

**University of the Witwatersrand, Johannesburg**  
**School of Accountancy**

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partial fulfilment of the requirements for the degree of Master of Commerce**

**BEPS Action 7 – The impact that changes to the PE definition  
will have on the manner in which Multinational Enterprises  
conduct cross-border business**

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## Abstract

‘The Organisation for Economic Co-operation and Development (OECD) Action Plan on Base Erosion and Profit Shifting (BEPS), is designed to prevent multinational businesses achieving non-taxation on profits or artificially shifting profits across borders to exploit lower corporate income tax rates’ (KPMG, 2014, p 5).

‘The OECD’s BEPS Action Plan, launched in July of 2013 and endorsed by the G20, included 15 key areas for identifying and curbing aggressive tax planning and practices and modernizing the international tax system’ (KPMG, 2013).

It can be argued that the aim of the ‘OECD Action Plan on BEPS’ is to make provision for G20 countries, OECD countries and all other interested stakeholders to come together on an equal footing to inter alia develop new international tax rules. One of the key focus areas of the ‘OECD Action Plan on BEPS’, is ‘Preventing the Artificial Avoidance of Permanent Establishment Status - Action 7’.

‘The aim of Action 7 is to develop changes to the definition of a permanent establishment (PE) to prevent abuses of that threshold, including through the use of commissionaire arrangements and the specific activity exemptions to avoid PE status where core activities are involved’ (KPMG, 2015, p 14).

The technical arguments to be argued for the purposes of this research report will inter alia involve commenting on commissionaire arrangements and how such arrangements have been problematic for international tax rules in their current form.

In addressing the problems inherent in the definition of a PE, ‘Preventing the Artificial Avoidance of Permanent Establishment Status - Action 7’ specifically proposes changes to Articles 5(5) and 5(6) of the ‘OECD Model Tax Convention’ which seek to revamp the dependent agent rule.

The specific activity exceptions in Article 5(4) have also been further clarified in the OECD commentary on the ‘OECD Model Tax Convention’ through the inclusion of an explanation of the activities that will be considered as being preparatory or auxiliary in nature, as well as supporting examples which help illustrate the meaning of the said terms.

In addition, the PE rule for construction projects set out in Article 5(3) will now include a principal purposes test, as well the addition of an example illustrating the application of the principal purposes test in the OECD commentary on the ‘OECD Model Tax Convention’ dealing with Article 5(3).

‘On 5 October 2015, the OECD issued a final package of reports in connection with its Action Plan to address BEPS, as well as a plan for follow-up work and a timetable for implementation.

Many countries have already adopted or are poised to adopt changes to their international tax systems based on the OECD recommendations. While implementation and timing will vary across borders, this final OECD release marks a crucial shift from the recommendation and consultation phase of BEPS to legislation and implementation’ (KPMG, 2015, p 2).

**Key Words:**

‘Action 7’, Article 5, ‘BEPS Action Plan’, Commissionaire Arrangements, Dependent Agent, Multinational Enterprises, ‘OECD Model Tax Convention’, PE.

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| <b>Declaration</b> |
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I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Takudzwa Matoushaya

13 April 2017

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## Chapter 1 - Introduction

### 1.1 The globalisation of economic activity

It can be argued that the globalisation of economic activities has been recognised as a crucial development that warrants close monitoring from an international tax perspective.

‘As national borders in international trade have faded, the global integration of national economies deepens, the mobility of capital accelerates and growth in international capital flows and trade is massive’ (Finnerty, Merks, Petriccione & Russo, 2007, p 1).

‘In a technical sense the term globalisation refers to [instances where] the growth in international trade has outperformed the growth in domestic trade. As investors have the option to invest / trade anywhere in the world, domestic laws have to be competitive to attract investors’ (Olivier & Honiball 2008, p vii).

It can also be argued that the expansion of commercial activity across the globe has created avenues for potential economic growth and development. However, it is submitted that the said economic developments have also resulted in some conflict between two key stakeholders in the global market place, namely, national governments (the state) and multinational enterprises (MNEs). Further, this conflict is centred on the issue of tax.

The state may seek to collect as much tax from potential taxpayers (for example, MNEs) as possible by electing to impose a system of strict tax rules to curb any unwarranted leakage of tax from the fiscus. The conflict arises, where MNEs

‘treat [corporate income tax payable to the state] as a cost to the business, [therefore] minimising the corporate income tax liability increases post tax earnings’ (KPMG, 2014, p 5).

Olivier and Honiball (2008, p vii), in considering whether there is need for revenue authorities to adapt their domestic tax systems for the purpose of making provision for the potential challenges that may arise as a result of the expansion of cross-border border commercial activities, specifically note that

‘the consequences of changes to a country’s corporate tax rate require careful consideration as an increase may impact negatively on the decisions of foreign investors to invest in that country’ (Olivier & Honiball 2008, p vii).

Accordingly, some MNEs may take an aggressive stance towards tax planning by setting-up their operations in foreign jurisdictions using complex operating structures and tax schemes with the aim of reducing corporate income taxes payable as much as possible.

## **1.2 Abusive tax schemes that fall within the grey area of the law**

The use of complex operating structures and tax schemes remains a contested issue in so far as the debate on tax avoidance and tax evasion is involved. In practice, legitimate tax planning (or as it is sometimes referred to, tax mitigation)

‘is concerned with the organisation of a taxpayer’s affairs (or the structuring of transactions) so that they give rise to the minimum tax liability within the law without resort to ... impermissible tax avoidance.

In short, the “hallmark of tax mitigation ... is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option” (SARS, 2005, p 4).

In contrast, tax evasion goes beyond what is permitted by law. For example,

‘the OECD has defined tax evasion as encompassing illegal arrangements through or by means of which liability to tax is hidden or ignored, that is, arrangements in which the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities. In an income tax context, it typically involves the non-payment of a tax that would properly be chargeable if the taxpayer made a full and true disclosure of income and allowable deductions’ (SARS, 2005, p 2).

Based on the above, it can be argued that abusive tax schemes lie in the grey area of the law that determines the boundaries for arrangements that constitute legitimate tax planning (tax avoidance) on the one hand, and those arrangements that are considered as being tax evasion, on the other.

It can be argued that, since their legal nature or the tax implications attaching thereto are not expressly prohibited by law, commissionaire arrangements (and other similar structures) are a good example of the complex operating structures falling within the grey area of the law. The OECD (2015a, p 9) is of the view that commissionaire arrangements are employed by MNEs for the purposes of conducting business in foreign jurisdictions without triggering any tax presence therein.

‘A commissionaire arrangement may be loosely defined as an arrangement through which a person sells products in a given state in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a state without technically having a PE to which such sales may be attributed for tax purposes and without, therefore, being taxable in that state on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission)’ (OECD, 2015a, p 9).

### **1.3 The issues affecting the effectiveness of the current state of international tax rules**

International tax rules are applied to regulate the cross-border activities of MNEs. The term international tax

‘refers to the international aspects of domestic laws. In other words ... international tax mainly involves an understanding of the interaction of [a country’s] tax system with that of a foreign country’ (Olivier & Honiball 2008, p 1).

However, in considering the application of domestic tax rules to the activities of MNEs, ‘international tax is often the most complex and challenging aspect of a country’s tax system’ (Olivier & Honiball 2008, p v). It can also be argued that international tax rules are inter alia used by revenue authorities to regulate tax schemes and arrangements falling within the grey area of the law, with the ultimate aim of mitigating the adverse tax implications of abusive tax practices and aggressive tax structuring, where possible.

It can be argued that the challenges faced by revenue authorities in addressing the abusive tax practices of MNEs may be attributed to several issues, however, there is one key issue that requires particular attention, namely,

‘in an increasingly interconnected world, national tax laws have not kept up with globalising businesses, accelerating capital mobility and the rise of the digital economy. Tax policymakers believe that this has left gaps and mismatches in international tax laws that can be exploited to generate double non-taxation’ (KPMG, 2016, p 1).

Notwithstanding the challenges faced in addressing the issue of BEPS, the tax strategies of MNEs continue to be examined by revenue authorities and this spotlight results in an ever increasing burden for MNEs to closely manage the additional requirements and responsibilities that are being imposed on them. It is therefore no surprise that

‘barely a day goes by without a news story criticising [MNEs] for structuring their operations to avoid paying their fair share of corporate income tax. Politicians also weigh in with their own judgements, encouraged by an indignant public’ (KPMG, 2014, p 6).

### **1.4 Restoring faith in the international tax system**

It is on this basis that the Organisation for Economic Co-operation and Development (OECD) took steps to address the issues (discussed in chapter 1.2 and 1.3) which have been affecting international tax rules in an adverse manner. The product of this initiative was the OECD’s ‘Action Plan on Base Erosion and Profit Shifting (BEPS)’, hereinafter referred to as the ‘BEPS Action Plan’. The ‘BEPS Action Plan’ itself

‘is designed to prevent multinational businesses achieving non-taxation on profits or artificially shifting profits across borders to exploit lower corporate income tax rates’ (KPMG, 2014, p 5).

Furthermore, the term BEPS

‘refers to tax planning strategies that exploit these gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity’ (OECD, 2017).

It can be argued that in instances where BEPS occurs, the end result is that little tax or no tax at all will be paid where it is lawfully due. Conversely, OECD commentators on the ‘BEPS Action Plan’ have also acknowledged that

‘double taxation would harm those MNEs that have contributed to boosting trade and investment around the world, supporting growth, creating jobs, fostering innovation and providing pathways out of poverty. Further, double taxation would also increase the cost of capital and could deter investment in the economies concerned’ (OECD, 2015b, p 4).

Therefore there is a need to strike a balance between competing interests, namely, the interests of MNEs in seeking to conduct profitable business enterprises in foreign jurisdictions in the absence of stringent tax and regulatory restrictions, and the interests of the state seeking to preserve the integrity of its tax system by enacting domestic tax legislation that prevents unwarranted tax leakage from the fiscus.

More specifically, it can be argued that the issue of BEPS should be a concern for both MNEs and states in so far as the collection of corporate income tax is involved. The OECD (2015c, p 3) identified the issue of BEPS as a significant concern for developing countries due to their heavy reliance on state funds raised from the levying of corporate income tax, particularly from MNEs.

‘Research undertaken by the OECD since 2013 confirms the potential magnitude of the BEPS problem. [For example], estimates [indicate] annual losses of anywhere from 4-10% of global corporate income tax ... revenues, [which amounts to] US\$100 to US\$240 billion annually. In developing countries, where reliance on corporate tax as a source of revenue is generally higher than in developed countries, the potential impacts are particularly stark. (OECD, 2015c, p 3).

In order to address the problems created by the issue of BEPS which arguably impact the tax systems of developing countries the most (as noted by the OECD above),

‘bold moves from policy makers are required to restore confidence in the international tax system and ensure that profits are taxed where economic activities take place and value is created’ (OECD, 2015a, p 3).

Further, OECD commentators on the ‘BEPS Action Plan’ have also asserted that ‘there is an urgent need to restore the trust of ordinary people in the fairness of their tax systems’ (OECD, 2015b, p 4). In taking proactive measures for introducing reforms to the current state of international tax rules,

‘[the] OECD and G20 countries have adopted a 15-point Action plan to address BEPS. [To this end, 15 Actions along three key pillars were identified, namely], introducing coherence in the domestic tax rules that affect cross-border tax activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty (OECD, 2015a, p 3).

Based on the above, it can be argued that the aim of the ‘BEPS Action Plan’ is to make provision for G20 countries, OECD countries and all other interested stakeholders to come together on an equal footing to inter alia develop new international tax rules.

The key areas to which the ‘BEPS Action Plan’ pertains have been set out in **Appendix 1** to this report. The main focus of the research report will be ‘Preventing the Artificial Avoidance of Permanent Establishment Status - Action 7’, hereinafter referred to as ‘Action 7’.

‘[‘Action 7’ calls] for a review of [the PE definition] to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition, such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors by commissionaire arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country’ (OECD, 2015a, p 9).

## **1.5 Significance of the research area**

Jiménez (2014, p 4), in considering the context and scope of ‘Action 7’ argues that

‘at first sight, Action 7 may seem of limited relevance. A closer analysis, however, reveals that this Action refers to very complex issues, both from a theoretical and practical perspective. From an academic viewpoint, [‘Action 7’] affects, first, one of the most relevant and complicated institutions of international taxation, PEs and Article 5 of the OECD Model Tax Convention ..., and second, attribution of profits to PEs and Article 7 of the OECD Model Tax Convention, another intricate and controversial issue. Third, there is a direct connection of this topic with transfer pricing issues and international taxation of groups of companies’ (Jiménez, 2014, p 4).

The research report will illustrate that the significance of the proposed research area, namely, the importance of ascertaining the threshold created by the concept of a PE in the context of applying Article 7 of the ‘OECD Model Tax Convention’ (the business profits article), for the purpose of determining whether a state’s right to tax the business profits of a foreign enterprise (e.g. a MNE) may be limited by a relevant double tax treaty.

Article 7 of the ‘OECD Model Tax Convention’ inter alia provides that the profits of a foreign enterprise are taxable in a state only to the extent that the enterprise has in that state a PE to which those profits are attributable.

For example, where a relevant double tax treaty applies, and further, in the absence of a PE of a foreign enterprise in a state (that is, the threshold created by the concept of a PE has not been met) the said state’s right to tax the business profits of that foreign enterprise may be limited. As such, the business profits accruing to the foreign enterprise may only be taxable in the country where that foreign enterprise is resident.

It must however be noted that the issue of the taxation of business profits in terms of Article 7 of the ‘OECD Model Tax Convention’ excludes the taxation of other income items that are specifically dealt with in the other Articles of the ‘OECD Model Tax Convention’ (e.g. Articles 10, 11 and 12 dealing with withholding tax on dividends, interest and royalties, respectively).

Therefore, the definition of a PE that is included in tax treaties is crucial in determining whether a foreign enterprise (e.g. a MNE) must pay income tax in another state. However, the problem is that the definition of a PE can be manipulated through artificial means resulting in a loss to the fiscus.

Accordingly, in addressing the problems inherent in the definition of a PE, ‘Action 7’ specifically proposes changes to paragraphs 5 and 6 of Article 5 of the ‘OECD Model Tax Convention’ which seek to revamp the dependent agent rule.

The specific activity exceptions in Article 5(4) have also been further clarified in the OECD commentary on Article 5 of the ‘OECD Model Tax Convention’ through the inclusion of an explanation of the activities that will be considered as being preparatory or auxiliary in nature, as well as supporting examples which help illustrate the meaning of the said terms.

In addition, the PE rule for construction projects set out in Article 5(3) will now include a principal purposes test. Further, an example illustrating the application of the principal purposes test will be added to the OECD commentary on Article 5(3) of the ‘OECD Model Tax Convention’.

## **1.6 Identifying the problem statement, sub-problems, research methodology, scope and limitations**

The problem statement that will be addressed in this research report entails an evaluation of how the changes to the definition of a PE that are being proposed by way of ‘Action 7’ will impact the operating structures and aggressive tax planning strategies of MNEs.

In answering the above, the respective chapters set out in this research report will each address a particular sub-problem. To this end, chapter 2 will address the sub-problem relating to the threshold

created by the concept of a PE and determining the limitations inherent in the present OECD definition of this concept.

Chapter 3 will address the sub-problem relating to the abusive tax practices of MNEs by outlining how MNEs artificially avoid PE status through the use of aggressive tax planning strategies and complex operating structures, such as the use of commissionaire arrangements and similar structures, including the use of the specific activity exceptions to the PE definition.

Chapter 4 will address the sub-problem relating to mapping the development and finalisation of the ‘Action 7’ measures which seek to propose changes to the definition of a PE, as well as outlining the key changes.

Chapter 5 will address the final sub-problem which entails an enquiry as to whether the proposed ‘Action 7’ measures will force MNEs to modify their current operating structures and aggressive tax planning strategies, including some consideration of the level of scrutiny likely to be applied by revenue authorities to the said structures going forward.

Chapter 6 will be the concluding chapter which will summarise the findings of the research report, and propose areas requiring further research.

The research methodology used for this qualitative study has been achieved by an extensive literature review, which includes books, journals / periodicals and electronic resources / internet and websites.

The scope of the research report will involve a discussion on the impact of the proposed ‘Action 7’ changes to the definition of a PE as defined in Article 5 of the ‘OECD Model Tax Convention’. The research report will however not cover the specific details of the other elements of the ‘BEPS Action Plan’ other than ‘Action 7’. The definition of a PE as envisaged under the US and UN Model Tax Conventions will also not be considered.

Further, the detailed income tax implications that may arise as a result of the creation of PE, through the application of the Article 7 (the business profits article) of the ‘OECD Model Tax Convention’ will also not form part of the considerations to be argued in this research report.

The research report will now proceed to consider the threshold created by the concept of a PE.

## Chapter 2 - The threshold created by the concept of a PE

### 2.1 Introduction

This chapter will address the threshold created by the concept of a PE, and will entail an examination of the limitations inherent in the definition of the said concept. The chapter will commence by providing a brief historic account of the development of the concept of a PE for the purpose of identifying whether any problems concerning the said definition have prevailed through the course of the development of the concept of a PE.

Following the above, the chapter address the question why the definition of a PE is important to revenue authorities and taxpayers. In doing so, the chapter will also address the complexities of determining what artificial avoidance of PE status constitutes. The chapter will then conclude by introducing the scope and context of the changes to the PE definition proposed under ‘Action 7’ which are inter alia aimed at addressing the abusive tax practices of MNEs.

The definition of a PE in the ‘OECD Model Tax Convention’ has been set out in **Appendix 2** to this research report. However, on a general level, a PE is inter alia defined as ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’ (OECD, 2014a, p 26).

### 2.2 The evolution of the concept of a PE through history

It can be argued that the concept of a PE has been considered as being an important aspect of international tax principles, from the point in time that the said concept was first introduced, to date. Cockfield (2003), as it will be noted below, is of the view that the concept of a PE may have been one of the earliest tools used by the League of Nations to address the issue of double taxation. Therefore, in considering the concept of PEs in the context of the ‘OECD Model Tax Convention’ and its evolution, Jiménez (2014, p 13) notes that

‘understanding the current problems of the PE ... calls for a reference to the historical evolution of the concept since, without this historical perspective, it is not easy to fully comprehend the present problems of that institution. Moreover, history may help [interested stakeholders] understand the policy, economics or legal reasoning behind the PE concept’.

To this end, Cockfield (2003) in commenting on the origins of the concept of a PE, notes that

‘an early version of the PE principle has been traced to the late 1800s, when European nations negotiated bilateral tax treaties to govern the tax treatment of cross-border economic activity. The modern version of the rule arose after World War I when nations became concerned that international double taxation was inhibiting international trade and investment.

Because of growing concern, the League of Nations commissioned a group of tax specialists to come up with a mechanism to ensure that double taxation would be avoided. The group arrived at a consensus and developed the PE concept that became enshrined in a 1927 model tax convention and later adopted in the 1963 OECD model tax treaty (as well as subsequent revisions of this model treaty in 1977 and 1992).

Jiménez (2014, p 13) in writing on the evolution of the concept of a PE, identified inter alia, three historic periods of relevance, namely, the work performed by the League of Nations on international tax rules in 1923, the OECD's work and the preparation of the draft 'OECD Model Tax Convention' over the period running from 1963 to 1977 and finally, the updates to the definition of a PE in the 1990s.

### ***2.2.1 First period of relevance in the history of the concept of a PE***

With reference to the first period of relevance, Jiménez (2014, p 14) noted that the work carried out by the League of Nations on international tax rules proposed a shift away from the source basis of tax to a residence basis of tax as a general rule. It is understood that during this period 'source and residence countries had different views of on how to tax business profits' (Jiménez 2014, p 14).

The proposed adoption of a residence basis of tax had an impact on the concept of a PE which was considered as being an exception to the residence basis of tax (that is, the concept of a PE is an exception to the residence basis of tax since the threshold created by the concept of a PE is applied for the purposes of determining the taxable presence of a non-resident / foreign enterprise conducting business operations in a state). As such,

'the concept of a PE was born as recognition of the source country rights in a scenario where taxation in a state of residence was proposed and fostered as a rule to eliminate double taxation' (Jiménez, 2014, p 18).

'It was assumed [that] source countries should be able to tax business profits attributable to production factors located within their territory ... [Therefore], the source country should only tax profits attributable to the "fixed elements" ... present within their territory. This explains why the 1928 Draft Model and the 1933 work of the League of Nations relied on a concept of a PE that focused on fixed places of business' (Jiménez, 2014, p 15).

The shift to a residence basis of tax that was proposed by the League of Nations also exposed the inherent weakness in the definition of the concept of a PE that applied at that time. For example, Jiménez (2014, p 15) notes that a subsidiary was initially regarded as a PE of its foreign parent. However, any 'reference to [subsidiaries constituting PEs] was eliminated in 1928 Drafts' (Jiménez, 2014, p 15) prepared by the League of Nations.

Jiménez (2014, p 15) in quoting the words of Carroll (1939), notes that for the purpose of avoiding the threshold created by the concept of a PE,

‘corporations [that is, MNEs] quite generally organised a local company [in the source country], so that the business assets within the country might be readily segregated ...’ (Jiménez, 2014, p 15).

In the context where foreign enterprises operating in a source state through a subsidiary were challenged by revenue authorities on the basis of the threshold created by the concept of a PE, such challenges on the said operating structures were defensible because

‘legal reality [that is, a subsidiary is a separate legal person from its parent company], as opposed to economic substance [that is, instances where a subsidiary actually carries on the business of its foreign parent], was given priority, since the limited exposure to double taxation as a consequence of aggressive behaviours in source countries ... could only be corrected not by piercing the veil of the subsidiary [and thus looking through to the parent company], but rather by treating it as an independent company’ (Jiménez, 2014, p 16).

## **2.2.2 Second period of relevance in the history of the concept of a PE**

Jiménez (2014, p 18) notes that the second period of relevance during the course of the development of the concept of a PE was the OECD’s work and the preparation of the draft ‘OECD Model Tax Convention’ over the period running from 1963 to 1977. The OECD’s work on Article 5 was aimed at achieving ‘administrative simplicity and [the] elimination of obstacles to international trade’ (Jiménez, 2014, p 18).

To this end, Jiménez (2014, p 18) notes that the work performed by the OECD during this period *inter alia* introduced two significant developments, namely, the exception for preparatory and auxiliary activities was added and the dependent agent PE<sup>1</sup> (which was previously included as part of the ‘fixed place of business’ requirement) was introduced as a standalone paragraph of Article 5.

It can be argued that the OECD’s 1963 changes relating to the exceptions for preparatory and auxiliary activities favoured the rights of resident countries (over the rights of source countries) which are preserved under the residence basis of tax adopted in terms of the work performed by the League of Nations in 1923. For example, the exceptions for preparatory and auxiliary activities that were added to Article 5 allow a foreign enterprise to conduct some commercial tasks from a fixed base in a state that are ancillary to the primary activities of the enterprise as a whole without the creation of a PE in that state.

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<sup>1</sup> Article 5(5) of the OECD Model Convention illustrates the test for determining whether an agent is considered to be of a ‘dependent status’. However, for purposes of clarity, the research report will specifically refer to the threshold of a PE as envisaged under Article 5(5) as ‘the definition of a dependent agent PE’.

Similarly, since the OECD added the authority to conclude contracts requirement to the dependent agent PE provisions set out in Article 5, the mere presence of a dependent agent in a state would not in itself constitute a PE for a foreign enterprise in that state. Rather, the determining criterion is the habitual conclusion of contracts by that dependent agent on behalf of the foreign enterprise.

Accordingly, the same result can be achieved (that is, no PE is created in a state) in the context where the foreign enterprise conducts business through an agent in a state, provided that the agent does not have the authority to conclude contracts on behalf of the foreign enterprise. However, this position (that is, the authority to conclude contracts being the determining criterion) will change once the proposed ‘Action 7’ changes are implemented (this will be discussed in chapter 4.3 of this research report).

Jiménez also notes that ‘after 1963 further refinement of the PE concept was needed’ (Jiménez, 2014, p 22). In this regard, additional work was performed in 1977 and, inter alia,

‘the question of how to deal with two or more different construction, building or assembly projects was raised with the conclusion that the twelve months period should apply per project “if the building sites are at different locations [and there is] no factual connection” even if the works are performed for the same principal. It should be recalled that, in this period, there was no separate provision similar to Article 5(3) of the OECD Model Tax Convention’ (Jiménez, 2014, p 22).

It was decided that the guiding principle for applying the threshold created by the concept of a PE where two or more different construction projects are involved

‘should be that combinations “will have to be considered individually, that is, taking into account the economic situation as it arises from such link-up”. As a consequence, “only such facilities will be deemed to constitute PEs as they play a substantial part in the economic life of the state of source and whose business results can be readily ascertained by the tax authorities of that state”’ (Jiménez, 2014, p 23).

Therefore, according to Jiménez (2014, p 21) it can be argued that the work performed by the OECD during this period, namely 1963 to 1977, established the structural framework for the modern PE concept as it is known today. Overall, the changes introduced by the OECD inter alia,

‘facilitated the reduction of tax basis in source countries and the proliferation of structures designed to avoid source country taxation’ (Jiménez, 2014, p 21).

### ***2.2.3 Third period of relevance in the history of the concept of a PE***

According to Jiménez, the final period of relevance in respect of the historic development of the concept of a PE that will be addressed in this research report is the changes to the definition of the concept of a PE in the 1990s. Jiménez (2014, p 26) notes that during this period, PEs were again the

centre of attention due to inter alia the increase in cross-border activities, development of new operating models for conducting business and an increased emphasis on tax planning strategies by MNEs.

‘These changes revealed the limits of the PE concept’ (Jiménez, 2016, p 21). Certain issues were identified with the fixed place of business requirement of Article 5(1) of the ‘OECD Model Tax Convention’. For example,

‘the connection between the fixed place of business and the carrying on of business was cut early by conducting business at places that in theory could not be “available” or at the disposal of the foreign enterprise: for example, hotels, homes of employees, premises of clients ...’ (Jiménez, 2014, p 27).

In addition, other issues relating to the dependent agent PE set out in Article 5(5) of the ‘OECD Model Tax Convention’ were also identified. In particular,

‘reliance on legal dependence (as opposed to economic one) made subsidiaries to (almost always) be considered as ‘independent’ creatures of the other companies of the same group. As long as their activity was remunerated at arm’s length and they are not dependent agent PEs ... substantial business profits could be stripped away from the country of source as long as they were attributable to a non-resident company’ (Jiménez, 2014, p 28).

It can be argued that, as a response to the problems identified above, the OECD sought to make further clarifications for the threshold created by the concept of the PE by inter alia making changes to the OECD commentary on Article 5 of the ‘OECD Model Tax Convention’. In addition, more studies were performed on the issue of the attribution of profits to PEs in light of the arm’s length principle which was developed under the OECD’s transfer pricing guidelines that were issued in 1995.

This research report has thus far sought to illustrate that the concept of a PE which was first introduced in terms of the work performed by the League of Nations as a mechanism for addressing the issue of double taxation, has been prone to changes based on the evolving nature of commercial activity throughout its history.

It can be argued that during the course of the periods of relevance in the history of the concept of a PE, law makers have had to adapt the policy, economic and legal reasoning that applies to the concept of a PE for the purpose of catering to the challenges raised by cross-border business activities at the given point in time where conflicts between the state and MNEs over the issue of tax prevailed.

It can be argued further that some of the problems that have been identified over the years regarding the concept of a PE have not been adequately addressed by policy makers such as the OECD, as the issues discussed continue to afflict the concept of a PE today. For example, MNEs may use complex operating structures that fall within the grey area of the law between tax avoidance and tax evasion,

such as commissionaire arrangements, for the purpose of artificially avoiding PE status in a source country (this will be discussed in chapter 3 of this research report).

### **2.3 The importance of the concept of a PE**

Having considered the historic evolution of the concept of a PE, the research proposal will now proceed to address the question why PEs are important for revenue authorities and taxpayers. In answering this question, the research report argues that, currently, the concept of a PE is of particular significance in so far as the application of a tax treaty for the avoidance of double tax is concerned. This can be illustrated on the basis that

‘virtually all modern tax treaties use PE as the main instrument to establish taxing jurisdiction over a foreigner's unincorporated business activities’ (Paliwal, (n d), note 18).

In considering the threshold created by the concept of a PE in the context of a tax treaty, the OECD commentary on Article 5 of the ‘OECD Model Tax Convention’ describes the concept of a PE as being a construct that can be used for the purposes of determining

‘the right of a contracting state to tax the profits of an enterprise of another contracting state’. [As noted in Chapter 1 above], under Article 7 a contracting state cannot tax the profits of an enterprise of the other contracting state unless it carries on its business through a [PE] situated therein’ (OECD, 2014a, p 94).

Therefore, this research report will argue that, whether a foreign enterprise (for example, a MNE) has created a taxable presence through the threshold created by the concept of a PE should be the most important consideration for revenue authorities and taxpayers as it sets the boundary for when a foreign enterprise generating business profits becomes liable for tax in a state and whether there is a possible obligation to register as a taxpayer in that state.

### **2.4 The problems inherent in the definition of a PE**

However, a possible challenge (other than the issues relating to how MNEs have changed the manner in which cross-border activities are performed over time) faced by both revenue authorities and taxpayers in applying the threshold created by the concept of a PE as defined in Article 5 of the ‘OECD Model Tax Convention’ to a particular set of facts, can arguably be attributed to the lack of clarity and different interpretations that can be applied to the concept of a PE. If the threshold created by the concept of a PE is analysed on a factual basis, there is a possibility that the concept of a PE can be applied differently depending on the fact pattern of each given case.

It can also be argued that, the OECD commentary on Article 5 of the ‘OECD Model Tax Convention’, which is aimed at providing clarity on the provisions of Article 5 itself, may also be prone to misinterpretation as such commentary could be read in diverging ways, with different meanings

ascribed to the content therein. This could also possibly result in contrasting interpretations of the provisions contained in the applicable Article set out in the ‘OECD Model Tax Convention’ or concepts discussed in the supporting OECD commentary thereto.

Therefore, in instances where there is no universally agreed and accepted understanding of the manner in which the threshold created by the concept of a PE should be interpreted, any diverging interpretations of the said concept could possibly result in conflicts between revenue authorities and taxpayers on issues concerning liability for tax in a state and the obligation to register as a taxpayer in the given state.

Furthermore, the challenges faced in interpreting the threshold created by the concept of a PE could also potentially result in conflicts between revenue authorities themselves, as they seek to impose their right to tax the business profits of a foreign enterprise, where such rights could otherwise be limited through the application of Article 7 of the ‘OECD Model Tax Convention’ (the business profits article).

The challenges relating to the interpretation of the provisions of Article 5 of the ‘OECD Model Tax Convention’, including the supporting OECD commentary thereto, may therefore create an avenue for MNEs to take advantage of any ambiguity inherent in the definition of PE, allowing such MNEs to employ abusive tax schemes or operating structures that help achieve the artificial avoidance of PE status.

Further, due to the possible challenges faced in interpreting the definition of a PE, an understanding of the mischief that ‘Action 7’ is actually targeted at, namely, the artificial avoidance of PE status, becomes even more complex. For example, the activities that may be considered as artificial avoidance for one state may not be the same for another state that interprets the concept of a PE differently.

## **2.5 Conclusion - the scope and context of the changes to the PE definition under ‘Action 7’**

It can be argued that, despite the problems that have been identified regarding the concept of a PE, it remains as one of the most important aspects of international tax principles and must not be disregarded. The OECD has acknowledged that the definition of a PE may need to be amended (that is, the definition prior to the proposed ‘Action 7’ amendments) in order to ensure that the concept of a PE remains fluid enough to keep pace with the changing times. This is the mandate of the OECD under ‘Action 7’ of the ‘BEPS Action Plan’.

Understanding the threshold created by the concept of a PE as well as the limitations inherent in the present format of the PE definition may help interested stakeholders to understand the scope and context of the changes to the PE definition under ‘Action 7’. As stated above

‘the aim of Action 7 is to develop changes to the definition of a PE to prevent abuses of that threshold, including through the use of commissionaire arrangements and the specific activity exemptions to avoid PE status where core activities are involved’ (KPMG, 2015, p 14).

Further, according to Jiménez (2014, p 5) the scope and context of ‘Action 7’ could be understood in terms of the main aim of the ‘BEPS Action Plan’, namely,

‘no or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it’ (Jiménez, 2014, p 5).

Therefore, it can be argued that ‘Action 7’ is particularly concerned with addressing the abusive tax practices of MNEs, in so far as those activities involve complex operating structures that can be used to artificially avoid the threshold created by the concept of a PE. The next chapter will include a detailed discussion on the abusive practices of MNEs and how such structures can be used to artificially avoid PE status.

## **Chapter 3 - The abusive tax practices of MNEs**

### **3.1 Introduction**

This chapter will discuss certain abusive tax practices of MNEs, including analysing the nature of the complex operating structures employed by MNEs for the purpose of reducing or completely avoiding their corporate income tax obligations in a foreign jurisdiction in which a business enterprise is carried on. As discussed in chapter 1.2, such practices can be regarded as being abusive because MNEs may artificially avoid PE status by using operating structures that are not expressly prohibited by law as they fall in the grey area between tax avoidance and tax evasion.

This chapter will outline how MNEs artificially avoid PE status through the use of aggressive tax planning strategies and complex operating structures, such as the use of commissionaire arrangements and similar structures, including the use of the specific activity exceptions to the PE definition.

As stated in chapter 2.3 above, the implications of MNEs avoiding the threshold created by the concept of a PE through artificial means, would see states (in the context of the application of a relevant tax treaty) having little to no taxing rights over the business profits accruing to non-resident MNEs operating within the confines of their geographical territories.

### **3.2 Commissionaire arrangements**

The chapter will commence by examining how commissionaire arrangements are used by MNEs to avoid the threshold created by the concept of a PE. As stated in chapter 1,

‘a commissionaire arrangement may be loosely defined as an arrangement through which a person sells products in a given state in its own name but on behalf of a foreign enterprise that is the owner of these products’. (OECD, 2015a, p 9).

In particular commissionaire arrangements have an impact on the dependent agent PE set out in Article 5(5) of the ‘OECD Model Tax Convention’. The avoidance of PE status may be achievable

‘since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, [therefore], it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a state. Commissionaire arrangements have been a major preoccupation of tax administrations in many countries, as shown by a number of cases dealing with such arrangements that were litigated in OECD countries. In most of the cases that went to court, the tax administration's arguments were rejected’ (Pareek, 2015).

### 3.2.1 OECD commentary on court cases dealing with the issue of commissionaire arrangements

This chapter will proceed by analysing OECD commentaries<sup>2</sup> on landmark judgments passed on the threshold created by the concept of a PE in the following court cases, *Zimmer Limited*, CAA Paris 2 February 2007, CE 31 March 2010 (The *Zimmer* case); *Dell Products v. Staten v/Skatt øst*, Case HR-2011-02245-A, 2 December 2011 (The *Dell* case); and *DSM Nutritional Products Europe Ltd. (formerly Roche Vitamins Europe Ltd.) v. Agencia Estatal de Administración Tributaria*, 14 Intl. Tax Law Rep. 892, 2012 (The *Roche* case).

After analysing the OECD case commentaries, this research report will argue that the issues relating to the use of commissionaire by MNEs for the purpose of avoiding PE status may be attributed to the hybrid nature of such arrangements, namely, the

‘commercial relationship [created by a commissionaire arrangement] will exhibit certain features of the distributor in that it enters into contracts for the sale of goods or services in its own name, and is contractually bound to the purchaser to deliver such goods or services. It will also exhibit certain features of an agency relationship, in that as a matter of commercial law it never takes title to the goods it delivers’ (Bloomberg, 2010).

Sullivan & Cromwell (2010, p 1) argue that the use of commissionaire structures by MNEs is popular in civil law jurisdictions such as France. By way of example,

‘since the risk and functions of a commissionaire are generally not as significant as those of a buyer-reseller ..., conversions of French subsidiaries from a buyer-reseller status to a commissionaire status generally lead to a reduction of the remuneration earned by the French subsidiary, and result in a significant decrease in the group income taxable in France’ (Sullivan & Cromwell, 2010, p 1).

#### ***Zimmer case***

The issue whether a commissionaire arrangement results in the creation of a dependent agent PE was considered by the French Supreme Administrative Court in the *Zimmer* case. The facts of the case involved Zimmer Limited, a company that is tax resident in the United Kingdom, which sold its products in France through its French subsidiary, Zimmer SAS. Pursuant to a decision made by Zimmer Limited in 1995 to cease using a distributor operating model for the French market, Zimmer Limited and Zimmer SAS concluded a commissionaire agreement, in terms of which Zimmer SAS would act in a commissionaire capacity for the purpose of selling Zimmer Limited’s products to customers in France (OECD, (n d), a).

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<sup>2</sup> Summaries on the *Dell*, *Roche* and *Zimmer* court cases prepared by the OECD will be relied upon, as no official transcripts of the said court cases translated into English were readily available.

The French revenue authorities raised an assessment for corporate income tax for the 1995 and 1996 years of assessment payable by Zimmer Limited on the basis that Zimmer Limited had created a PE in France. Zimmer Limited unsuccessfully appealed the assessment raised by the French revenue authorities in the Administrative Court of Appeal of Paris. Zimmer Limited took the matter on further appeal before the Supreme Administrative Court (OECD, (n d), a).

The issue that was tabled before the Supreme Administrative Court to decide upon was

‘whether [Zimmer Limited] carried on a business in France through a dependent agent (that is, the French company Zimmer SAS) under Article 4(4) of the treaty [between the United Kingdom and France], so that a portion of profit of [Zimmer Limited] is attributable to a PE in France and subject to tax therein’ (OECD, (n d), a).

The Supreme Administrative Court commenced its judgment by considering the provisions of Article 4(4) of the treaty between the United Kingdom and France which sets out the conditions under which a dependent agent PE will be created, namely, where

“a person - other than an agent of an independent status ... has, and habitually exercises in that state, an authority to conclude contracts in the name of an enterprise ...” (OECD, (n d), a).

In this regard, the Supreme Administrative Court noted that commissionaire arrangements did not fall into the ambit of the arrangements envisaged under Article 4(4) on the basis that the said provision

‘requires contracts being concluded “in the name of” the foreign enterprise, whilst a commissionaire acts “in its own name” ....’ (OECD, (n d), a).

As such, it can be argued that the activities of a commissionaire (that is, Zimmer SAS in selling products in France in its own name) do not bind the principal (that is, Zimmer Limited, who retains the legal ownership of the goods) to any contracts with third parties (that is, French customers). In other words, the activities of the commissionaire (who is considered as being an agent of an independent status) do not create a direct legal relationship between the principal and the third party customers. On this basis, the Supreme Administrative Court came to the conclusion that

‘a commissionaire does not entail a direct representation, which is a prerequisite to constitute a PE for the principal [in terms of Article 4(4) of the treaty between the United Kingdom and France]’ (OECD, (n d), a).

Further, in analysing certain aspects of Zimmer Limited’s operating structure, the Supreme Administrative Court observed that

‘there was no implication that the contracts concluded by Zimmer SAS gave rise to a direct legal relationship between [Zimmer Limited] and third party customers’ (OECD, (n d), a).

Accordingly, the Supreme Administrative Court overturned the decision of the Administrative Court of Appeal of Paris and ruled that there was no PE created by Zimmer Limited in France as Zimmer Limited did not carry on its business enterprise through a dependent agent in France (OECD, (n d), a).

In considering the judgment passed in the *Zimmer* case, it can be argued that the decision of the Supreme Administrative Court may be in conflict with the OECD's views on the issue concerning the possibility of an agent of an independent status binding a principal to a contract with a third party. In particular, paragraph 32(1) of the OECD commentary on Article 5 of the 'OECD Model Tax Convention' specifically states that

'the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph equally applies to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise' (OECD, 2014a, p 107).

In considering the implications of the OECD commentary (in the paragraph set out directly above) relating to the possibility of the activities of an independent agent creating a PE for a foreign enterprise, an argument can be made that even in the context of an agent of an independent status, the activities of that agent can actually bind a principal to a contract with a third party, for example, where the said agent actually has (in substance over form) the authority to bind a principal to a contract even if that contract is not in the principal's name.

Further, an analysis of whether an independent agent has the authority to bind a principal to a contract is a factual enquiry that must be determined on a case by case basis. As such, looking to the facts of the *Zimmer* case in particular,

'Zimmer SAS could accept orders, present estimates and documents within the framework of tender offers and conclude sales contracts for the account of the [Zimmer Limited] without prior approval. In addition, Zimmer SAS could negotiate prices, grant discounts and payment facilities to existing or new clients without the prior approval of the taxpayer' (OECD, (n d), a).

Therefore, looking to nature of the activities performed by Zimmer SAS in terms of the commissionaire arrangement, it can be said that although Zimmer SAS acted in its own name in dealing with French customers, when viewed from an objective standpoint the activities performed by Zimmer SAS satisfied some of the essential elements required for the conclusion of a contract of sale, namely, an offer to enter into a contract (Zimmer SAS could present documents within the framework of tender offers), the acceptance of the offer (Zimmer SAS could accept orders and conclude contracts), and finally the consideration paid under the contract (Zimmer SAS could

determine the final price payable by French customers for products by negotiating pricing, granting discounts and payment facilities).

Therefore, based on the OECD's views, it can be argued that Zimmer SAS may have had, in substance, the authority to bind Zimmer Limited to contracts with customers in France, and thus created a PE for Zimmer Limited in France.

It can be said that OECD commentary can be used for the purpose of providing clarity on the provisions of the 'OECD Model Tax Convention'. However, Linderfalk and Hilling (2015, p 34) note that although

‘tax administrators, courts and taxpayers frequently resort to [OECD commentaries] to express propositions about the proper understanding of tax treaties ... international tax law experts have long debated the relevance of changes to OECD Commentaries for the purpose of interpreting previously concluded tax treaties’ (Linderfalk and Hilling, 2015, 34).

Therefore, it can also be argued that the Supreme Administrative Court hearing the *Zimmer* case was not obligated to consider the views of the OECD on the possibility of the activities of an agent of independent status creating a PE for a foreign enterprise (as set out in paragraph 32(1) of the OECD commentary) since OECD commentaries may be used as interpretive aids for tax treaties.

### ***Dell case***

In a similar fact pattern as the *Zimmer* case, the issue whether a commissionaire arrangement creates a PE for a foreign enterprise was also considered by the Norwegian Supreme Court hearing the *Dell* case. The facts of the case involved Dell Ireland, a company incorporated and tax resident in Ireland, which sold computer components to customers in Norway through Dell AS, a related company within the Dell group of companies. The goods were sold to customers in Norway in terms of a commissionaire arrangement concluded between Dell Ireland and Dell AS (OECD, (n d), b).

After an assessment was raised by the Norwegian revenue authorities, Dell Ireland sought to defend its operating structure on the basis that no PE was created in Norway under its commissionaire arrangement with Dell AS, since Dell AS contracted with customers in Norway in its own name. As such, Dell AS could not constitute a dependent agent of Dell Ireland as Dell AS did not have the authority to conclude contracts that are legally binding on Dell Ireland (OECD, (n d), b).

After an unsuccessful challenge in the Oslo District Court, Dell Ireland appealed the matter in the Borgarting Court of Appeal. The Court of Appeal ruled in the favour of the Norwegian revenue authorities and held that Dell Ireland had created a PE in Norway through the activities of Dell AS. In passing judgement the Court of Appeal inter alia observed that,

‘a “functionalistic-realistic” approach should be endorsed rather than a literal-formalistic approach in interpreting the words “authority to conclude contracts in the name of the enterprise” in Article 5(5) of the treaty [between Ireland and Norway] because ... a commission relationship would result in source taxation being [easily] avoided even though the financial attachment between the agent and principal was strong’ (OECD, (n d), b).

Dell Ireland took the matter on further appeal to the Supreme Court, which overturned the judgment passed by the lower Court of Appeal.

‘The Supreme Court started with the literal interpretation of the treaty and concluded that the commissionaire must enter into a legally binding agreement in the name of the principal. Due to the fact that Article 5(5) of the treaty was identical with the OECD Model Convention, relevance was given to the OECD commentary on Article 5. In this respect, the Court, however, observed that the commentary did not give any specific guidelines to the present case’ (OECD, (n d), b).

The Supreme Court in passing its judgment also made specific reference to the *Zimmer* case by observing the fact that a similar operating structure had withstood the scrutiny of the French courts, where it was found that a commissionaire arrangement did not create a dependent agent PE for a foreign enterprise in France. In concluding its judgment, the Supreme Court also

‘made reference to technical and practical considerations and observed that if the argument put forth by the tax authorities [that is, that a functional-realistic approach on a case by case basis should be undertaken to determine whether the commissionaire binds the principal] were accepted, it would be very difficult to apply Article 5(5) in practice’ (OECD, (n d), b).

‘Consequently, the Supreme Court held that the taxpayer did not have a PE in Norway’ (OECD, (n d), b). Therefore, it can be said that, Dell AS (in executing its responsibilities as set out in the commissionaire arrangement) was not considered as being a dependent agent of Dell Ireland as envisaged under the provisions of Article 5(5) of the treaty between Ireland and Norway (OECD, (n d), b).

### ***Roche case***

However, the Supreme Court in Spain hearing the *Roche* case came to a different conclusion from the decisions passed in the *Zimmer* and *Dell* cases. It must be noted that the *Roche* case did not however involve a commissionaire arrangement, but rather a similar operating structure was implemented (as described below).

The *Roche* case involved a Spanish tax resident company, Roche Vitamins, which signed two contracts with its Swiss tax resident parent company, DSM Nutritional Products Europe (‘DSM’). The first contract was for the manufacturing of goods by Roche Vitamins and DSM agreed to buy the

entire stock of goods manufactured. In the second contract, Roche Vitamins would act as an agent and promote the products to customers in Spain on behalf of DSM. In terms of the operating structure,

‘Roche Vitamins [leased out] a small warehouse [to DSM] to store the products before sending them to the clients ... In addition, DSM was the one responsible for invoicing, but the purchase orders could be processed by any of the two companies, but Roche Vitamins was not allowed to alter or negotiate the sale conditions nor accept / conclude any contract on behalf of [DSM]’ (OECD, (n d), c).

The Spanish revenue authorities were of the opinion that DSM had created a PE in Spain in terms of Article 5 of the treaty between Spain and Switzerland. The case first came before the National Court which was called upon to decide on *inter alia*

‘whether [DSM] acted in Spain through a physical or agency PE under Article 5(1) and / or 5(4) of the treaty concluded between Spain and Switzerland’ (OECD, (n d), c).

In considering the physical (general) PE requirement under Article 5(1) of the treaty between Spain and Switzerland, the court noted that although DSM did have a fixed place of business in Spain (that is, the warehouse leased from Roche Vitamins), such premises did not constitute a PE as the activities performed at the said premises, namely, the storage of products before sending them to customers, was of a preparatory and auxiliary nature as envisaged under the exceptions set out in Article 5(3) of the treaty between Spain and Switzerland (OECD, (n d), c).

The National Court proceeded to consider the issue whether a dependent agent PE (as envisaged under Article 5(4) of the treaty between Spain and Switzerland) had been created in Spain as a result of the activities performed by Roche Vitamins on behalf of DSM. On this point, the court applied a wide interpretation of Article 5(4) and ruled that a dependent agent PE had in fact been created by DSM. In coming to this conclusion, the court *inter alia* argued that

‘the dependent agent clause works not only when the agent has authority to contract on behalf of the foreign principal, but also when, by nature of its activity [that is, the agent] it is involved in the business activities of the [foreign enterprise in the source country]’ (OECD, (n d), c).

DSM appealed the judgment passed by the National Court in the Supreme Court. However, without giving any extensive reasons for coming to its decision, the Supreme Court upheld the judgment of the National Court. Accordingly, DSM’s appeal was dismissed (OECD, (n d), c).

### ***Interpretation of the concept of a PE in the Zimmer, Dell and Roche cases***

The judgments passed by the courts in the *Zimmer, Dell* and *Roche* cases evidence the contradictory manner in which the concept of a PE could be interpreted. The judgments show that there is a degree of difficulty involved in determining whether a dependent agent PE has been created, in the context of a commissionaire arrangement.

Further, it can be argued that the judgments in the *Zimmer* and *Dell* cases illustrate that a literal and formalistic approach to interpreting the provisions of a double tax treaty and / or the OECD commentary to Article 5 of the 'OECD Model Tax Convention' (as applicable) may result in no dependent agent PE being created where an agent does not have the authority to bind a principal to a contract.

Whereas, it can be argued that the *Roche* case illustrates that a functionalistic-realistic or a case-by-case approach to the interpretation of the same provisions may result in the creation of a PE even in the absence of the agent's authority to bind a principal to a contract, provided that the agent performs extensive activities on behalf of that principal which in substance bind the principal to a contract.

Accordingly, in so far as commissionaire arrangements are concerned and given the varying possible outcomes based on the approach taken to interpret the concept of a PE, there is no certainty for MNEs and revenue authorities as to how a court may decide upon the merits of particular case.

The risk in the hands of a MNE is that if an audit instituted by revenue authorities concludes that a commissionaire arrangement results in the creation of a PE, the MNE using such a structure may need to attribute business profits to that PE and this may lead to more taxes payable by that MNE in the source state. Further, this will ultimately result in less business profits accruing to that MNE. The associated risks for revenue authorities relate to the unwarranted limitation of source taxing rights and the loss of potential tax revenue.

The research report has sought to argue that the issues relating to the use of commissionaire by MNEs for the purpose of avoiding PE status may be attributed to the hybrid nature of such arrangements, since such arrangements combine 'elements of both an agency and a distributor relationship' (Bloomberg, 2010). In this context, it can be said that revenue authorities or courts may face challenges in applying the threshold created by the concept of a PE to commissionaire arrangements on a consistent basis. This has been illustrated in the final judgments passed by the superior courts hearing the *Zimmer, Dell* and *Roche* cases, which differ from the various judgments passed by lower courts hearing the same cases.

Therefore, it can be argued that the proposed ‘Action 7’ changes to the definition of a PE as set out in Article 5(5) of the ‘OECD Model Tax Convention’ for the purpose of providing clarity on the appropriate treatment of commissionaire arrangements and other similar structures are a welcome development for the stakeholders concerned. The proposed ‘Action 7’ changes will be discussed in chapter 4.

### **3.3 Other abusive structures employed by MNEs**

The research report will now proceed by addressing other abusive structures employed by MNEs for purposes of artificially avoiding the threshold created by the concept of a PE, through the splitting up of contracts or fragmentation of activities performed in a state.

The OECD has stated that the splitting up of contracts may be problematic for the specific threshold created by the concept of a construction PE as defined in Article 5(3) of the ‘OECD Model Tax Convention’,

‘the exception in [Article 5(3) of the ‘OECD Model Tax Convention’], which applies to construction sites, has given rise to abuses through the practice of splitting-up contracts between closely related enterprises’ (OECD, 2015a, p 11).

Article 5(3) sets out a specific definition for a PE in so far as construction or installation projects are concerned. In particular,

‘a building site or construction or installation project constitutes a PE only if it lasts more than twelve months’ (OECD, 2014a, p 27).

The threshold created by the concept of a PE under Article 5(3) may at first sight appear to be a simple construct to apply since the permanence test required to trigger the PE is set out in the Article 5(3) definition of a PE itself, namely, the minimum period of twelve months that is required before the construction project can be considered as being a PE. It can be argued that the decisive consideration for when a PE is created is therefore whether the construction or installation project has lasted for more than twelve months.

This differs from the general PE defined under Article 5(1) of the ‘OECD Model Tax Convention’ which does not include the permanence test within the wording of the definition of a PE set out in the said paragraph. Rather the ‘fixed’ requirement, usually a period of six months, is read into the provisions of Article 5(1) through the OECD commentary (OECD, 2014a, p 97).

It can be argued that, although the conditions under which a PE is created in terms of Article 5(3) are expressly clear (that is, a PE is created if that construction or installation project lasts more than 12 months), the application of that PE concept may not be as simple.

This can be illustrated through the concerns raised in the OECD commentary to Article 5 of the ‘OECD Model Tax Convention’, that acknowledges at paragraph 18 that

‘enterprises (mainly contractors and subcontractors working on the continental shelf ...) divided their contracts into up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group’ (OECD, 2014a, p 102).

In such an instance, since ‘the twelve month test is applied to each individual project’ (OECD, 2014a, p 102), MNEs can artificially avoid PE status where several group entities are each assigned a specific contract which represents a single component of an entire construction or installation project. Such projects can last for several years, however, MNEs can ensure that a PE is not created in terms of Article 5(3) by ensuring that each company within the group does not exceed the twelve month period in delivering its services under the specific contract assigned to it in the context of the MNE servicing the complete construction project.

Similar to the possible abuses perpetrated by MNEs by splitting up contracts between closely related enterprises, the fragmentation of activities can be used by MNEs to artificially avoid PE status by abusing the exception to the PE definition set out in Article 5(4) of the ‘OECD Model Tax Convention’.

Article 5(4) of the ‘OECD Model Tax Convention’ sets out a list of activities which are deemed as not constituting a PE. For example, the ‘OECD Model Tax Convention’ (2014a, p 27) provides that these activities inter alia include,

‘the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; ... the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise’ (OECD, 2014a, p 27).

Further, Article 5(4)(f) also provides that

‘the maintenance of a fixed place of business solely for a combination of the activities mentioned in subparagraphs a) to e) [of Article 5(4)] will not result in the creation of a PE], provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character’ (OECD, 2014a, p 27).

The meaning ascribed to activities that will be considered as being preparatory or auxiliary in nature is discussed in the OECD commentary to Article 5 of the ‘Model Tax Convention’. In this regard OECD commentary notes that

‘a wide number of forms of business organisations are excluded, which although they are carried on through a fixed place of business, should not be treated as PEs. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question’ (OECD, 2014a, p 104).

The OECD (2015a, p10) has noted MNEs can artificially avoid PE status by

‘fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exemptions of Article 5(4)’ (OECD, 2015a, p 10).

### **3.4 Conclusion**

This chapter has sought to illustrate the manner in which MNEs use abusive tax schemes and complex operating structures that lie in the grey area of the law between tax avoidance and tax evasion, to artificially avoid PE status. This may allow MNEs take advantage of the shortcomings inherent in the definition of a PE which relate to the lack of clarity and varying interpretations that can be applied to the provisions of Article 5 of the ‘OECD Model Tax Convention’.

For example, commissionaire arrangements which have been problematic for revenue authorities in civil law jurisdictions, as illustrated by the *Dell*, *Roche* and *Zimmer* cases, specifically impact the threshold created by the concept of a PE under Article 5(5) and (6). The OECD (2015a, p 11) has also noted that the splitting up of contracts between closely related enterprises is an issue for construction PEs as defined under Article 5(3).

Further, the OECD (2015a, p 10) also notes that MNEs may seek to abuse the exceptions to the PE definition under Article 5(4) by fragmenting the activities of a cohesive business operation and arguing that such activities are preparatory or auxiliary in nature.

Consequently, for the purpose of curbing the abusive practices of MNEs, the OECD recognises that ‘the current definition of PE must be changed in order to address BEPS strategies’ (OECD, 2015a, p 14). To this end,

‘changes ... will be made to Article 5 of the OECD Model Tax Convention and the commentary thereon as a result of the work on Action 7 of the BEPS Action Plan. It should be noted that these changes are prospective only and, as such, do not affect the interpretation of the former provisions of the OECD Model Tax Convention and of treaties in which these provisions are included, in particular as regards the interpretation of existing paragraphs 4 and 5 of Article 5’ (OECD, 2015a, 14).

## Chapter 4 - ‘Action 7’: Changes to the definition of a PE

### 4.1 Introduction

Chapter 4 of the research report will examine the development and finalisation of ‘Action 7’ of the ‘BEPS Action Plan’ which seeks to propose changes to the definition of a PE, as well as outlining the key changes.

#### 4.1.1 *Mapping the development and finalisation of ‘Action 7’*

The OECD has produced three papers in the course of the development of ‘Action 7’. This started with the ‘Public Discussion Draft’ which was issued on 31 October 2014, following this a ‘Revised Discussion Draft’ was issued on 15 May 2015 and subsequently, a final version of the ‘Action 7’ report was issued on 5 October 2015.

##### ***‘Public Discussion Draft’***

As a starting point for the development of the proposed changes to the PE definition under ‘Action 7’,

‘the Focus Group on the artificial avoidance of PE Status, which was set up in order to carry out the work on Action 7, discussed various aspects of the PE definition that could give rise to BEPS concerns and identified a number of strategies resulting in the artificial avoidance of PE status. It then examined a number of options for changes to Article 5 that would address these strategies’ (OECD, 2014b, p 6).

The ‘Public Discussion Draft’ was structured as a series of alternative options aimed at addressing five avoidance strategies impacting the threshold created by the concept of a PE, namely, artificial avoidance of PE status through commissionaire arrangements and similar strategies (A), artificial avoidance of PE status through the specific activity exemptions (B), splitting up of contracts (C), insurance (D) and profit attribution to PEs and interaction with action points on transfer pricing (E) (OECD, 2014b, p 3).

The OECD invited stakeholders to provide comments on the ‘Public Discussion Draft’, and as a result, ‘more than 850 pages of comments were received and a public consultation meeting was held on 21 January 2015’ (OECD, 2015d, p 10). ‘The comments received ... reflected a number of concerns with respect to [avoidance strategies] A to D (OECD, 2015d, p 11).

However, the research report will only illustrate some of the key concerns that were raised under the various alternative options for avoidance strategy A, namely, artificial avoidance of PE status through commissionaire arrangements and similar strategies<sup>3</sup>. With regard to alternative option A,

‘most of the concerns expressed related to the uncertainty of the concept “habitually engages with the specific persons in a way that results in the conclusion of contracts” ... A large number of objections were also received on the part of Option A that referred to “the supply of goods owned by the enterprise or for the provision of services by the enterprise”: it was also suggested that this phrase was also unclear and overreaching. (OECD, 2015d, p 11).

For alternative option B,

‘most the concerns expressed related to the uncertainty of the concept “negotiates material elements of contracts” ... One commentator, however, noted that the conclusion of standardised contracts might not be caught by the provision. (OECD, 2015d, p 11).

The comments on alternative option C related to the vagueness and lack of clarity in ‘the phrases “by virtue of the legal relationship” and “contracts ... on the account and risk of the enterprise”’ (OECD, 2015d, p 11). Lastly, as alternative option D ‘was a combination of parts of options B and C, there were few specific additional comments on that option’ (OECD, 2015d, 12).

‘When Working Party 1 discussed the comments at its March 2015 meeting, the majority concluded that option B was preferable to options A, C and D’. (OECD, 2015d, p 12).

### ***‘Revised Discussion Draft’***

In considering the comments that were received on all of the avoidance strategies identified in the ‘Public Discussion Draft’, the Working Party 1 decided that the next step to be taken was to

‘move from a series of alternative options to one specific preferred proposal with respect to each PE avoidance strategy identified’ (OECD, 2015d, p 2).

To this end, the proposed changes to the provisions of Article 5 were amended in terms of the ‘Revised Discussion Draft’, ‘and on which the Committee on Fiscal Affairs [invited further comments from stakeholders]’ (OECD, 2015d, 4). It can be said that the ‘Revised Discussion Draft’ narrowed down the alternative options proposed under each of avoidance strategies identified by the OECD (that is, A to E, as set out in the ‘*Public Discussion Draft*’ sub-paragraph above).

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<sup>3</sup> In considering the fact that more than 850 pages of comments on the ‘Public Discussion Draft’ were received by the OECD, not all of the concerns that were raised under the various avoidance strategies will be addressed in this research report. For illustrative purposes, the research report will only consider some of the concerns raised on avoidance strategy A, namely, artificial avoidance of PE status through commissionaire arrangements and similar strategies.

In considering the amendments to the proposed option under avoidance strategy A, namely, artificial avoidance of PE status through commissionaire arrangements and similar strategies,

‘the Working Party also agreed ... that it would be important to provide additional commentary guidance on the changes that would be made to paragraphs 5 and 6 [of Article 5 of the ‘OECD Model Tax Convention’]’ (OECD, 2015d, p 12).

It can be said that the ‘Revised Discussion Draft’s’ inclusion of changes to the OECD commentary on the ‘OECD Model Tax Convention’ was an important development, as the ‘Public Discussion Draft’ only included proposed amendments and additions to the actual provisions of Article 5. As stated in the *Zimmer case* sub-paragraph of chapter 3.2.1 above, since OECD commentaries may be used as interpretive aids for tax treaties, it can be argued that any updates to the actual provisions of Article 5 should be complemented by similar updates to the OECD commentary which helps explain the meaning ascribed to the provisions of Article 5.

Interested stakeholders were requested to send their comments on the ‘Revised Discussion Draft’ to the OECD by ‘12 June 2015’ (OECD, 2015d, p 2). As was the case under the ‘Public Discussion Draft’, stakeholders also raised several concerns regarding the amendments proposed under the ‘Revised Discussion Draft’<sup>4</sup>.

With regard to avoidance strategy A, namely, artificial avoidance of PE status through commissionaire arrangements and similar strategies, it was proposed that paragraphs 32.5 and 32.6 of the OECD commentary should be further clarified. The concern raised was that

‘it is very difficult to assess what the phrases “or negotiates the material elements of a contract” and “concludes contracts or negotiates the material elements of a contracts” mean for the service industry and namely for the financial sector. In particular for the banking industry where employees are visiting clients outside the country of residence of the bank further guidance should clarify what kind of activities are regarded as material elements of a contract’ (OECD, 2015e, p 296).

In addition to the concern addressed in the paragraph directly above, stakeholders also raised the concern that

‘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

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<sup>4</sup> As noted in the footnote 2, several comments on the ‘Revised Discussion Draft’ were also received by the OECD. Therefore, not all of the concerns that were raised under the various avoidance strategies will be addressed in this research report. For illustrative purposes, the research report will only consider some of the concerns raised on avoidance strategy A, namely, artificial avoidance of PE status through commissionaire arrangements and similar strategies.

arrangements, and will apply to many transactions that do not raise BEPS-related concerns' (OECD 2015e, p 300).

Following the finalisation of the discussions on the amendments proposed under the 'Revised Discussion Draft' the OECD released its final report on 'Action 7' on 5 October 2015. The final report on 'Action 7' followed most of the proposals put forward in terms of the 'Revised Discussion Draft'. The 'Action 7' proposals will be implemented through a 'Multilateral Instrument' which 'was adopted in November 2016' (National Treasury, 2017, p 137).

### ***'Action 7' - final report***

The research report will now proceed to address some of the key changes introduced for the purpose of amending the definition of a PE set out in Article 5 of the 'OECD Model Tax Convention', including the supporting OECD commentary thereto.

As discussed in chapter 3 above, 'Action 7' is inter alia concerned with three specific cases, namely, commissionaire arrangements, the splitting up of contracts between closely related enterprises, as well as the fragmentation of activities. The changes to the definition of a PE proposed under 'Action 7' have been set out in **Appendix 3** to this research report.

## **4.2 Changes to Article 5(5) - dependent agent PE and Article 5(6) - independent agent rule**

With regards to the issues concerning the use of commissionaire arrangements by MNEs to artificially avoid PE status, 'Action 7' (OECD, 2015a, p 16) proposes changes to the wording of paragraphs 5 and 6 of Article 5, as well as the supporting OECD commentary thereto, to bring the said provisions in line with the main aim of the 'BEPS Action Plan', namely,

'to prevent multinational businesses achieving non-taxation on profits or artificially shifting profits across borders to exploit lower corporate income tax rates' (KPMG, 2014, p 5)

The test for the dependent agent PE as set out in Article 5 of the 'OECD Model Tax Convention' focuses on the habitual conclusion of contracts by an agent. 'Action 7' proposes a revised test for the dependent agent PE by inserting, inter alia, the following wording in paragraph 5 of Article 5,

'where a person ... habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise ...' (OECD 2015a, p 16).

By way of example, looking to the fact pattern of the *Zimmer* case (OECD, (n d), a) which was discussed in chapter 3, Zimmer SAS as the commissionaire (agent) could perform most of the significant tasks leading up to the conclusion of contracts with customers, such as accepting orders, tendering offer documents and negotiating pricing with customers (OECD, (n d), a).

Further, there was no evidence that Zimmer Limited (as the principal) questioned any of the contractual terms that Zimmer SAS agreed with French customers (OECD, (n d), a). It can be argued that a commissionaire arrangement based on such terms may result in the creation of PE under the new definition of a dependent agent PE, since the updated definition of a dependent agent PE favours a functionalistic-realistic approach to interpreting the threshold created by the concept of a PE.

This is because the wording used in the updated definition appears to place a greater emphasis on the actual activities performed by the agent in the process of concluding contracts. As such, the actual authority to conclude contracts does not set the limits of the new dependent agent test, as the said test now looks more to the factual substance of the activities performed by an agent. Therefore, where the nature of the activities performed by the agent have the ability to bind the principal to a contract, such activities may result in the creation of a dependent agent PE.

However, PWC (2015, p 1) have cautioned that the wording used in the new definition of a dependent agent PE may have left some unanswered questions concerning the scope of the new dependent agent test. In particular,

‘the criteria for assessing whether the “principal role” test is met and the meaning of ‘material modification’ [remains unclear].

A particular concern will be whether, and in what circumstances, client relationship functions that involve introducing new business to a client (covering potentially a very broad spectrum of agency activity), are caught’ (PWC, 2015, p 1).

‘Action 7’ also proposes changes to the independent agent rule as set out in paragraph 6 of Article 5 of the ‘OECD Model Tax Convention’. In general, the activities of an agent of an independent status should not create a PE for a MNE where that agent acts in the ordinary course of its own business. The following wording has been introduced to the provisions of paragraph 6 -

‘Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise’ (OECD, 2015a, p 16).

The updated wording for paragraph 6 of Article 5 also goes on to explain the circumstances under which a person will be considered as being closely related to an enterprise, namely,

‘if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if [one company] possesses directly or indirectly more than 50 per cent of the beneficial interest in the [other company]’ (OECD, 2015a, p 17).

Therefore, by way of example, it can be argued that where an agent, Company A, acts exclusively on behalf a non-resident entity, Company B, falling within the same group of companies (that is, where there is more than a 50% shareholding connection between the said companies), Company A will be precluded from claiming an independent agent status and such an arrangement may create a dependent agent PE for Company B in the state where Company A performs the given activities on behalf of Company B.

However, it can be argued that that the proposed changes to the independent agent rule could also be considered as narrowing the said rule too much, and may have a negative impact on certain operating structures that have not been set up for the purpose of artificially avoiding PE status.

For example, where an entity in a group of companies has the expertise and technical capabilities that are required for the purpose of performing a particular task / service, it may make more sense (from a business operational standpoint) for that entity to act exclusively on behalf of other related entities falling within the same group of companies that require that given task / service. Although the entity acts exclusively for other related entities within the same group of companies, such an entity should not be precluded from qualifying for an independent agent status.

In other words, an entity should be allowed to act exclusively for its related group entities if such an operating structure is based on sound commercial rationale that is not motivated by tax considerations. Therefore, the legitimate co-ordinated efforts of closely related enterprises should not always be perceived as constituting abusive tax schemes. However, where a narrow approach to interpreting the independent agent rule is applied, such operating structures may no longer be viable under the amended PE definition.

#### **4.3 Changes to Article 5(4) - specific activity exceptions**

‘Action 7’ (OECD 2015a, p 28) also proposes changes to the wording of the specific activity exceptions to the PE definition as set out in Article 5(4) of the ‘OECD Model Tax Convention’. As stated in chapter 3, the current provisions of Article 5(4) set out a list of activities which are deemed as not creating a PE even though such activities are performed at a fixed place of business.

In particular, ‘Action 7’ proposes amendments to the wording used in Article 5(4), that will result in all of the exceptions illustrated therein, being ‘subject to an [overall] ‘preparatory or auxiliary condition’ (OECD, 2015a, p 28).

‘Action 7’ (OECD, 2015a, p 30) also proposes amendments to the wording used in the OECD commentary to Article 5, for the purpose of providing further clarity on the meaning of the terms preparatory or auxiliary. To this end, the wording introduced to paragraph 21.2 of the OECD commentary to Article 5 provides that,

‘as a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes an activity, it will often be carried on during a relatively short period ... An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole’ (OECD, 2015a, p 30).

Furthermore, ‘Action 7’ also proposes the addition of a new anti-fragmentation rule as paragraph 4.1 to Article 5 of the ‘OECD Model Tax Convention’. The proposed wording to be introduced provides *inter alia*

‘[the exceptions to the PE definition] shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place ... [and those activities] constitute complementary functions that are part of a cohesive business operation’ (OECD, 2015a, p 39).

Paragraph 27.1 of the OECD commentary illustrates the meaning of complementary functions by providing that,

‘places 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, distributing those goods through another. [As such], an enterprise cannot fragment a cohesive business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity’ (OECD, 2014a, p 106).

Therefore, in terms of the exceptions to the amended PE definition, where the business operations performed by a MNE (or by closely related enterprises) from a fixed place of business in a state are split into separate activities (which are executed on a smaller scale), such activities may not be considered as being preparatory or auxiliary in nature if those activities constitute ‘essential and significant’ (OECD, 2015a, p 30) parts of a cohesive business enterprise. Consequently, the MNE will be unable to artificially avoid PE status, as such activities will not qualify under the exceptions to the PE definition.

The ‘Action 7’ proposal to make all of the Article 5(4) exceptions to the PE definition subject to an overall preparatory or auxiliary requirement has not been accepted by all stakeholders participating in the BEPS discussions. The OECD has noted that,

‘some states consider that some of the activities referred to in paragraph 4 are intrinsically preparatory or auxiliary and, in order to provide greater certainty for both tax administrations and taxpayers, take the view that these activities should not be subject to the condition that they be of a preparatory or auxiliary character’ (OECD, 2015a, p 38).

Therefore, the proposed ‘Action 7’ changes also make provision for states to ‘adopt a different version of Article 5(4) as long as they include the anti-fragmentation rule’ (OECD, 2015a, p 28).

#### **4.4 Changes to Article 5(3) - construction PE**

In so far as construction PEs are concerned, the proposed ‘Action 7’ amendments to Article 5(3) of the ‘OECD Model Tax Convention’ also address the issue relating to ‘the artificial splitting-up of longer-term contracts to fall within the [twelve month permanence test]’ (PWC, 2015, p 2).

In this regard ‘Action 7’ (OECD, 2015a, p 42) proposes that a principal purposes test, which is being proposed in terms of a separate Action under the ‘BEPS Action Plan’, namely, ‘Action 6 - Preventing treaty abuse’, will be used to address the issues raised concerning the splitting up of contracts. ‘Action 7’ (OECD, 2015a, p 42) provides that the principal purposes test will be added to the OECD commentary.

The research report will not address the scope and aim of ‘Action 6 - Preventing treaty abuse’, however, in considering some of the changes proposed by the said Action, EY (2016a, p 1) noted that under principal purposes test

‘a treaty benefit shall not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction (subjective test), unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the treaty (objective test). The subjective test is, from the viewpoint of the tax authorities a relatively ‘easy’ test. The objective test, however, can provide for some relief for taxpayers’ (EY, 2016a, p 1).

It can be argued that, where it can be illustrated (both from a subjective and objective standpoint) that a MNE split up contracts relating to long term construction or installation projects, for the purpose of artificially avoiding the threshold created by the concept of a construction PE as defined in Article 5(3) of the ‘OECD Model Tax Convention’, the principal purposes test will be applied and such contracts will be considered as falling under one cohesive project and the twelve month permanence test will be applied to the cohesive project.

In addition, ‘Action 7’ (OECD, 2015a, p 42) also proposes the addition of a new example to the OECD commentary on the ‘OECD Model Tax Convention’ for the purpose of illustrating the application of the principal purposes test (the example has been set-out in **Appendix 3** of this research report).

## 4.5 Conclusion

This research report has sought to illustrate the manner in which the proposed ‘Action 7’ amendments to the PE definition will address the issue of artificial avoidance of PE status. With regard to the proposed changes under ‘Action 7’ (OECD 2015 a, p 16) to paragraphs 5 and 6 of Article 5, it can be argued that the test for the dependent agent PE has been widened so as to place more emphasis on the substance of the activities performed by an agent, rather than just limiting the said test to the authority to conclude contracts.

The exceptions to the PE definition as set out in Article 5(4) have been further clarified under ‘Action 7’ (OECD, 2015a, p 39), for the purpose of preventing the artificial avoidance of PE status through the fragmentation of activities that constitute essential elements of a cohesive business enterprise.

The proposed amendments under ‘Action 7’ (OECD, 2015a, p 30) have also provided more clarity for the type of activities that will be considered as being preparatory or auxiliary in nature. In addition, ‘Action 7’ (OECD, 2015a, p 42) also proposed that the principal purposes test will be used as the mechanism for addressing the issue relating to the artificial avoidance of PE status through the splitting up of contracts.

The proposed ‘Action 7’ amendments (together with the other Actions of the ‘BEPS Action Plan’), will be implemented via changes to the domestic laws and the respective tax treaty networks of participating countries to the ‘BEPS Action Plan’. In South Africa, for example, in the 2017 national budget speech, the National Treasury confirmed that,

‘South Africa’s future tax treaty negotiations will take the recommendations dealing with fragmentation of activities and avoidance of PE status through specific activity exemptions into account. The aim is to prevent entities artificially avoiding their status as a PE (a fixed place of business) by breaking up their cohesive business into smaller operations’ (National Treasury, 2017, p 137).

With specific regards to the changes to be made to tax treaties that are currently in place, it is envisaged that the implementation of the changes is achievable through a ‘Multilateral Instrument’ which ‘was adopted in November 2016’ (National Treasury, 2017, p 137).

‘South Africa is among more than 100 countries and jurisdictions that have reached consensus on the Multilateral Instrument capable of incorporating tax treaty-related base erosion and profit shifting measures into the existing network of bilateral treaties’ (National Treasury, 2017, p 137).

It is envisaged that the ‘Multilateral Instrument’ will be implemented at ‘a signing ceremony [that] will be held in June 2017 in Paris’ (OECD, 2016a). This research report will argue that, once implemented, the proposed ‘Action 7’ changes will impact the manner in which MNEs conduct business. This matter will be discussed in greater detail in chapter 5.

## **Chapter 5 - The impact of the changes to the definition of a PE on the way MNEs conduct business**

### **5.1 Introduction**

Chapter 5 will involve an evaluation of the impact of the proposed ‘Action 7’ changes. For this purpose, the final sub-problem that will be addressed in this research report will focus on whether the proposed ‘Action 7’ measures will force MNEs to modify their current operating structures and aggressive tax planning strategies, including some consideration of the level of scrutiny likely to be applied by revenue authorities to the said structures going forward.

‘[‘Action 7’] sets forth specific amendments modifying paragraphs 4, 5 and 6 of Article 5 of the [‘OECD Model Tax Convention’], together with proposed commentary to provide guidance on the new rules.

Once implemented, [the proposed] amendments will have implications for how companies operate global businesses going forward as current operating models could create new PEs in other countries for these companies. New PEs would mean additional tax filing obligations and increased potential for controversy. Moreover, the issue of profit attribution to these new PEs is an important matter for businesses, and the work on that issue [is yet to be finalised]’ (EY, 2015).

As a result, if PEs were to be triggered in new locations, MNEs may be under an obligation to account for profits which were not previously allocated to such locations. Therefore, MNEs may need to pay corporate tax in jurisdictions where they previously had no tax exposure under the current PE definition (that is, the definition prior to the proposed ‘Action 7’ amendments).

The research report will now proceed to address certain operating structures that will be impacted by the changes to the PE definition.

### **5.2 Commissionaire structures**

It can be argued that MNEs operating in foreign jurisdictions using commissionaire arrangements and similar structures may have a tough time defending any possible challenges raised by revenue authorities, based on the wording included, in the new PE definition, namely,

‘habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise ...’ (OECD, 2015a, p 16),

There is a risk that such arrangements could result in the creation of a dependent agent PE. This can be argued on the understanding that, in assessing the nature of commissionaire arrangements revenue authorities may apply more functionalistic-realistic approach to applying the threshold created by the

concept of PE (as stated in chapter 4.2). In this regard, where an agent (commissionaire) ‘habitually concludes contracts ... without material modification by the enterprise’ (OECD, 2015a, p 16) a PE may be created, even if those contracts are not actually in the name of that principal.

### ***Other operating structures that are similar to commissionaire arrangements***

Where MNEs send their employees to perform sales activities in foreign jurisdictions, such activities may create a PE as defined in Article 5(1) of the ‘OECD Model Tax Convention’ if the employees operate from ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’ (OECD, 2014a, p 26).

However, a PE as defined in Article 5(1) may be avoided where the employees do not operate from a fixed place of business (that is the, the ‘fixed’ requirement in the PE definition is not met). However, a potential argument could be made that, even in the absence of a fixed place of business, such arrangements could now also be potentially captured under the amended PE definition. For example, where an MNE has employees who frequently travel to other countries to perform sales activities on behalf of that MNE, a dependent agent PE may be created if the employees ‘play principal role leading to the conclusion of contracts’ (OECD, 2015a, p 16).

Therefore, going forward MNEs (in assessing possible PE risk exposure under the new definition) should not only consider the period of time spent by employees in a foreign jurisdiction. OECD commentary (OECD, 2014a, p 97) notes that a period of six months is sufficient to satisfy the permanence test that is applied under Article 5(1) of the ‘OECD Model Tax Convention’, but it is also important for MNEs to take note of the nature of activities performed by the employees in that foreign jurisdiction.

Where it can be determined that the activities performed by employees or agents could result in the creation of a PE, MNEs conducting business in a foreign jurisdiction using a commissionaire arrangement or similar structure may need to reconsider the operating structure, either by significantly limiting the scope of activities that can be performed by employees or agents, or ceasing the performance of those activities altogether. Where MNEs elect to continue using such structures, an alternative for MNEs, could be setting up governance policies and legal documentation that can be used to closely manage PE risks. In this regard it may be advisable for MNEs to consult tax professionals on the preparation of PE risk management documentation.

### **5.3 The representative office operating model**

With regard to the exceptions to the definition of a PE as set out in Article 5(4) of the ‘OECD Model Tax Convention’, the proposed ‘Action 7’ amendments to the said provisions may have an impact on MNEs that use a representative office operating model (also commonly referred to as a liaison office) for conducting business in foreign jurisdictions.

‘Any activity carried out by a business in a country that results in revenue being generated or value created is likely to be deemed by local tax authorities as a PE ... Local tax authorities will in turn assess corporate tax on deemed revenue arising in-country. In most countries, in order to recognise a PE or a taxable presence, the revenue-generating entity needs to be formally registered under some corporate identity, typically a branch, representative office or subsidiary (Radius, (n d)).

‘A representative office is an office established by a company to conduct marketing and other non-transactional operations, generally in a foreign country where a branch office or subsidiary is not warranted. Representative offices are generally easier to establish than a branch or subsidiary, as they are not used for actual “business” (for example, sales) and therefore there is no incentive for them to be regulated’ (CTI Review, 2016).

It can be argued that the representative office operating model allows a MNE to perform some level of business activity in a state without creating a taxable presence therein based on the understanding that the activities performed by that MNE in the said state are of a preparatory or an auxiliary character in relation to the business of the MNE as a whole.

It can be argued further that, even if a fixed place of business in state is established (that is, a PE is created as a result of the activities performed by the representative office), MNE’s exposure to tax risk remains low as there are no profits attributable to that PE, since a representative office does not generate income. Rather, a representative office only performs non-income generating activities that support the overall business carried on by a foreign enterprise.

In examining the threshold created by the concept of a PE as defined in Article 5 of the ‘OECD Model Convention’, SAICA (2007) noted that offshore banks can operate in South Africa using a representative office operating model. To this end it was stated that,

‘off-shore banks wishing to set up a representative office in South Africa should consider the South African tax implications of those activities. Typically, offshore banks set up representative offices mainly for purposes of identifying potential clients for the offshore bank and doing some marketing to such clients. [The representative office] ... usually progress the relationship with the client’ (SAICA, 2007).

By way of example, it can be argued that an offshore bank that is a resident of Country A, may employ the representative office operating model for the purpose of prospecting the local market in Country B. The activities performed by the offshore bank in Country B could include marketing product offerings and engaging in discussions with local customers for potential business opportunities. In such a structure, the main banking activities of the foreign bank (such as, customer credit risk assessments, deposit taking, lending and payment services), will be performed in Country A.

However, where the activities performed by the representative office in Country B are considered as being preparatory or auxiliary nature in relation to the business activities carried on (by the offshore bank) in Country A, it can be argued that no PE is created in Country B since the activities performed by the representative office could qualify under the exceptions to the PE definition set out in Article 5(4).

In light of the proposed ‘Action 7’ changes to the definition of a PE, MNEs may however need to assess the representative office operating model for the purpose of determining whether the activities performed by a representative office in a foreign jurisdiction would still qualify under the exceptions to the amended PE definition as set out in Article 5(4), since the OECD has

‘agreed to modify Article 5(4) ... so that each of the exceptions included in that provision is restricted to activities that are otherwise of a “preparatory or auxiliary” character’. (OECD, 2015a, p 28).

Further, ‘Action 7’ (OECD, 2015a, p 30) also proposes amendments to the wording used in the OECD commentary to Article 5, for the purpose of providing further clarity on the meaning of the terms preparatory or auxiliary. To this end, the wording introduced to paragraph 21.2 of the OECD commentary to Article 5 provides that,

‘an activity that has a preparatory ... precedes an [essential and significant] activity, it will often be carried on during a relatively short period ... An activity that has an auxiliary character ... is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole’ (OECD, 2015a, p 30).

Therefore, banks employing the representative office operating model for business operations in foreign jurisdictions, will need to take note of the clarified meaning of preparatory and auxiliary as set out in paragraph 21.2 of the OECD to commentary.

In so far, as the preparatory requirement is concerned, it can be argued that where the activities performed by the representative office precede the main activities of the foreign bank, for example, marketing products and preparing brochures for new customers, the activities performed by the representative office could qualify as being preparatory in nature. However, it is questionable whether such activities would still qualify as being preparatory in nature where the said activities are performed over a significant period of time, for example, where the representative office continues to engage existing customers on the terms of the product offerings taken up with the foreign bank.

However, in instances where the representative office performs its activities over a significant period of time, such activities may still qualify under the auxiliary requirement provided that the said activities do not form ‘an essential and significant part of the activity of the enterprise as a whole’ (OECD, 2015a, p 30). The risk arises where the representative is viewed as performing the main

business activities of the foreign bank itself, for example, negotiating credit terms, or assessing customer credit risk profiles.

Accordingly, where the ‘preparatory and auxiliary’ requirements are not met, the activities performed by the representative office may not qualify under the Article 5(4) exceptions to the amended PE definition, and the representative office may also create a PE for the foreign bank in a state.

Where a representative office is considered as a PE for the foreign bank, revenue authorities may challenge the operating structure by arguing that a portion of the business profits generated by the foreign bank are attributable to that PE, and accordingly such profits should be taxed in the state where the representative office is located. On this basis, the business profits generated by the foreign bank may need to be split between two jurisdictions.

This research report has argued that the representative office operating model allows a MNE to perform some level of business activity in a state without creating a taxable presence therein. However, this may not be the case where the representative office is considered as having created a PE for the non-resident, and business profits are attributable to that PE. Therefore, the risk in the hands of the MNE conducting business in a foreign jurisdiction using a representative office operating model is that, some of the advantages attaching to the use of such a structure (namely, not having a taxable presence in the source country) will be undone where the activities of the representative office do not meet the preparatory and auxiliary requirement of the amended PE definition under Article 5(4).

#### **5.4 Maintenance of a stock of goods in a foreign country**

Further to the arguments made in chapter 5.3 above, it can also be argued that the proposed ‘Action 7’ changes (OECD, 2015a, p 30) relating to the clarified meaning ascribed to the activities that are considered as being preparatory or auxiliary in nature, may also need to be considered closely by MNEs that maintain a stock of inventory in a foreign country for the purpose of storage, display or delivery.

For example, in terms of this operating model, the stock of inventory could be stored at the warehouse or premises of a related entity or third party for the purpose of storage, display or delivery. Such an operating structure is specifically defined as an exception to the PE definition under Article 5(4)(b) of the ‘OECD Model Tax Convention’.

In considering the impact of the proposed ‘Action 7’ changes on the exception to the PE definition listed in Article 5(4), EY (2016c, 107) has noted

‘that the exemption in sub-paragraph b) would be irrelevant where the stock of an enterprise is stored at a warehouse maintained by an independent logistics provider because such warehouse would not

constitute a fixed place of business as the enterprise does not have this third-party warehouse at its disposal. However, if the enterprise were allowed unlimited access to a separate part of that warehouse in order to inspect and maintain the stock, then it would have that place of business at its disposal and whether sub-paragraph b) applies would depend on whether the activity of maintaining stock at the warehouse is of a preparatory or auxiliary character' (EY, 2016c, 107).

Therefore, it can be argued that where a fixed place of business is maintained, there is a risk that a PE may be created where the activities relating to the maintenance of a stock of goods are not auxiliary in nature as they constitute a 'significant and essential' (OECD, 2015a, p 30) part of the overall business of a MNE. The risk is of particular concern to MNEs that are distributors of goods.

This can be argued by way of an example, where a MNE that is tax resident in Country A may elect to expand its customer base by selling its products in a foreign jurisdiction, namely, Country B. The MNE may incorporate a wholly owned subsidiary in Country B. The MNE sells its products to the subsidiary, and the subsidiary (which acts as a limited risk distributor) in turn sells the products to customers in Country B. However, in terms of this structure, the MNE assumes the principal role for the distribution of products and may take responsibility for the following activities: manufacturing the products in Country A; exporting all products to Country B; storing the products in a warehouse in Country B; selling products to the subsidiary flash title (that is, where legal ownership of the products passes from the manufacturer to the subsidiary during the process of shipping); and arranging for final delivery of product to the end customer of the subsidiary.

Where Country A and Country B are located far apart, with significant transport costs involved in the export of products from one country to the other, the MNE may elect to maintain large stockpiles of products in a warehouse in Country B for the purpose of minimising transport costs and ensuring that goods are delivered to the subsidiary's end customers in a timely and cost efficient manner.

However, where the activities relating to the storage of goods for the purpose of a delivery is viewed as a significant aspect of the overall business of the MNE, then the said activities will not qualify as being auxiliary in nature. Therefore, the activities of the MNE may create a PE in Country B, as the leased warehouse will constitute a fixed place of business.

Even, in the event that the activities relating to the the storage of goods for the purpose of a delivery are considered as being auxiliary and preparatory in nature, the the anti-fragmentation rule may apply since the MNE and the subsidiary are closely related enterprises. The aim of the anti-fragmentation rule, is to prevent enterprises from

'fragmenting a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity' (OECD, 2014a, p 106).

MNEs operating under a distributor model may therefore have to review their operating structures in order to confirm whether the maintenance of a stock of goods in a foreign country constitutes a significant and essential element of the overall business carried on. It can be argued that the risk involved may be mitigated by changing the status of the subsidiary in the source country from being a ‘limited risk’ distributor to a ‘full risk’ distributor.

By way of example, it can be argued that, under the ‘full risk’ distributor alternative, the subsidiary can take direct responsibility for importing the goods and storing the goods for the purpose of delivery to its end customers. However, a ‘full risk’ distributor model may result in less profits for the MNE as the price margins on the products sold would need to be adjusted to take into account the MNE’s reduced risks in relation to the products sold.

## **5.5 Toll manufacturing operations**

Deloitte (2015) has also noted that MNEs that currently conduct business operations in foreign jurisdictions using toll-manufacturing arrangements will also need to review their current operating structures in light of amended PE definition.

‘In a toll manufacturing arrangement, a company provides its raw materials or semi-finished goods to a third-party [or a related party] service provider. The service provider, who often has specialised equipment or infrastructure, provides a subset of manufacturing processes on behalf of the company using those materials or goods for a fee’ (Goldner et al, 2013, p 1).

‘In today’s corporate environment, many companies consider toll manufacturing arrangements in emerging market countries to reduce costs while maintaining access to a highly educated and technologically advanced work force’ (Goldner et al, 2013, p 1).

MNEs that use toll-manufacturing structures to operate in foreign jurisdictions, may qualify under the exception to the PE definition set out in Article 5(4)(c), namely,

‘the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise’ (OECD, 2015a, p 29).

However, under the amended definition of a PE, the Article 5(4)(c) exception will now be subject to the overall preparatory and auxiliary requirement. As noted in chapter 5.4 above, the proposed ‘Action 7’ changes may have a significant impact on cross border arrangements relating to the maintenance of stock. Deloitte (2015) is of the view that,

‘the first test for most multinationals will be whether the premises in the local country (for example, a warehouse, or toll manufacturing facility) is “at the disposal” of the non-resident entity. “At the disposal” remains a concept introduced in the commentary, and does not form part of the model treaty wording, but again the policy intent is clear. Even if the premises are “at the disposal,” exceptions are available for preparatory or auxiliary activities’ (Deloitte, 2015).

‘However, the anti-fragmentation rule may apply to these exceptions, and for large multinationals it is likely that there will be other activity by group companies in the same country such that the exceptions will not apply. This may mean significant additional compliance for principals of toll manufacturing operations, and those that hold stock overseas for other reasons’ (Deloitte, 2015).

## **5.6 Construction and installation projects**

‘Action 7’ amendments to Article 5(3) of the ‘OECD Model Tax Convention’ also address the issue relating to ‘the artificial splitting-up of longer-term contracts to fall within the [twelve month permanence test]’ (PWC, 2015, p 2).

MNEs that split up contracts between closely related enterprises so that each contract lasts for less than twelve months will need to ensure that they do not fall foul of the principal purposes test, which inter alia examines whether connected activities were split up for the purposes of obtaining a tax benefit.

‘The determination of whether activities are connected will depend on the facts and circumstances of each. Factors that may especially be relevant for that purpose include: whether the contracts covering the different activities were concluded with the same person or related persons; whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons; whether the activities would have been covered by a single contract absent tax planning considerations; whether the nature of the work involved under the different contracts is the same or similar; whether the same employees are performing the activities under the different contracts’ (OECD, 2015a, p 43).

## **5.7 Level of scrutiny to be applied by revenue authorities going forward**

With regard to level of scrutiny likely to be applied by revenue authorities (to the operating structures discussed above) going forward, it can be argued that possibly more disputes will arise concerning the allocation of taxing rights and the attribution of profits to new PEs. This may also result in more cases being brought before the courts. In this regard, it may be important for revenue authorities to understand that

‘if conflicting interpretations arise because the PE threshold is unclear ..., the resulting disputes will almost certainly go unresolved, with no treaty relief from double taxation, even in competent authority proceedings, absent effective arbitration. The risk of unrelieved double taxation is further heightened by the general lack of appetite for effective dispute resolution and the absence to date of additional profit attribution guidance’ (OECD, 2015e, p 310).

OECD commentators on the ‘BEPS Action Plan’ are of the view that it may be imperative for revenue authorities to focus on the upcoming challenges, which include,

‘supporting the implementation of the recommended changes in a consistent and coherent manner, monitoring the impact on double non-taxation and on double taxation, and designing a more inclusive framework to support implementation and carry out monitoring (Goldner et al, 2013, p 1).

[The challenge is that] some of the revisions ... [may] require changes that can be implemented via tax treaties, including through the Multilateral Instrument. Some require domestic law changes. [As countries are sovereign], it is therefore up to them to implement these changes, as long as the changes do not conflict with their international legal commitments’ (OECD, 2015b, p 11).

## **5.8 Conclusion**

The research report has argued that the changes proposed under ‘Action 7’ will have a significant impact on the way MNEs conduct business using certain operating structures, namely, commissionaire arrangements, representative office operating models, the maintenance of a stock of goods in a foreign country, toll manufacturing operations and construction / installation projects.

It can be argued that, in so far as representative office operating models, the maintenance of a stock of goods in a foreign country and toll manufacturing operations are concerned, MNEs may mitigate PE risk exposure by limiting the activities performed in a foreign jurisdiction in order to ensure that such activities remain preparatory and auxiliary in relation to the overall business enterprise carried on.

However, where commissionaire arrangements, and construction / installation projects are involved, MNEs may need to overhaul the features of such operating structures since it can be argued that the dependent agent test and principal purposes test have a strict basis of application (that is, the said tests can be applied widely). Both tests look to the objective facts and examine the substance of the activity taking place.

As a recommendation, it would be advisable for MNEs that conduct cross-border business using the operating models discussed in this chapter, to perform a review of their current operating structures (which may not create a taxable presence under the current threshold of the concept of PE), since there is a risk that those structures could now potentially create a taxable presence under the amended PE definition. Where new PEs are created, MNEs will need to register and pay tax in the relevant source state.

## Chapter 6 - Conclusion

This research report has argued that economic developments that have been brought forth by globalisation may potentially result in economic growth for some countries, but the said developments also create conflict between the state and MNEs. This conflict is centred on the issue of tax.

‘With multinational businesses increasingly accused of manipulating existing rules to artificially shift profits across borders and take advantage of lower tax rates, the question has been raised whether the current international tax principles [established historically] are still fit for purpose’ (KPMG, 2014, p 6).

The conflict stems from the issues inherent in the current format of international tax rules, that have failed to keep up to pace with the manner in which MNEs have begun to conduct cross-border business operations.

MNEs may sometimes use complex operating structures and aggressive tax strategies for the purpose of conducting cross-border business operations. The use of complex operating structures remains a contested issue in so far as the debate on tax avoidance and tax evasion is involved. The research report has considered various types of operating structures which can be used by MNEs to reduce tax payable in a foreign jurisdiction. An example of such an operating structure is a commissionaire arrangement.

As noted by Pareek (2015), the use of commissionaire arrangements by MNEs has been problematic for revenue authorities as illustrated by the number of cases that have been brought before the courts. In line with the views of the OECD (p 2015a, p 9) on the legal nature of such arrangements, it can be argued that, since commissionaire arrangements are not expressly prohibited by law, such arrangements can be used by MNEs to conduct sales activities in foreign jurisdictions without creating a taxable presence therein. Further, Sullivan & Cromwell (2010, p 1) have noted that commissionaire arrangements are particularly common in civil law jurisdictions such as France.

The use of complex operating structures and aggressive tax strategies by MNEs (such as the fragmentation of connected activities performed in a state and argument that each activity is preparatory or auxiliary in nature and therefore qualifies under the exceptions to the PE definition), results in BEPS, where ‘[profits are shifted] to low or no-tax locations where there is little or no economic activity’ (OECD, 2017).

The OECD took steps to address the issues which have been affecting international tax rules in an adverse manner. The product of this initiative, was the OECD's 'BEPS Action Plan'.

'With the adoption of the BEPS package, OECD and G20 countries, as well as all developing countries that have participated in its development, will lay the foundations of a modern international tax framework under which profits are taxed where economic activity and value creation occurs' (OECD, 2015b, p 11).

The technical arguments addressed in this research report pertain to the threshold created by the concept of a PE. The OECD (2015a, p 9) has acknowledged that a PE is an important aspect of international tax in so far as the application of tax treaty for the avoidance of double tax is concerned, since a country's right to tax the profits of a foreign business enterprise may be limited where the foreign enterprise has not created a PE therein.

Chapter 2 of this research report has identified certain problems inherent in the current definition of a PE as set out in the 'OECD Model Tax Convention' (that is, the definition prior to the proposed 'Action 7' amendments), namely, the varying interpretations that can be applied to the definition of a PE and the absence of a universally accepted method for applying the threshold created by the concept of a PE. In this regard, chapter 2.4 of this research report has argued that the result is, the concept of a PE can be interpreted in diverging and often conflicting ways. The lack of clarity and the varying interpretations that can be ascribed to the meaning of the definition of a PE, potentially expose the said concept to possible abuse by MNEs through the use of complex operating structures and aggressive tax strategies.

Based on the views of KPMG (2014) on the current state of international tax rules, namely, 'national laws have not kept up with globalising businesses [and] accelerating capital mobility' (KPMG, 2016, p 1), this research report has argued that, the definition of a PE will need to be refined in order to ensure that the concept of a PE remains fluid enough to keep pace with the changing times and the manner in which MNEs conduct business. This is the mandate of the OECD under 'Action 7' of the 'BEPS Action Plan'.

'The aim of Action 7 is to develop changes to the definition of a PE to prevent abuses of that threshold, including through the use of commissionaire arrangements and the specific activity exemptions to avoid PE status where core activities are involved' (KPMG, 2015, p 14).

In addressing the problems inherent in the definition of a PE, 'Action 7' specifically proposes changes to Articles 5(5) and 5(6) of the 'OECD Model Tax Convention' which seek to revamp the dependent agent rule.

The test applied under Article 5(5) now focuses on the activities performed by the agent rather than focusing on the authority to conclude a contract. The OECD (2015a, p 15) notes that as a matter of policy

‘where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business’ (OECD, 2015a, p 15).

In terms of the other proposed changes under ‘Action 7’ (OECD, 2015a, p 28), the specific activity exceptions in Article 5(4) have also been further clarified in the OECD commentary on the ‘OECD Model Tax Convention’ (OECD, 2015a, p 30), through the inclusion of an explanation of the activities that will be considered as being preparatory or auxiliary in nature, as well as supporting examples which help illustrate the meaning of the said terms.

Based on the clarified meaning for the activities that will be considered as being preparatory or auxiliary under the changes to the OECD commentary (OECD, 2015a, p 30), chapter 4.3 of this research report has argued that, in order to qualify for the exceptions set out in the new PE definition, the activities performed by the MNE must not be considered as being an essential and significant part of the business operations performed by the enterprise as a whole.

‘Action 7’ (OECD, 2015a, p 42) also proposes changes to the PE rule for construction and installation projects set out in Article 5(3). The OECD (2015a, p 43) provides that

‘the principal purposes test will be added to the ‘OECD Model Tax Convention’ ... [and will be used to] address the BEPS concerns related to the abusive splitting-up of contracts’ (OECD, 2015a, p 43).

Further, ‘Action 7’ (OECD, 2015a, p 42) provides that an additional example illustrating the application of the principal purposes test will also be added to the OECD commentary on the ‘OECD Model Tax Convention’.

In answering the problem statement raised in the research report, namely, an evaluation of how the changes to the definition of a PE that are being proposed by way of ‘Action 7’ will impact the operating structures and aggressive tax planning strategies of MNEs, the research report has argued (in chapter 5.7) that the said changes will have a significant impact on the way MNEs conduct business using certain operating structures, namely, commissionaire arrangements, representative office operating models, the maintenance of a stock of goods in a foreign country, toll manufacturing operations and construction / installation projects.

It can be argued that, in so far as representative office operating models, the maintenance of a stock of goods in a foreign country and toll manufacturing operations are concerned, MNEs may mitigate PE risk exposure by limiting the activities performed in a foreign jurisdiction in order to ensure that such activities remain preparatory and auxiliary in relation to the overall business enterprise carried on.

However, where commissionaire arrangements, and construction / installation projects are involved, MNEs may need to overhaul features of such operating structures since it can be argued that the dependent agent test and principal purposes test can be applied widely.

As a recommendation, it would be advisable for MNEs that conduct cross-border business using the operating models discussed in chapter 5, to perform a review of their current operating structures (which may not create a taxable presence under the current threshold of the concept of PE, that is, the definition prior to the proposed ‘Action 7’ amendments), since there is a risk that those structures could now potentially create a taxable presence under the amended PE definition under the ‘Action 7’ proposals.

#### ***Other areas that require further research***

In the ‘Action 7’ report, the OECD acknowledged that the attribution of profits to PEs is an area that requires further research (OECD, 2015a, p 45). A detailed discussion on the issue of attribution of profits to PEs did not form part of the scope of this research report. However, it can be argued that the proposed ‘Action 7’ changes to the definition of a PE should not be considered in isolation from the issue relating to the attribution of profits to PEs since the two matters are closely related.

When new PEs have been created under the amended definition, the appropriate methods to be applied for the purpose of determining the amount of business profits that should be allocated to such PEs could still be a contested issue between MNEs and revenue authorities.

The preliminary work performed by the OECD on the issue of attribution of profits

‘focussed on whether the existing rules of Article 7 of the OECD Model Tax Convention would be appropriate for determining the profits that would be allocated to PEs resulting from changes included in [the ‘Action 7’] report. The conclusion of that work is that these changes do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 but that there is a need for additional guidance on how the rules for Article 7 would apply to PEs resulting from changes in this report, in particular PEs outside the financial sector’ (OECD, 2015a, p 45).

To this end, the OECD issued its draft report on ‘Additional Guidance on the Attribution of Profits to PEs’ for public comment on 4 July 2016. The first round of comments on the first draft of the ‘Additional Guidance on the Attribution of Profits to PEs’ were due on the 5 September 2016.

## Appendices

### 7.1 Appendix 1: BEPS Action Plan

The 'BEPS Action Plan' covers the following key Action points (OECD, 2016b) -

Action 1: Addressing the tax challenges raised by the digital economy.

Action 2: Neutralise the effects of hybrid mismatch arrangements.

Action 3: Strengthen CFC rules.

Action 4: Limit base erosion via interest deductions and other financial payments.

Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance.

Action 6: Preventing treaty abuse.

**Action 7: Preventing the artificial avoidance of PE status.**

Action 8-10: Assure that transfer pricing outcomes are in line with value creation.

Action 11: Measuring and monitoring BEPS.

Action 12: Require taxpayers to disclose their aggressive tax planning arrangements.

Action 13: Re-examine transfer pricing documentation.

Action 14: Make dispute resolution mechanisms more effective.

Action 15: Develop a multilateral instrument.

## 7.2 Appendix 2: The definition of a PE

Article 5 of the ‘OECD Model Tax Convention’ (OECD, 2014a, p 26) sets out the definition of a PE, namely,

### **‘Article 5 PERMANENT ESTABLISHMENT**

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
  - a) a place of management;
  - b) a branch;
  - c) an office;
  - d) a factory;
  - e) a workshop, and
  - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
  - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
  - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
  - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
  - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
  - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other'.

### 7.3 Appendix 3: ‘Action 7’ - proposed changes to the PE definition

The final report on ‘Action 7’ (OECD, 2015a, p 42) proposes the addition of a new example to the OECD commentary on Article 5(3) of the ‘OECD Model Tax Convention’ for the purpose of illustrating the application of the principal purposes test, through the following means,

#### **‘CHANGES DEALING WITH THE SPLITTING-UP OF CONTRACTS**

1. Add the following example to the commentary on the principal purposes test rule proposed in the report on Action 6:

*Example J: RCo is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO is jointly and severally liable with SUBCO for the performance of SUBCO’s contractual obligations under the SUBCO-SCO contract.*

*In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract under which SUBCO agreed to perform part of the construction project was for RCO and SUBCO to each obtain the benefit of the rule in paragraph 3 of Article 5 of the State R-State S tax convention. Granting the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph as the time limitation of that paragraph would otherwise be meaningless’.*

The final report on ‘Action 7’ proposes ‘making all the subparagraphs of Article 5(4) subject to a preparatory or auxiliary condition’ (OECD, 2015a, p 28), through the following means,

***‘MAKING ALL THE SUBPARAGRAPHS OF ART. 5(4) SUBJECT TO A “PREPARATORY OR AUXILIARY” CONDITION***

*Replace paragraph 4 of Article 5 by the following (changes to the existing text of the paragraph appear in **bold italics** of additions and ~~strikethrough~~ for deletions):*

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ~~of a preparatory or auxiliary character~~;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character~~,

***provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character’.***

In addition, ‘Action 7’ also proposes a ‘new anti-fragmentation rule’ (OECD, 2015a, p 39), through the following means,

***NEW ANTI-FRAGMENTATION RULE***

*Add the following new paragraph 4.1 to Article 5:*

***4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and***

*a) that place or other place constitutes a PE for the enterprise or the closely related enterprise under the provisions of this Article, or*

*b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,*

*provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation’.*

The final report on ‘Action 7’ proposes ‘changes to paragraphs 5 and 6 of Article 5’ (OECD, 2015a, p 16), through the following means,

#### **CHANGES TO PARAGRAPHS 5 AND 6 OF ARTICLE 5**

*Replace paragraphs 5 and 6 of Article 5 by the following (changes to the existing text of Article 5 appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

5. Notwithstanding the provisions of paragraphs 1 and 2 ***but subject to the provisions of paragraph 6***, where a person ~~other than an agent of an independent status to whom paragraph 6 applies~~ is acting ***in a Contracting State*** on behalf of an enterprise and ~~has, and habitually exercises, in a Contracting State, an authority to conclude contracts,~~ ***in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are***

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 the right to use, or***

c) ***for the provision of services by that enterprise,***

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

~~6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker,~~

~~general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.~~

*a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.*

*b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise'.*

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