

Financial Instruments

TAX AND ACCOUNTING REVIEW

The monthly briefing service for tax and treasury specialists

More permanent establishments

Following the release of the OECD's final package of recommendations for the BEPS Action Plan, Andrew Howard and Chris Agnoli examine Action 7, analysing some of the key proposals and drawing comparison with the UK's Diverted Profits Tax.

The Organisation for Economic Co-operation and Development (OECD)'s final report on Base Erosion and Profit Shifting (BEPS) Action 7, 'Preventing the Artificial Avoidance of Permanent Establishment Status', makes a number of recommendations which are aimed at expanding the circumstances in which a permanent establishment will arise under double taxation agreements. The significance of this is that primary taxing rights for the new permanent establishments will pass from the state of residence to the state in which the permanent establishment is located. The OECD is seeking to address many of the same issues that the UK has recently tried to address with its unilateral diverted profits tax (DPT)[1] and it is interesting to compare the two. (For more information on the DPT, see our previous article, 'A practical approach to the DPT', in FITAR Volume 20 Issue 4, <http://www.fitar.co.uk/tax/a-practical-approach-to-the-dpt-109870.htm>).

Commissionaire and marketing arrangements

The most significant recommendation is to seek to introduce measures to prevent the use of 'commissionaire arrangements' and marketing arrangements aimed at avoiding the creation of permanent establishments. Assuming this recommendation is implemented, it will be more difficult to sell to customers in a particular jurisdiction without subjecting at least some of the profits to tax there, in doing so shifting a boundary in international taxation stretching back at least as far as the Champagne cases of the 19th century,[2] and perhaps recognising that an issue arises as much as a result of technology increasing the ease, efficiency and volume of distance sales, as of the ingenuity of multinationals and their advisers.

The proposed changes to Article 5(5) of the OECD model treaty are such that if 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, 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."

A commissionaire arrangement is one by which a person concludes contracts for the sale of products in a jurisdiction in its own name, on behalf of an overseas principal that is the owner of the products and fulfils the contract, but without creating enforceable rights and obligations between the overseas principal and the customer. The outcome of this arrangement under the current model treaty is generally accepted to be that the arrangement does not give rise to a permanent establishment of the overseas principal on the basis that the contract is not in the name of the overseas principal and does not bind it. As a result, the commissionaire is only taxable on its remuneration (ie a commission) and not on a share of the profit from the relevant sale. The addition of limbs (b) and (c) to Article 5(5) should reverse this, as the revised commentary to Article 5 of the model treaty proposed by the OECD (the Revised Commentary) stipulates.[3]

More significantly for the UK (the 'commissionaire' is a civil law concept), the OECD also identifies arrangements pursuant to which the negotiation of contracts or the procurement of customers is undertaken in a state but the contract is subsequently entered into abroad to avoid meeting the requirement of the current language in Article 5(5) of the model treaty that a person "has, and habitually exercises ... an authority to conclude contracts" on behalf of another party in order to constitute a permanent establishment.

The proposed changes to the OECD model treaty reduce the OECD's historic focus on the place of conclusion of contracts and instead look to the process and acts leading up to the conclusion of those contracts. Whilst 'rubber stamping' of contracts overseas is already not sufficient to avoid a permanent establishment,[4] this does not seem to have been interpreted widely, catching only the most artificial arrangements.

One advantage of the existing position under the OECD model treaty is that it draws a relatively clear line. While it should be easier to apply than some of the proposals made earlier in the BEPS process, the new test will still require a subjective judgement. The Revised Commentary does not add much clarity. Only three examples are given, and one of those seems a fairly clear case of rubber stamping. The example of an arrangement that will not give rise to a permanent establishment is drug reps marketing to doctors, who subsequently prescribe the relevant drugs. The example of an arrangement which will be caught is an internet retailer whose local subsidiary visits customers and indicates the price payable under the retailer's fixed price structure, with the contract then being concluded online with the retailer on its standard terms.

There is a large grey area between these two fairly stark extremes and further guidance is likely to be highly desirable to minimise disputes and ensure consistency between tax authorities.

How does the DPT deal with marketing arrangements?

Marketing arrangements are also the target of the second limb of the UK's DPT. In our view the concept of an 'avoided permanent establishment' for the purposes of those rules is, in general, likely to catch the same arrangements as will now be treated as giving rise to permanent establishments under the OECD model treaty. As we noted in our previous article, the UK's examples all involve connected parties whose function falls just short of concluding contracts, as do the OECD examples.

The route taken to reach a similar destination is quite different, however. The OECD has simply expanded the circumstances in which a permanent establishment will arise, whereas the UK has chosen the route of anti-avoidance legislation.

The DPT charge arises where, in brief summary:

- (a) a person is carrying on an activity in the UK in connection with the supply of goods, services and other property by a foreign company;
- (b) it is reasonable to assume that such activity is designed so as to ensure that the foreign company does not carry on a trade in the UK for UK tax purposes (the design test); and
- (c) one of the main purposes is to avoid or reduce a UK tax charge (the motive test).

The UK casts the activity net much wider than the OECD but relies on the design test (in particular) and the motive test as filters. In contrast, the OECD seeks a more specific description of the activity which it is targeting (the principal role test) but does not apply any filters by reference to design or motive.

In the DPT interim guidance,^[5] HMRC published an example where a principal in a low tax jurisdiction

has a large staff of qualified persons as well as a subsidiary conducting UK sales support activities leading up to customer engagement by the principal. In this example the DPT would not apply on the basis that the activities supported the commercial roles of the two entities in the group and were not designed to avoid a UK permanent establishment. However, in another example where the same principal had limited substance, the DPT would apply.

It is interesting to consider the OECD's test in the context of this fact pattern. The actual DPT example is skewed by the fact that it is the principal which negotiates the contracts but becomes more interesting if you imagine that this was instead an oversight function. Unless the principal actively interferes in the negotiated position that is brought to it, then it appears that a permanent establishment will arise, notwithstanding that the principal has substance and is able to oversee the local activities (even if it is generally happy with what is brought to it by the local subsidiary). Even more than the DPT, the OECD does not require arrangements to be artificial or to lack substance in order to be caught.

It is also not relevant for the OECD's test that there may not be any tax advantage gained by the arrangement. In the absence of a tax motivation condition, the more limited function which can give rise to a permanent establishment could even have the unintended effect of encouraging principals to establish permanent establishments in lower tax jurisdictions.

Independent agent

The second significant change which the OECD has proposed is to narrow the concept of independent agent by amending the model treaty to specify that:

“where 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...”

The concept of independent agent is significant because a person acting on behalf of an enterprise as an independent agent in the ordinary course of their business will not give rise to a permanent establishment. The current position is that any control relationship is not relevant to determining independence.

In the earlier discussion draft, it was proposed as an absolute rule that exclusive or near-exclusive agents (whether or not related parties) could not be independent. As it is, the Revised Commentary suggests that independence in this scenario will be the exception rather than the rule,^[6] with its application limited to examples such as a start-up which has yet to acquire new customers.

This change is intended to complement the first change discussed above, and to stop the commissionaires and marketing subsidiaries that will now be caught by

the expanded definition of permanent establishment from arguing that, because they carry out their functions on the same terms as a third party would, they should be treated as independent.

A question which may arise is whether it is significant that the exclusion only applies to independent *agents* when it is not necessary to be an agent to give rise to a permanent establishment? In other words, if you are habitually playing the principal role leading to the conclusion of contracts but can demonstrate that you are independent; do you fail to qualify for the exclusion because you are not technically an agent? We do not think that is the intention and some support can be found for this view in the non-technical use of the word 'agent' at some places in the Revised Commentary.[7] Nonetheless, where it is intended to rely on independence under a treaty which has adopted the OECD proposals, it may be preferable to ensure that a formal agency relationship is in place.

This change, if implemented, may make it difficult for, among others, some fund managers, in particular managers of captive funds, to avoid giving rise to a permanent establishment for treaty purposes, even though it doesn't seem likely that these are the intended target.

UK domestic law has a similar exclusion for independent agents in general and more particularly for investment managers who meet certain conditions, including an independence condition. These exclusions are currently interpreted in the same way as the existing treaty concept (control relationships are irrelevant) so it will be interesting to see if UK domestic law is changed in line with the OECD proposals.

The DPT contains a safe harbour for arrangements where the avoided permanent establishment qualifies as an agent of independent status for UK tax purposes.[8] However, this safe harbour is narrowed in a connected party context so that it only applies where the more specific IME, independent broker or Lloyd's agent exceptions apply, possibly giving a clue as to where UK domestic law might go.

Specific activity exemptions

Under the OECD model treaty, certain activities, such as the use of facilities solely for the purpose of storage, display or delivery of goods, are specifically excluded from giving rise to a permanent establishment. These activities will now only be excluded where they are of a 'preparatory or auxiliary character'. An example of activity which would previously have been excluded but will now be caught by the Revised Commentary[9] is a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in that state.

Criticism has been aimed at this change for creating uncertainty by moving away from a bright line test. In recognition of this, the Revised Commentary recognises that some states may wish to stick to the existing drafting.[10]

The equivalent UK exemption[11] follows the existing OECD position. It seems likely that the UK will want to adopt the changes into domestic law. We do not think that arrangements which will now be covered under this proposal would be caught by the DPT due to the wording of the design test; such arrangements would not (and would not be designed to) prevent the overseas principal from trading in the UK. Instead, this activity would not be taxable due to a specific domestic provision providing that there is no permanent establishment. We note that HMRC guidance chooses to ignore this subtle distinction, saying: "*in practice, this means that the activity is designed so as to ensure that the foreign company does not have a UK PE*".

Attribution of profits

Given that it will be easier to create a permanent establishment, particularly in connected party and marginal situations, the issue of attribution of profits is likely to become even more significant. The OECD has indicated that it will be carrying out follow-up work with a view to providing additional guidance as to how attribution should operate for the new permanent establishments resulting from the recommendations. It is likely that a number of the new permanent establishments will seek to argue that there should be no further allocation beyond the arm's length remuneration which is already likely to be required by transfer pricing rules.

Assuming domestic laws will change in line with the treaty, businesses may face additional secondary liability risks as the UK and others have rules allowing tax to be collected from the permanent establishment.

The future of the DPT

The OECD's proposed changes seem to address the issues which the disguised permanent establishment limb of the DPT was introduced to address as well as some additional issues not covered by the DPT. Does that mean that this part of the DPT can be repealed, assuming treaty changes are implemented?

The short answer is no, at least not without changes to the domestic rules bringing non-residents into the charge to corporation tax. A double tax treaty is a shield and not a sword: as things stand some of the changes may not have an impact in the UK because the newly created treaty permanent establishments may not be within the scope of the domestic charge to corporation tax.

However, assuming the changes proposed by the OECD are adopted, as seems likely, the punitive rate

under the DPT will look even more peculiar, and simply expanding the scope of the charge to corporation tax to reflect the treaty changes and dispensing with this leg (at least) of DPT seems a sensible outcome. This is likely to require statutory clarification of the case-law concept of trading in the UK, as well as changes to the permanent establishment definitions. Despite the tax rate differential, this approach may not result in a loss of revenue for the UK because non-UK tax can be credited against DPT whereas no credit would be expected under the normal domestic charge on a permanent establishment.

Implementation

Although there is further process before the changes are formally adopted, it seems clear that the changes to the model treaty and its commentary will be made as proposed as this is within the OECD's control. However, those changes will not of themselves have an impact on allocation of taxing rights until new treaties are put in place containing the proposed changes. The key to the widespread implementation of these changes will therefore be the negotiation of the multilateral instrument, which is scheduled to be concluded by the end of 2016. The changes proposed by this action plan, with the possible exception of the specific activity exceptions, are more confidently stated (with less optionality) than, for example, the treaty abuse changes, and this may reflect greater international consensus in favour of these changes and therefore a greater likelihood of them being adopted as part of the multilateral instrument.

In light of the comments made above about changes to UK law, it is also interesting that this action plan is purely

focused on treaties and does not include any attempt to harmonise the scope of domestic rules imposing the charge to tax on non-residents, which will govern in situations where no treaty exists.

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References

1. Section 86 of Finance Act 2015. Reference to the DPT in this article are to the disguised permanent establishment limb in section 86, not the more general limb in section 80.
2. See *Grainger v Gough* [1896] AC 325, though it should be noted that UK domestic law subsequently moved away from a narrow focus on the place of contract – see *FL Smidth and Company v Greenwood* [1921] 3 KB 583 where Atkin LJ said: “I think the question is, where do the operations take place from which the profits in substance arise?”
3. Proposed paragraph 32.8.
4. Paragraph 32.1 of the current commentary to Article 5 of the OECD model treaty.
5. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/422184/Diverted_Profits_Tax.pdf.
6. See proposed paragraph 38.7.
7. See, for example, paragraph 33.1.
8. Section 86(5) of Finance Act 2015.
9. Proposed paragraph 22.
10. Proposed paragraph 30.1.
11. Section 1143 Corporation Tax Act 2010.