreciates the opportunity to comment on the OECD Revised Discussion Draft regarding the artificial avoidance of permanent establishment status. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.



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