BEPS Action 7 – what do the OECD's new permanent establishment proposals mean for business?

For almost a hundred years, OECD member countries have accepted that a non-resident's business will only become subject to tax in certain narrow circumstances. This has been widely criticised in recent years by the media and politicians – and it may now be changing.

In a revised discussion draft published on Friday, as part of its "BEPS" Project, the OECD are proposing that mere negotiation should create a taxable permanent establishment. This has wide implications for cross-border trade and business.

We look at the practical impact of the proposals on key industries and sectors and ask what steps businesses should be taking to anticipate these changes.

Why are these proposals being introduced?

The BEPS Project was launched by the OECD and G20 in 2013 to tackle "base erosion and profit shifting" - tax planning strategies that shift profits from high tax jurisdictions to low tax jurisdictions. The project is divided into fifteen "Actions", of which a key element is Action 7 ("prevent the artificial avoidance of PE status"). The stated purpose of this is to counter artificial arrangements which are put in place to avoid having a taxable presence in a country – one of the tax planning strategies that has been most heavily criticised in recent years.

Action 7 focuses on perceived avoidance of permanent establishment status using either agency or similar (e.g. commissionaire) arrangements, or on reliance on exemptions from the current permanent establishment definition, particularly those relating to "preparatory and auxiliary" activities.

Who will be affected?

Many international businesses which currently operate cross-border will be affected, as will many enterprises which want to do business in other countries in the future. And we think that this will be the case whether or not their existing or proposed structure is driven by tax considerations. The problem is that some of the structures the BEPS Project views as unacceptable tax avoidance can also result from commercial necessity, regulatory restrictions, or can even arise where tax is not a primary driver.

What is the current permanent establishment concept?

Under the current OECD model language, there are two circumstances where a permanent establishment will be established in a country:

- where a non-resident company has a fixed place of business in that country; or

- where the non-resident company has a dependent agent concluding contracts on its behalf in that country ("agency permanent establishment").

Profits which are attributable to a permanent establishment are generally taxable in the country in which that permanent establishment is located.

Proposed changes to agency permanent establishment rules

Under the current OECD model, an agent acting in a country on behalf of an enterprise will create a permanent establishment in that country if:

- the agent *"habitually exercises authority to conclude contracts in the name of the enterprise";* unless
- the agent is an independent agent acting in the ordinary course of its business (the "independent agent carve-out"). An agent is regarded as independent where it is legally and economically independent from its principal.

The OECD proposes to change both parts of this test. Under the OECD proposals an agent acting in a country on behalf of an enterprise will create a permanent establishment where:

- the *agent "habitually concludes contracts, or negotiates the material elements of contracts, that are: (a) in the name of the enterprise, or (b) for the transfer of ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or (c) for the provision of services by that enterprise";* unless
- the independent agent carve-out applies. But for this purpose a new "independent agent" test will apply – where a person *"acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected"* that person will no longer be an independent agent.

The revised discussion draft includes related amended commentary, which has some helpful guidance on the OECD's views on how to interpret the proposed provisions.

(There were previous proposals to add specific provisions for insurance businesses, but these have now been dropped.)

Proposed changes to "preparatory and auxiliary" exemption and other exemptions

The current OECD model includes several specific exemptions from the permanent establishment definition. For example, there is an exemption for the maintenance of local warehouses for the storage, display or delivery of goods.

The new proposals:

- strengthen the requirement that activities must be "preparatory and auxiliary" in order to fall within one of the specific exemptions;
- prevent the artificial fragmentation of cohesive business operations between related parties to get within the "preparatory and auxiliary" exemption. Under the proposed rules, the activities of related parties are viewed in combination, rather than in isolation, when determining whether the "preparatory and auxiliary" threshold is exceeded; and
- prevent contracts being split up into shorter contracts of less than 12 months with the purpose of benefitting from a specific exemption.

Again, the revised discussion draft includes amended commentary, which has some helpful guidance on the proposed provisions.

Practical impact of proposals

In our experience, most businesses selling goods or services cross-border will want to prevent permanent establishments accidentally arising because an agent concludes sales on their behalf. This is common across all industry sectors. So, for example, travel agents are in practice almost never agents – they are appointed by hotels, airlines etc to facilitate introductions, and the hotels and airlines are careful that the eventual contract is between them and their customer, principal to principal. This is not something we would usually describe as tax planning – it is simple compliance and good governance (that, to continue with the travel agent scenario, prevents a hotel in one jurisdiction from having dozens of permanent establishments, all over the world, wherever its customers may be based). In other sectors it is similarly common to take care to prevent a fixed place of business arising.

The question is whether this kind of arrangement will be caught by the new BEPS permanent establishment proposals. Businesses of all types will need to re-consider their arrangements for trading and selling goods or services cross-border.

It should be stressed that a taxable permanent establishment is, from a compliance perspective, not something some businesses will want to deal with – the uncertainty regarding which profits are allocated to the permanent establishment means that in many sectors it may be preferable to establish a fully taxable local subsidiary than have a permanent establishment arise. For this reason, permanent establishments are currently rare outside those sectors where branches are desirable or necessary from a regulatory or commercial perspective (most obviously, banks and airlines).

We set out below some examples of how we see specific sectors being affected:

Example 1 – sale of goods (e.g. pharmaceuticals)

Company A, which is based in Country A, manufactures pharmaceutical items, for which there is a ready market in Country B. Rather than Company A appointing a distributor in Country B, Company B, a group company which is resident in Country B, provides sales and marketing support in Country B. As part of that arrangement, Company B is involved in the negotiation of, but does not conclude, contracts to be entered into between Company A and customers. When orders are made, the relevant items are dispatched directly to the customer by Company A from its storage facility in Country A.

Company B's activities relate to the negotiation of contracts which will be entered into by Company A. If Company B acts wholly or almost exclusively for Company A, or for Company A and other group companies, it will not be an independent agent. This means that, under the OECD proposals, Company A is likely to have a permanent establishment in Country B.

How can the group respond? It could replace Company B with a third party that acts for other businesses, and is therefore likely to be an independent agent. Alternatively, it could restructure its arrangements with Company B so that all negotiation is handled by Company A, and Company B's role is limited to marketing and initial pre-contractual discussions. Or, of course, it could accept that it now has a permanent establishment in Country B. But this may be unacceptable for some businesses, given the number of countries in which the group likely has similar arrangements, and the complexity of its tax affairs if a permanent establishment arises in each of those countries.

Example 2 - commissionaire arrangements

The facts are the same as in Example 1, except Company B negotiates and concludes contracts with customers in its own name – i.e. it does not act for Company A when entering into those contracts, and Company A is not bound by the customer contracts. However, under a separate contract between Company A and Company B, Company A is bound (as against Company B) to provide items directly to customers in Country B on whatever terms have been agreed by Company B.

Under current rules, the arrangements do not generally create a local permanent establishment of Company A, as contracts are concluded in Company B's name, not Company A's name. As Company B does not at any time own the items which are sold, it cannot be taxed on the profits derived from the sales (it is only taxed on the remuneration that it receives for carrying out the services).

However, under the OECD proposals, Company A is likely to have a permanent establishment in Country B by reason of the arrangements with Company B (unless the independent agent carve-out applies – on which, see the previous example). Company B concludes contracts with customers in Country B that contemplate the transfer of ownership of the pharmaceutical items from Company A to those customers. Under the proposed OECD wording, it is not relevant that Company A is not a party to that contract.

How can the group respond? Again, it could replace Company B with a third party (but query if that is commercially feasible). It could restructure its operations so that Company B no longer contracts with customers, but rather introduces the customers to Company A. Or it could accept that a permanent establishment arises.

Example 3 – online supplies of goods

As before, Company A is based in Country A. It manufactures widgets, for which there is a market in Country B. Customers in Country B order widgets on-line directly from Company A. Items are stored until purchased in a large warehouse in Country B. When orders are fulfilled, those items are delivered from the warehouse in Country B.

Under the OECD proposals, Company A is likely to have a permanent establishment in Country B – i.e. the warehouse. This will be the case if the warehouse is owned by or otherwise at the disposal of Company A, and the storage in and delivery of items from the warehouse are core (i.e. "essential and significant") business activities, and not merely of a preparatory and auxiliary nature.

The group in this case has fewer options as to how it reacts. It could argue that its warehouse activities are not "essential and significant" (depending on the facts and Country B's interpretation of the new rules). It could simply accept that a permanent establishment arises (although this seems unlikely for some businesses). Or it could restructure and establish a new subsidiary in Country B which contracts with local customers, owns the warehouse and fulfils the orders. The subsidiary would be fully taxable, but that is perhaps a preferable result to a taxable permanent establishment.

Example 4 – financial services

A team based in Bank C's head office in Country C has a close working relationship with Customer C, which is also based in Country C. Customer C wishes to obtain additional financial services. These services cannot be provided by Bank C, but can be provided by Bank C's subsidiary, Bank D, which is resident in Country D and has particular expertise in those services. Bank C introduces Bank D to Customer C, and Bank C's client relationship team is involved in putting together the arrangements under which the services are provided.

Under the OECD proposals, Bank D may have a permanent establishment in Country C as a result of the activities of Bank C's client relationship team. This will be the case if the activities of the team are sufficient to amount to the negotiation of contracts which will be entered into by Bank D. Unless Bank C provides similar services to non-group companies, it is unlikely to be an independent agent.

Bank D is unlikely to want the complication of a new permanent establishment; instead we expect banks will put guidelines in place to prevent this kind of scenario from arising (at least in those countries that adopt the proposal).

Example 5 – aircraft leasing

Airline G, which carries on a commercial airline business and is resident in Country G, wishes to lease an aircraft on operating lease terms from Lessor H, which is based in Country H. Lessor H's marketing team has

built the relationship with Airline G, and, during a visit to Country G, that team negotiates the terms of a proposed lease to Airline G. However, no individual in that team has authority to conclude a contract with Airline G – rather, any proposed leasing arrangement is subject to formal approval procedures, which are followed solely in Country H.

Under the OECD proposals, these arrangements may be sufficient for Lessor H to have a permanent establishment in Country G. Although it may not have a fixed place of business in Country G, contracts to be entered into by Lessor H, and under which it will provide services, have been negotiated by a person acting there. And in arrangements involving marketing teams which are drumming up business in multiple countries, the result could be that an entity has a permanent establishment in a number of different countries.

The only solutions would seem to be to accept that a permanent establishment arises or to be careful to avoid material negotiations taking place outside Lessor H's home jurisdiction. Neither will be straightforward.

Example 6 - cross border investment by funds

A private equity fund, Fund K, is established in Country K. Fund K appoints Advisor L, which is resident in Country L to act as an advisor to the Fund. In that capacity, Advisor L advises the Fund in relation to transactions to be undertaken by the Fund. Advisor L receives an arm's length fee for those services and is subject to the supervision and direction of the Fund manager. Advisor L does not conclude contracts on behalf of the Fund and acts in a purely advisory capacity. However, Advisor L, in its capacity as an advisor to the Fund, still engages with potential targets and sellers of target companies in a way that could ultimately result in the conclusion of contracts by the Fund.

As Advisor L is involved in discussions that ultimately lead to the making of an investment by Fund K, the question is whether Advisor L is "negotiating material elements of contracts" on behalf of Fund K under the OECD proposed wording (even though Advisor L has no power to bind Fund K). This depends upon how broadly "negotiate" should be interpreted under the OECD proposed wording. There is some guidance on the meaning of "negotiate" in the revised commentary, which says that an agent can still be regarded as negotiating the material elements of contracts on behalf of an enterprise where the contracts are subject to further approval or review processes by that enterprise. It would therefore seem that, depending upon the exact discussions that Advisor L has in Country L, it may be open to a tax authority to argue that a permanent establishment has been created for Fund K in Country L (even though Advisor L has no power to bind Fund K). If Advisor L acts exclusively for Fund K, it may also be more difficult successfully to argue that the independent agent carve-out applies.

Example 7 - contracts involving global delivery

Many businesses require services (e.g. advisory or professional services) to be delivered to them in locations throughout the world. Rather than negotiate multiple contracts locally, they will often negotiate a master contract with a service provider which is part of a group with a presence in many or all of those locations, for the delivery of those services in multiple countries – this means that businesses can ensure that the services are always provided under the same terms, and to the same standard.

The "master supplier" of the goods and services will generally arrange for the provision of the goods or services locally by group companies (or other associated entities). For example, the master contractual terms may be incorporated by reference into a local agreement with a subsidiary. Tax is then paid by the local supplier on the local activities in the relevant country.

Under the OECD proposals, each local supplier could have a permanent establishment in the country in which the master contract is negotiated. The master supplier will have negotiated material elements of contracts that will then be entered into by the local supplier, and under which services will be provided locally by that supplier.

And, given the relationship between the master and local suppliers, the independent agent carve-out will not apply.

Similar issues may also arise in relation to other arrangements relating to supplies of goods and services to global businesses in multiple jurisdictions.

As a consequence, some businesses may be more reluctant to put in place "master" contracts – this may be the case for, e.g. multi-branch ISDA agreements. Other businesses may look at alternative contract structures, such as sub-contracting arrangements, or give careful consideration to the extent to which terms negotiated by a lead group supplier should be imposed on other members of the supplier group.

What is missing from these proposals?

It is clear that the OECD proposals will result in many more businesses having local permanent establishments in other countries.

But just because an entity has a local permanent establishment does not necessarily mean the local permanent establishment will be subject to more local tax. Local tax will be payable only on the profit of the non-resident company which is attributed to that permanent establishment.

And the proposals are silent on the important question of profit attribution. Rather than proposing any changes to the existing rules and guidance on the attribution of profits to a permanent establishment, the discussion draft says that follow-up work on the attribution of profits will be carried out after September 2015 with a view to providing guidance before the end of 2016.

There is therefore a major piece missing from the information which is needed in order to assess the full impact of the proposals.

What can we say now about the impact of the proposals?

Although we cannot assess the full impact without further clarity on how profits will be attributed to and taxed on permanent establishments going forward, it is possible to identify a number of practical implications now.

A key point here is that (although it had been hoped that the BEPS Project would introduce greater clarity) the proposed tests introduce a far greater element of subjectivity than the current rules. We think that, as a result, there is considerable scope for the tests to be applied differently by different countries.

More generally, we think the proposals will result in much uncertainty, an increased compliance and administrative burden, and increased costs for international businesses.

If the proposals are implemented, many permanent establishments could be created where routine, low value or low risk activities are carried out. However, in many cases in which a permanent establishment would be established under the proposed rules, an arm's length price should already be payable for the services provided by it to the non-resident company. This may mean that no, or very little, additional tax should be paid in the country in which the permanent establishment is created – but additional tax compliance and administration requirements will still need to be met.

For example, in many countries, there is an obligation to register a permanent establishment for tax purposes. For some businesses, registration (and other tax administration) obligations could be imposed in multiple countries. This could be a significant burden for large groups, which will need to consider the position of all entities within the group. And because these administrative obligations generally arise even if no, or minimal, tax is actually payable by the permanent establishment administrative costs could be higher than the relevant tax in many cases.

Although OECD guidance on profit attribution may well help, we are also concerned that the proposals are likely to trigger an increase in the number of disputes between taxpayers and tax authorities. Just as importantly,

there could be an increase in the number of disputes between different tax authorities. First, different tax authorities may reach different conclusions on whether a permanent establishment has been created at all. Second, the creation of more permanent establishments increases the risk of countries trying to tax those permanent establishments (by arguing that profits of a non-resident company should be attributed to the relevant permanent establishment). Any inconsistent application of profit attribution rules between different countries increases the risk of double taxation and prolonged disputes – which are likely to be complex and fact-based. In turn, this will increase uncertainty for businesses, and stretch the resources both of taxpayers and the tax authorities involved.

Businesses will try to ensure certainty and to avoid such disputes. Businesses may increasingly feel the need to discuss proposed arrangements in advance with both local and their home tax authorities to confirm whether a permanent establishment exists and the profit that should be attributed to it. Although this will, again, be an expensive and time-consuming process and will stretch the resources of all the parties involved, we think that this course of action will in many cases be the "least bad" option for businesses.

When and how will the proposals be implemented?

As the proposals involve changing the permanent establishment concept in tax treaties, they necessarily cannot be implemented without amending tax treaties. That presents an immediate problem - there are over 3,000 treaties worldwide, making individual negotiation and amendment wholly impracticable.

The suggestion, therefore, is that a "multilateral instrument" is created, with the effect that all treaties between the countries that sign the instrument would be immediately amended. This is being progressed in BEPS *Action 15.* However, discussions to date have concerned the form and nature of the instrument itself, not the content. Whilst clearly having the potential to streamline the process, several difficulties would remain. First, some countries will not accept the BEPS proposals (the US likely being an important example), and treaties with those countries will plainly not be amended. Second, some countries may accept some but not all of the BEPS proposals, and the "multilateral instrument" would therefore have to contain an element of optionality. Third, many countries have a slow ratification process, taking many months or even years.

Hence, whilst there have been indications that a multilateral instrument could be finalised and ready for countries to sign as early as the end of 2016, it is likely that many treaties will not be amended for some time after that. The OECD indicated last week that they expect the new rules to be in place "well before 2020".

We therefore expect to see at least some countries which do not wish to delay implementation putting in place unilateral measures in domestic law which are similar to, or inspired by, the BEPS permanent establishment proposals. The UK's diverted profits tax is an early example of this (see our briefing on the DPT here); the Australian multinational anti-avoidance rule is another (see the Australian government press release here).

Will the proposals be subject to legal challenge?

If implemented by EU countries, there is a serious unanswered question as to whether the proposed changes to the permanent establishment concept are compatible with EU law. Businesses would undeniably find it more difficult and expensive to carry out cross-border business in other Member States, with a risk of double taxation arising. These difficulties may (depending upon the details of local implementations) amount to a restriction of the EU law fundamental freedoms. Tax authorities would presumably respond that any restriction is justified by the need to prevent tax avoidance. However, historically the Court of Justice of the European Union has permitted restrictions of fundamental freedoms on this basis only when "wholly artificial arrangements" are put in place – and most of the arrangements the BEPS proposals are designed to counter are in no sense "wholly artificial".

Take the position of insurance companies by way of example. EU principles relating to freedom of establishment and the freedom to provide services permit insurance companies in one EU Member State to provide services in other Member States without establishing a branch or subsidiary in that other Member State.

This is reflected in the specific regulatory regime which operates within the EU. Although the revised discussion draft confirms that the OECD is aware of business concerns about a potential mismatch between the regulatory and tax position, it remains the case that, under the OECD proposals (and in contrast to the current position), insurance companies operating in other Member States under this model could often be treated as having a permanent establishment in those other states, even though they would not have an establishment in those other states for regulatory purposes. A mismatch between the tax and regulatory position is likely, at the very least, to result in additional practical and administrative burdens for insurance businesses.

The OECD and the EU Member States are, we understand, conscious of the potential complications EU law introduces. But if the proposals proceed in their current form, then it is likely (perhaps even inevitable) that their legality will ultimately be the subject of EU law challenge.

What should you be doing?

It is too early to determine the precise impact of the changes, particularly given that we are still waiting for further BEPS proposals on the "profit attribution" rules. For now, we would advise focusing on:

- monitoring implementation of the proposals, and its relationship with other aspects of BEPS;
- considering if you can help the OECD understand the implications of the proposals on non-tax motivated structures e.g. by submitting comments and examples of uncontroversial commercial arrangements that may be adversely affected;
- reviewing your existing business structures – even if it is too early to make final decisions, you should start work on assessing the potential impact of the proposals now; and
- making sure you take the proposals into account when drafting contractual documentation (e.g when documenting new agency-type arrangements and when drafting any permanent establishment undertakings in contracts).

What happens next?

The OECD has invited comments on its discussion draft by 12 June with a view to finalising the proposals towards the end of June. The OECD may still refine the proposals on Action 7, but we do not anticipate material changes at this stage. Further follow-up work on profit attribution issues relation to Action 7 will be carried out after September 2015, with the aim being to provide guidance on this issue before the end of 2016.

For further information, please speak to your usual Clifford Chance contact, or one of our BEPS team members listed overleaf.

Key contacts

Thierry Blockerye
Partner, Brussels
+32 2533 5061
thierry.blockerye
@cliffordchance.com

Eric Davoudet
Partner, Paris
+33 14405 5272
eric.davoudet
@cliffordchance.com

François-Xavier Dujardin
Partner, Luxembourg
+49 697199 1628
francois-xavier.dujardin
@cliffordchance.com

Carlo Galli
Partner, Milan
+39 0280 6341
carlo.galli
@cliffordchance.com

Avrohom Gelber
Partner, New York
+1 212878 3108
avrohom.gelber
@cliffordchance.com

Nicholas Mace
Partner, London Tax
+44 207006 4679
nicholas.mace
@cliffordchance.com

Dan Neidle
Partner, London
+44 207006 8811
dan.neidle
@cliffordchance.com

Uwe Schimmelschmidt
Partner, Frankfurt
+49 697199 1628
uwe.schimmelschmidt
@cliffordchance.com

Pablo Serrano
Partner, Madrid
+44 207006 4679
pablo.serrano
@cliffordchance.com

Anthony Stewart
Partner, London
+44 207006 8183
anthony.stewart
@cliffordchance.com

Michiel Sunderman
Partner, Amsterdam
+31 20711 9658
michiel.sunderman
@cliffordchance.com

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www.cliffordchance.com

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