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ELI J. DICKER
Executive Director

W. PATRICK EVANS
Chief Tax Counsel

23 December 2014

Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial
Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via Email: taxtreaties@oecd.org

RE: Public 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 Discussion Draft or Draft). The Discussion Draft recommends modifications to the definition of a permanent establishment (PE) in Article 5 of the OECD's Model Tax Convention on Income and Capital (Model Convention). The modifications address when certain activities conducted by a multi-national enterprise (MNE), or an agent acting on behalf of the MNE, will constitute a PE of the enterprise.

The OECD requested comments on the Discussion Draft no later than 9 January 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments. In addition, TEI requests the opportunity to speak in support of these comments at the public consultation meeting on the Action 7 Discussion Draft, scheduled for 21 January 2015 in Paris.

I. TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals.[1] 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.

II. TEI Comments

TEI commends the OECD for recommending changes to the definition of a PE in the Model Convention itself rather than modifying the OECD's official commentary on the Convention (the Commentary). Changes to the Commentary are more susceptible to differing interpretations among tax authorities. Moreover, in certain cases, changes to the Commentary may effectively amend the language of the Model Convention without the deliberative process required for amendments to the Convention. Modifying the language of the Model Convention will more likely lead to consistent application of PE definition across tax authorities, which will provide certainty for taxpayers and result in less controversy and litigation. In addition, TEI welcomes the continued focus on physical presence in the general definition of a PE under paragraph 1 of Article 5 – "a fixed place of business through which the business of an enterprise is wholly or partly carried on" – which remains undisturbed in the Draft.

A. Background Considerations

Article 5 of the Model Convention was designed, in part, as a kind of "safe harbour" to avoid or minimise international disputes regarding taxing jurisdiction between source and resident countries. By both broadening the definition of a PE and limiting the exceptions to that definition, the Discussion Draft moves the tax jurisdictional line in favor of the source country. The impetus for this move is primarily tax authority dissatisfaction with *commissionnaire* structures that do not constitute a dependent agency arrangement under paragraph 5 of Article 5 and the perceived improper exploitation of the specific activity exceptions in paragraph 4. The move towards source country taxation and a broader reach of the PE definition, however, is in tension with the OECD's work on transfer pricing documentation under Action 13 of the Plan and the requirement of a detailed value chain and economic analysis to set appropriate transfer prices. A proliferation of PEs within an MNE's operations will only complicate this analysis when determining the proper amount of remuneration between a PE and the rest of the enterprise.

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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).

Moreover, it should be unsurprising that MNEs strive to avoid creating a PE in a particular jurisdiction just as they strive to avoid double taxation in transfer pricing matters between jurisdictions. An unanticipated PE assertion may result in unexpected – and potentially drastic – tax consequences, an exacerbated compliance burden, and double taxation. Just as unsurprisingly, these potentially drastic consequences incentivise tax authorities to assert a PE. Indeed, in the experience of TEI's members, some countries go so far as to assert a PE to force MNEs to settle on unrelated transfer pricing issues, or even as a way to "make up" for taxes the authorities are unable to collect on transfer pricing matters. The OECD should recognise that it indirectly encourages tax authorities in these endeavors by introducing unnecessary uncertainty into the PE definition while also lowering the PE threshold.

Regrettably, the Discussion Draft begins on the wrong footing by stating that "in many cases *commissionnaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where the sales took place."[2] Elsewhere, the Discussion Draft labels certain taxpayer arrangements as an "abuse"[3] or not in conformance with the "original purpose"[4] of Article 5 of the Model Convention. Proceeding from the premise that most, if not all, of the arrangements described in the Discussion Draft are "artificial" has apparently freed the OECD to propose sweeping changes to the PE definition. These changes, however, are either more appropriate to abusive situations, such as the ability of tax authorities to ignore separate legal entities and recharacterise contracts, or would be better effected elsewhere, such as through transfer pricing rules. No matter which of the various options in the Draft the OECD chooses in the final amendments to Article 5, the changes to the PE definition will increase the uncertainty of when an enterprise's activities, or the activities of an agent, will give rise to a PE as compared to the current rules. This will result in more controversy and litigation, consuming both taxpayer and tax authority resources.

B. Elimination of *Commissionnaire* Structures and Similar Arrangements (Options A through D)

As noted, the Discussion Draft generally views *commissionnaires* as structured "primarily" to permit MNEs to erode the tax base of the State of sale. There is no discussion, however, of the *commissionnaire* as a legitimate business arrangement often used by unrelated parties to conduct their respective enterprises. The Draft thus offers no analysis of why a *commissionnaire* should be considered an "artificial" mechanism when used by an MNE to operate its business. The Discussion Draft adopts this view of *commissionnaires* across the board, even in cases when a *commissionnaire* approach best reflects the relationships in place within an MNE, which are generally organised for legitimate business reasons (such as delineating

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2 Discussion Draft, pages 6 and 11.

3 *See* Discussion Draft p.7 (regarding the "abuse" of Article 5(3) through the "splitting-up of contracts").

4 *See id*. (regarding the use of the specific activity exceptions in Article 5(4) to avoid PE status).

delegations of authority and responsibilities, reducing compliance costs, or avoiding tax volatility). Indeed, in some cases a *commissionnaire* structure may result in an increased profit allocation to a high tax jurisdiction, which is hardly evidence of source State base erosion.

In this regard, it is worth noting that many, if not most, MNEs generally no longer take a country-by-country "silo" approach to their affairs by constructing a separate, fully integrated operation in each jurisdiction. Instead, operations take place on a worldwide basis with a more homogenous approach to the activities conducted in a particular jurisdiction when compared to other jurisdictions. MNEs generate product demand through global advertising rather than via sales personnel "on the ground" negotiating and concluding contracts with customers in individual countries. In this business environment, utilising a *commissionnaire* arrangement in individual jurisdictions makes commercial sense from a cost minimisation standpoint by eliminating the need for a fully integrated, local sales and distribution operation, whether or not an MNE's local tax burden is reduced. A *commissionnaire* structure is also relatively simple as it allows an MNE to concentrate its inventory ownership in a single company within an MNE group.

Nevertheless, the OECD has clearly concluded that *commissionnaire* and similar arrangements must be eliminated, at least between related parties. The Discussion Draft thus proposes four alternative amendments to paragraphs 5 and 6 of Article 5 of the Model Convention (referred to as Options A through D), each of which would likely eliminate the *commissionnaire* arrangement. Each of these options, however, also come with potentially negative collateral consequences for both taxpayers and tax authorities.

Before commenting on Options A throug D, it bears noting that while a *commissionnaire* may result in the reduction of the local tax base in certain circumstances, restoring a "fair allocation" of taxation rights – in this case by eliminating *commissionnaires* – will not necessarily mean an increase in local taxable profits. In a number of industries, overall profit margins are much lower than prior to the 2008 financial crisis. Thus, while a *commissionnaire* has low – but also stable and positive – profits, this does not mean that the foreign principal is enjoying excessive profits (as the example in paragraph 7 of the Discussion Draft appears to assume). Indeed, there may be instances where a principal company bears significant losses simply because the MNE's overall profit is not sufficient to ensure that all limited function and risk entities (*e.g.*, manufacturers, distributors) receive an appropriate positive return. This raises an issue for OECD Member States and other participants in the BEPS project of whether they will accept that such losses will be allocated to their jurisdictions as part of "restored balance between source and residence states" through the elimination of *commissionnaires*. A buy-sell entity, in contrast to a *commissionnaire*, will not necessarily be protected from sharing in the overall loss of an MNE, which may include a local loss. That is to say, by attempting to tax a greater share of an MNE's profits attributable to a PE under a modified PE definition, the Member States must also welcome a greater share of MNE risks and potential losses attributable to that same PE.

1. *Options A through D Amending Paragraph 5 of Article 5*

Options A through D present several alternative changes to paragraph 5 of Article 5, each of which is intended to eliminate the ability of an MNE to utilise a *commissionnaire* arrangement to distribute its products in the *commissionnaire's* jurisdiction without giving rise to a PE. While each of these options would likely succeed in eliminating such arrangements, the cost of that result is increased uncertainty surrounding the activities of an agent that give rise to a PE of an enterprise. This undermines the primary advantage of the current text of paragraph 5 – the certainty of whether an MNE has a PE through the activities of a person as a dependent agent.

The added uncertainty of the proposed changes in Options A through D is particularly regrettable in the PE context because the consequences of creating an unexpected PE can be dire. These may include a tax on the gross amount of an MNE's revenue through the denial of allocable deductions for all years in which the PE existed, along with interest and penalties. Moreover, the number of years subject to tax could be significant because the statute of limitations may not begin to run until a return has been filed in the jurisdiction. In addition, substantial double taxation will almost certainly result from the creation of an unexpected PE. Thus, unlike transfer pricing adjustments that generally occur along a spectrum, the "PE or no PE" determination is generally an all or nothing exercise that significantly raises the stakes of any dispute. The injection of substantial uncertainty into the PE definition and its attendant potentially substantial tax consequences will negatively affect the free flow of capital across borders, particularly for enterprises contemplating entry into new markets.

Turning to the PE definition itself, in general, under current paragraph 5, if a person acting on behalf of a foreign enterprise does not sign contracts that are legally binding on the enterprise – "conclud[ing] contracts in the name of the enterprise" in the language of the Model Convention – then the person's activities will not give rise to a PE of the enterprise. This approach is simple to apply and draws a clear line between what the person can and cannot do on behalf of the enterprise without giving rise to a PE. Options A through D would eliminate these clear lines and introduce additional uncertainty to the PE determination.

A potential alternative to Options A through D would be to simply add to the current text of Article 5 that "any related *commissionnaire* (or similar arrangement) will be characterised as a limited risk distributor for purposes of" the Model Convention. Any resulting controversy can then be determined through a transfer pricing analysis of the proper remuneration of the limited risk distributor, rather than through a retroactive assertion of a PE and the difficult process of attributing profits to the PE under Article 7 of the Model Convention. This approach would provide clarity while addressing the OECD's target with few unintended consequences. It may, however, be viewed as a targeted special rule not suitable for inclusion in the Model Convention, which characteristically uses broader language of general application. Absent such an approach, of the four alternatives proposed in the Discussion Draft, in TEI's view Option D

provides the clearest indication of when the activities of an enterprise will give rise to a PE, although it is by no means perfect.

When compared to Options A through C, Option D has the advantage of requiring that person acting on behalf of an enterprise either "conclude contracts" or "negotiate the material elements of contracts" before the enterprise will be deemed to have a PE because of the person's activities. Further, this person must also "habitually" engage in these activities – a term used in current paragraph 5 and therefore presumably one that will have the same meaning in new paragraph 5. Concluding contracts and negotiating material elements delineates the focus of any dispute over whether the activities of a person create a PE – did the person sign contracts? Did the person negotiate material elements of contracts? If so, did the person do this "habitually"? The primary uncertainty under Option D will be whether contract term is "material." Tax authorities may view materiality differently than taxpayers or even other tax authorities. In TEI's view, material elements may include the price, number of items, the personnel performing the contract, the delivery terms, *etc*. This uncertainty will undoubtedly result in a greater amount of controversy than the current text of paragraph 5. Such controversy will, however, almost certainly be lower than the controversy that would arise if the OECD adopted one of Options A through C.

With respect to "material elements" of a contract, TEI recommends inserting the word "commercial" so the text reads "material commercial elements." This would help focus this portion of new paragraph 5 on the "business" terms of the contract. Other contractual elements that might be described as "standard" or "boilerplate" and are negotiated by, *e.g.*, an enterprise's legal department or other personnel responsible for the enterprise's non-core functions, rather than its business personnel, should not be considered material elements and their negotiation should not give rise to a PE. Such elements would generally include representations and warranties, choice of law provisions, indemnifications, confidentiality and privacy provisions, audit rights, insurance, *etc.* TEI recommends that the OECD develop a representative list of contract terms that may generally be considered immaterial for inclusion in the Commentary, as well as examples of various approaches to determining materiality.

Option D also requires a legal relationship between the person and the enterprise, such that a contract is "on the account and risk of the enterprise." This requirement, which is not included in Option B, provides additional certainty about who may act on behalf of an enterprise. As the explanatory note with respect to similar language in Option C states, "[t]his formulation refers to contracts that are on the account and risk of the foreign enterprise *by virtue of the legal (not economic) relationship* between the person and the intermediary . . . ."[5] The use of a legal relationship to determine whether a contract is on the account and risk of an enterprise is preferable to the use of an economic relationship. A legal relationship is generally evidenced by a signed, written contract, whereas an economic relationship is indeterminate and highly

[5] Discussion Draft, p. 14 (emphasis added).

dependent on particular facts and circumstances that constantly change and may be difficult to determine with sufficient certainty.

In sum, these elements make Option D the best of the four Discussion Draft options that would eliminate *commissionnaires* because it provides the most guidance and certainty to taxpayers and tax authorities, despite being inferior to the current text of paragraph 5 in that regard. Further, Option D is preferable to Option B because Option D requires a legal relationship between the foreign enterprise and the person acting in the local jurisdiction on the enterprise's behalf.

Option A, on the other hand, would include the following language in Article 5(5) for determining when an enterprise will be deemed to have a PE in a Contracting State:

> where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts
>
> 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 a right to use, or
>
> c) for the provision of services by that enterprise . . . . [6]

This language is too vague and overbroad to provide the necessary certainty to the PE definition. In particular, it is unclear what is meant by the term "specific persons." The explanation merely notes that this is intended to cover situations where the intermediary (the "person" in the modified paragraph 5 language) habitually interacts with "identifiable persons" in a way that results in the conclusion of contracts. The use of identifiable persons is no more helpful than specific persons.

More problematic is the language "in a way that results in the conclusion of contracts." It is unclear what is required for activities to "result[] in the conclusion of contracts." Does the activity have to be a "but for" cause? Does it need to be a necessary and sufficient activity? Could it be merely a necessary activity? Option A does not specify which of these alternatives may apply (if any). The language becomes even more difficult to apply when (i) there is more than one "but for" cause for, or more than one activity leading to, the conclusion of a contract, and (ii) those causes or activities are performed by different persons in different locations. The explanation attempts to provide additional clarification by stating that the language is intended to cover situations where the intermediary's interactions with identifiable persons "directly result" in the conclusion of contracts. A "direct result" would "require a direct causal

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[6] Discussion Draft, p. 11-12.

connection between that interaction and the conclusion of the contract."[7] This attempt at clarification, however, merely repeats Option A's proposed language in a slightly different form. The explanation also states that the language "would not, however, require that the contract be formally concluded by the intermediary." Thus, Option A is vague and substantially departs from the clarity of the current language of paragraph 5 by removing the bright line of formal contract conclusion by the intermediary and replacing it with a nebulous "engages with" or "habitually interacts" standard that has no clear bounds so long as a contract "results" from the intermediary's activities. Further, potentially any engagement or interaction that a tax authority could plausibly point to as "resulting" in the conclusion of contracts would create a local PE. The language is therefore also overbroad.

The same language is used in Option C, which should also be rejected for the reasons set forth above with respect to Option A.

2. *Proposed Modifications to Paragraph 6 of Article 5*[8]

The Discussion Draft proposes to replace current paragraph 6 in its entirety. Paragraph 6 provides that an enterprise will not have a PE in a jurisdiction if it carries on business in that jurisdiction through an independent agent acting in the ordinary course of the agent's business. This paragraph is an exception to the "deemed" PE of paragraph 5 for enterprises that operate through a dependent agent. New paragraph 6 would continue to provide an exception for independent agents operating on behalf of an enterprise in the ordinary course of agent's business, so long as the agent also acts "on behalf of various persons." The second sentence of new paragraph 6, however, states that "[w]here . . . a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises." Thus, under new paragraph 6, the independent agent exception is not available if a person acts exclusively for a foreign enterprise, even if the person is not associated with the enterprise (*i.e.*, where the person is an unrelated third party).

While the intent of new paragraph 6 to remove the "independent" status of exclusive agents is relatively clear, its application is problematic in certain respects. First, it is unclear how to determine whether an agent is acting "exclusively or almost exclusively" on behalf of an enterprise. The Draft does not provide a time period for measuring when a person acts "exclusively." This raises the possibility that an "exclusive" relationship may arise over any period of time, no matter how short. TEI recommends that paragraph 6's new language be changed to: "[w]here . . . a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises **<u>for a period of at least 12 months</u>**" then the person will not be treated as an independent agent. This would provide certainty to when a nominally

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[7] Discussion Draft, p. 12.

[8] Options A through D propose identical changes to paragraph 6 of Article 5.

independent agent will not be accorded that status under Article 5. Concerns that such a change would encourage a foreign enterprise to structure its contracts with an in-country agent to avoid the 12 month threshold could be addressed in the same manner as changes suggested in the Draft under paragraph 3 (discussed below).

Second, it is also unclear how to measure when an agent acts "almost" exclusively on behalf of an enterprise or related enterprises. Potential measures include revenues generated, time spent, number of clients, a combination of the three, or some other measure. For example, if an agent has a client that generates 95% of its revenue, and a single other client generates 5%, does that agent act "almost exclusively" on behalf of the first client? Suppose instead of a single other client, ten clients account for the other 5% of the agent's revenue, and also 15% of the agent's time – does the result change? Or what if it is three other clients and 10% of the agent's time? And again, the Discussion Draft does not provide a time period for measuring the various gauges of exclusivity. Further, the language raises the possibility that an enterprise could end up with a PE through no activities of its own if an agent no longer acted on behalf of other clients. That is, if an agent with two clients that each accounted for 50% of the agent's business loses one of those clients, would the other client have a PE because the agent is now acting "exclusively" on behalf of that client?[9] For these reasons, a better approach would be to eliminate the "almost exclusively" language from new paragraph 6 and provide that an agency PE cannot be created if the exclusivity arises through the unilateral actions of the agent or the unrelated clients of the agent. Another alternative would be to prescribe, perhaps in the Commentary, measurement approaches to the "almost exclusively" analysis.

Third, it is unclear whether an agent that acts exclusively or almost exclusively on behalf of an enterprise, but only performs preparatory or auxiliary functions, could nevertheless constitute a PE of the enterprise. It appears that this cannot be the case as such an agent would then fall under paragraph 5, which states that a person acting on behalf of an enterprise will not constitute a PE of the enterprise if the person's activities are limited to those in paragraph 4, regarding preparatory and auxiliary activities. Nevertheless, the OECD should clarify that an exclusive agent that does not qualify for the exception to PE status in paragraph 6 for independent agents is not a PE under paragraph 5 if it only performs activities described in paragraph 4.

New paragraph 6 would also subject to PE status cases where an unrelated and independent, yet exclusive, agent operates in that manner for non-tax business reasons. For example, an agent may be exclusive to a particular enterprise to protect that enterprise's trade secrets and other confidential information from competitors and yet be unrelated to the enterprise. Despite the lack of a tax planning motive, such an exclusive agent would constitute a PE, whereas under current paragraph 6 it would depend on whether the agent was

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[9] This issue would be mitigated by the adoption of our recommendation to require exclusivity to run for at least 12 months.

"independent" and acting in the ordinary course of its business. This would create difficulties for certain businesses that operate through exclusive, and yet independent, agents in dozens of countries around the world. Under new paragraph 6, such a business would face the prospect of having a PE in each of those jurisdictions, potentially even in years where no contract is concluded in a particular jurisdiction. If a multi-billion dollar tender is won in such a country and a success fee is paid to the independent agent (treated as a dependent agent under the new language and thus constituting a PE), the allocation of the tax base will give rise to controversy between the enterprise's jurisdiction and the agent's jurisdiction, with the taxpayer in the middle.

Finally, the effect of new paragraph 6 on related party distributors, such as a limited risk distributor, is unclear. Some MNEs set up separate subsidiaries exclusively to market or distribute products or services in a new country. The subsidiary and its parent would be compensated for their respective functions and risks based on arm's length transfer pricing principles and each would be taxed on the income allocated to their respective tax jurisdictions. Under the proposed changes, however, the subsidiary may now be considered a dependent agent of the parent, thus creating a PE of the parent in the local jurisdiction. This appears to be the case even though the related local subsidiary would already have a PE of its own in the local jurisdiction. The local country may then attempt to tax the income related to the distribution arrangement twice, once to the parent and again to the subsidiary. The OECD should provide that if the related local entity already has a PE in the local jurisdiction, then it would be considered an independent agent with respect to its parent (or other associated enterprise) and not also constitute a separate PE of the parent (or enterprise). The correct amount of remuneration to the local entity could then be determined under transfer pricing principles.

C. Proposed Modifications to the Specific Activity Exemptions in Paragraph 4 (Options E through H)

The Discussion Draft proposes several alternative modifications to paragraph 4, which currently excludes certain activities or fixed places of business from creating a PE of an enterprise. As with the Discussion Draft's proposed alternatives to modify paragraphs 5 and 6, Options E through H would increase the uncertainty of determining whether the conduct of an enterprise gives rise to a PE.

In TEI's view, Option E is the most administrable and practical of the proposed changes to paragraph 4. Option E would require all of the various exceptions in paragraph 4 to be of a "preparatory or auxiliary character." Current paragraph 4 permits a business to carry out certain activities in a State regardless of the activities' character as preparatory/auxiliary or core business functions. While the lack of a distinction between the nature of the activities is one of the primary objections to certain portions of paragraph 4, the current paragraph nevertheless provides certainty to taxpayers and tax authorities (*e.g.*, it is usually a simple matter to determine whether an activity constitutes the "delivery" of goods). As modified by Option E,

however, paragraph 4 would continue to permit MNE's to position goods "in-country" for delivery to customers on a timely basis (*e.g.*, without unanticipated logistical setbacks or customs delays) without establishing a PE in cases where such positioning is not a core function or profit driver of the enterprise. The primary downside to Option E is that it places substantial pressure on determining whether an activity is "preparatory or auxiliary." This is ultimately a facts and circumstances determination that will depend on the key profit drivers of a particular MNE and industry.

Options F through H present alternative approaches if Option E is not adopted. Option F would remove the reference to "delivery" from subparagraphs a) and b) so the use of facilities for the delivery of goods or the maintenance of a stock of goods for delivery would not automatically be exempted from PE status. Option G would eliminate purchasing goods from the exception to PE status for the maintenance of a fixed place to conduct such an activity, which is now included in subparagraph d). Option H would eliminate subparagraph d) in its entirety, so the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information would no longer be automatically exempt from PE status.

The difficulty of Options F through H is that if an enterprise, *e.g.*, maintained a fixed place of business solely for the delivery of goods, then many tax authorities would automatically deem such a fixed place of business a PE under paragraph 1 of Article 5. This would be the case even though paragraph 1 requires not only a fixed place of business, but that the fixed place be one "through which the business of an enterprise is wholly or partly carried on." Of course, it could be said that anything an MNE does is part of its business, and thus any operation carried out through a "fixed place" constitutes a PE. Current paragraph 4, however, generally prohibits such an interpretation by permitting an enterprise to conduct certain activities from a fixed place without creating a PE. This allows an enterprise to conduct such activities while avoiding the attendant administrative burden and associated compliance difficulties of a PE (*e.g.*, allocating income and expenses to the activity for purposes of computing a net income tax). This is a logical approach in the PE determination for activities that are in the vast majority of cases minimal and immaterial, or at least are not key value drivers of an enterprise. Options F through H would all but eliminate this approach in the case of delivery, purchasing, and/or collecting information. Under these options, enterprises who conduct such functions in their business, but where the functions are not critical to the business's success or failure or are not key profit drivers, would be hesitant to enter new markets for fear of creating a PE.

Options G and H would each eliminate the exception to PE status for the maintenance of a fixed place of business "solely for the purpose of purchasing goods or merchandise . . . ." While these options appear to be targeted at MNEs that have a substantial in-country purchasing team, they would have the perverse effect of creating a PE for even a minor liaison desk at a particular supplier. Such desks are often merely maintained to pass on quality-control

data to the purchasing entity. It does not appear to be the intent of the OECD to create a PE for such an activity, which is clearly preparatory and auxiliary.

For enterprises where delivery, purchasing, or information collection constitute a profit drivers (even if only one among other drivers), Option E should be sufficient to cause such activity to give rise to a PE of that enterprise.[10] In TEI's experience, such functions will often not be key profit drivers for businesses. In particular, businesses that maintain a stock of goods in a local country to deliver to other businesses (so-called "B2B" transactions), are unlikely to view the storage of goods as something other than preparatory or auxiliary, as this is just an additional service to its customers. Even in cases where expedited delivery is critical for B2B transactions, such sales generally occur through a local entity and so the amount of revenue at stake will be much lower. In contrast, a business that sells goods directly to consumers ("B2C" transactions) may consider it critical that these goods be delivered within a very short period of time as that business competes with local retail stores. Thus, the basic ability to maintain a stock of goods in country for the purpose of, *e.g.*, delivery without giving rise to a PE should not be of concern to tax authorities with respect to the activity of most enterprises that primarily engage in transactions with other businesses. Option E is sufficient to distinguish between these two types of transactions, and therefore Options F through H are unnecessary. If the OECD nevertheless decides to adopt one of Options F through H, TEI recommends that the changes apply only to B2C transactions.

D. <u>Fragmentation of Activities (Options I and J)</u>

Options I and J present slightly differing alternatives to address situations where MNEs fragment activities between associated enterprises to take advantage of current subparagraph 4(f). This subparagraph permits an enterprise to conduct a combination of the activities described in subparagraphs 4(a) through e) through a fixed place of business without giving rise to a PE, so long as "the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary nature." Paragraph 27.1 of the Commentary on Article 5 limits a taxpayer's ability to fragment activities, providing that "[a]n enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity." The aggregation principle in the Commentary currently applies only to multiple places of business of a single enterprise and only if the places are not "separated organisationally." The Commentary notes, however, that "[p]laces of business are not 'separated organisationally' where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place,

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[10] For example, if an enterprise has a "purchasing department" located in a particular jurisdiction that substantially contributes to the enterprise's profitability through cost savings, it may be appropriate to treat those activities as a PE, even though they are not profitable on a standalone basis due to their nature as purchasing, but not selling, activities. This would, however, create the difficult task of determining how much profit to attribute to the activities of the PE.

distributing those goods through another etc." If an enterprise fragments its operations across separate legal entities, however, then the aggregation principle of Paragraph 27.1 cannot be applied to combine such activities to give rise to a PE.

Options I and J would add new paragraph 4.1 to Article 5 to provide that the aggregation principle in Paragraph 27.1 of the Commentary can be applied where the multiple places of business belong to associated enterprises, if the activities "constitute complementary functions that are part of a cohesive business operation."[11] This would prevent an MNE from fragmenting its activities across legal entities under the exceptions to PE status in paragraph 4 to conduct a fully integrated business in a contracting state without giving rise to a PE.

Regrettably, like the other Option in the Discussion Draft, the proposed anti-fragmentation rules would increase the uncertainty of the PE determination and are susceptible to subjective application. In particular, it is unclear what is meant by the phrase "complementary functions that are part of a cohesive business operation." In many industries it is common to separate what might be complementary functions of a cohesive business into different legal entities. For example, in the real estate industry it is common to hold each investment/location in a separate legal entity to limit an enterprise's liability, and yet the overall real estate portfolio typically would be managed in a single entity as part of a "cohesive business." In the telecommunications industry, businesses may be held in separate entities due to different regulatory requirements or to enhance the stock value of each business. In the automotive industry, the dealership business may be held in a separate entity from the manufacturing business. These examples may be viewed as complementary functions and part of a cohesive business operation, but there are valid business reasons to operate through separate entities, such as to segregate risks or provide clear reporting line responsibility. Moreover, in many cases these businesses can be, and are, operated as separate, sustainable enterprises by unrelated parties (such as a car manufacturer and dealership) that do not have a great awareness of the other entities' business.

In addition, 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. The proposed anti-fragmentation rules, however, would grant tax authorities a blank cheque to re-characterise and combine legal entities (based in- or out-of-country) for purposes of attracting PE status to in-country activities. This would be the case even where such entities have been set up for valid business purposes and not solely for tax

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[11] Discussion Draft, p. 20-21.

planning, and, in the case of Option J, even where none of the entities has operations in a jurisdiction that would constitute a PE on its own.

We also note that the modifications proposed in Options I and J potentially go beyond the changes to the PE definition and reach into other areas, such as recharacterisation of contracts and business structures that may be considered abusive and transfer pricing issues between related entities. The consideration and adoption of such changes should be left to other BEPS actions. By creating a force of attraction between PEs and associated enterprises, the OECD is intentionally upsetting the delicate balance that has developed in the international tax system over decades. By extending such force of attraction to activities of different functions and entities through Model Convention language that gives a blank cheque to tax authorities to interpret the PE threshold at will, the OECD is breaking a dam that will give rise to a flood of PE assertions and subsequent controversy and litigation. Stated differently, the proposed rules permitting aggregation of purportedly fragmented activities combined with a lower PE threshold effectively operate as a kind of free-standing anti-abuse or "substance-over-form" rule. Such a rule would be unmoored from a jurisdiction-specific body of statutory, regulatory, and case law to ground the analysis of the rule in certain principles and limit its application to abusive circumstances. If the OECD ultimately chooses to adopt one of Options I or J, TEI urges the OECD to limit this force of attraction rule to situations where (i) both PEs share the immediate same functional reporting line within an MNE; and (ii) both PEs are of the same legal entity.

Finally, we note that if the OECD adopts the change to paragraph 4 represented by Option E, whereby all of the activities in that paragraph would be subject to the requirement that they be of a "preparatory and auxiliary character," then the concerns that underlie Options I and J should be substantially diminished. This would render the addition of paragraph 4.1 set forth in Options I and J unnecessary.

E. <u>Splitting Up of Contracts (Options K and L)</u>

Options K and L address situations where an enterprise splits up what should be a single contract into two or more contracts between separate entities for the sole purpose of avoiding the 12 month time threshold in paragraph 3 of Article 5 related to construction or installation projects. The Discussion Draft notes a similar concern with the application of the 183 day threshold of the service-PE provisions in the Commentary, as well as in Article 5(3)(b) of the United Nations Model Treaty. Each option would disregard the separate nature of the two contracts for purposes of the 12 month time threshold. Option K would address this issue by adding an "automatic" rule to take into account any activities performed by associated enterprises for the sole purpose of determining whether the 12 month threshold of paragraph 3 has been exceeded. Option L would address this issue through the general anti-abuse rule proposed as part of the work under BEPS Action 6 regarding treaty abuse, and supplement that provision with an example in the Commentary.

TEI agrees that separating what in substance is a single contract into two or more contracts solely for purposes of avoiding the 12 month time threshold of paragraph 3 should not be respected. However, a rule that "automatically" combines activities of associated enterprises that take place at the same construction or installation site is too harsh and ignores legitimate business reasons for conducting activity at the same site through separate entities. For this reason, while the inclusion of a general anti-abuse rule in the Model Convention is regrettable, limiting the ability of tax authorities to aggregate contracts only to cases where the splitting-up of contracts is tax-motivated, as is the case with Option L, would be preferable to aggregating any contracts that satisfy the conditions of Option K, whether tax motivated or not. Option K would be much improved if it included a minimum period of presence for an enterprise (the Draft suggests 30 days in any 12 month period) as well.

In general, legitimate business reasons for separating operations into two different entities should be sufficient to prevent tax authorities from aggregating the contracts. Examples of such circumstances include:

1. An enterprise may have two separate businesses: a residential construction company and a wireless telecommunications company. Both companies happen to expand into Country X. The residential construction company has a project that would take it 6 months to complete. The telecom wireless company has a project to set up wireless towers that would take it 6 months to complete. Tax authorities should not be permitted to aggregate the two time periods merely because the two companies are associated.

2. An enterprise wins a tender for a construction site that includes (i) construction work, (ii) the installation of electrical appliances, and (iii) the installation of surveillance and communication equipment. That enterprise installs the electrical appliances itself, yet subcontracts the construction work and the surveillance and communication equipment installation to two separate associated enterprises. Tax authorities should not be permitted to aggregate the in-country time period of both associated enterprises merely because the two companies are associated.

3. An enterprise wins a tender to build a prototype which requires ten months of in-country activity. After a five month respite, the company wins a separate contract for full rate production requiring another ten months of in-country activity. While the two contracts are related, the enterprise was not guaranteed the second contract. Under the revised language, tax authorities would not only be empowered to declare the combined contracts a PE, but would also be entitled to subject the enterprise to penalties for not timely declaring a PE for the first contract. TEI recommends that these kinds of circumstances – where entering into separate contracts is not under the sole control of the enterprise or is

required by the nature of the work – be excepted from the "automatic" rule of Option K, should it be adopted.

Finally, we note that enterprises may split up contracts to avoid or minimise the actions of certain over-assertive tax authorities for issues that are not of the type identified in the Draft's background discussion of Options L and K.[12] For example:

1. An enterprise may separate the provision of in-country services from out-of-country services to a single customer into separate contracts, so that local tax authorities may not attempt to tax the entirety of a contract due to *de minimis* in-country activities and regardless of where the economic performance occurs, driving double taxation.

2. An enterprise may separate contracts for the provision of goods and services to a single customer to avoid an argument by the tax authorities in the customer's jurisdiction that *de minimis* service activity transforms the entire contract into a supply of services that are then subject to withholding taxes.

These types of "defensive" contractual arrangements should be respected as separate, and not subject to collapse under Option K or the general anti-abuse rule, because they accurately reflect the underlying economics of the arrangement (*i.e.*, goods vs. services and in-country vs. out-of-country activity).

Should Options K and/or L be implemented, TEI recommends that the OECD limit the perverse effect of the current proposals by indicating in the text that (i) taxpayers may separate phases of the same contract in separate contracts if the separation accurately reflects the underlying reality of the arrangement, and (ii) the separation of contracts by activity type should continue to be respected.

F. PEs and the Authorised OECD Approach for Attributing Profits Under Article 7

In 2010, the OECD published its *Report on the Attribution of Profits to Permanent Establishments* (the Report). The Report includes the primary OECD guidance for attributing profits to PEs under Article 7 "Business profits" of the Model Convention. According to the Report, under Article 7 a PE is treated as a separate and distinct enterprise from its parent company and assets and risks related to the PE's (hypothetical) business are allocated to it. As there are no contractual arrangements between a parent company and its PE – because the PE is not a separate entity – assets and risks are allocated between the PE and the parent company by reference to the place of performance of "significant people functions." The PE is considered to assume the risks if significant people functions relevant to the risks are performed by the personnel of the PE at the PE's location (*i.e.*, "risks follow functions"). As a second step, under

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[12] *See* Discussion Draft, p. 21-22.

Article 9, the remuneration between the two enterprises is determined through a transfer pricing analysis.

It is clear that the determination of the existence of a PE precedes the question of profit attribution. In practice, the question of attribution of profits to PE can be just as contentious and uncertain as the preliminary question of whether a PE exists. This is evidenced by the practical difficulties that arise from the application of the Authorised OECD Approach recommended in the Report. Take the example of when significant people functions are performed by different members of an MNE group with respect to a single asset. In that case, it is difficult to attribute income to the asset in such a way that is consistent with the accounting rules regarding the ownership and income of the asset. Further, many countries will readily accept an attribution of profits to a PE within their jurisdiction as a result of such an analysis, but would be reluctant to accept a share of attributed losses to the same PE under the same analysis. Double taxation results from this inconsistency. A separate shortcoming of the Report is that it focuses its detailed guidance largely on the banking and insurance industries and does not adequately address the application of the attribution rules to PEs in other economic sectors. Non-financial sector PEs will be much more prevalent than they are now after the adoption of the new PE definition set forth in the Discussion Draft, no matter which particular option the OECD chooses to adopt.

The BEPS project thus far has yet to address the questions of remunerating risks and capital, much less attempt to refine the Report's attribution principles or extend its guidance beyond financial services and insurance. If Action 7 lowers the PE threshold resulting in a proliferation of PE assertions, TEI recommends that the OECD coordinate the adoption of a lower threshold with an update of the Report's attribution rules, or phase in the changes to the PE threshold to give adequate time for attribution issues to be discussed and the Report updated appropriately.

G. Transition Period and Grandfathering

The Discussion Draft does not provide a transition period or grandfathering provision for implementation of the new PE definition in Article 5. MNEs that have legitimate structures under the current version of the Model Convention and the Commentary, or other arrangements that would be affected by the modifications proposed in the Discussion Draft, should be given a transition period to change their operations to conform to the new definition. The transition period should be for a minimum of three years, preferably longer. In addition, the OECD should specifically provide that tax authorities may not assert a PE under the new definition in Article 5 for open prior tax years – an all too common experience of TEI's members across many jurisdictions.

III. Conclusion

TEI understands the need of the Member States and other jurisdictions participating in the BEPS project to modify the PE definition to eliminate certain structures and activities that enable MNEs to conduct substantial business within a country without giving rise to a PE. Lowering the PE threshold, however, will inevitably lead tax authorities to assert a myriad of PE findings that would impose a substantial new administrative and tax burden on MNEs. It is therefore imperative that the new PE definition in Article 5 draw clear lines so that taxpayers and tax authorities alike are on notice of what constitutes a PE to permit MNEs to plan their activities and tax authorities to administer the law fairly. The vague and overbroad changes presented by many of the options in the Discussion Draft would lead to a substantial increase in disputes and a significant reduction in cross-border investment and economic growth.

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding the artificial avoidance of permanent establishment status. As noted, TEI requests the opportunity to speak in support of these comments at the public consultation in Paris on 21 January 2015.

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 TEI's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President