

**Public Discussion Draft**

# **BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS**

**31 October 2014 – 9 January 2015**





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**PROPOSED DISCUSSION DRAFT:  
PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS**

31 October 2014

**WORK ON ACTION 7 OF THE BEPS ACTION PLAN (PREVENT THE  
ARTIFICIAL AVOIDANCE OF THE PE STATUS)**

The OECD *Action Plan on Base Erosion and Profit Shifting*,<sup>1</sup> published in July 2013, identifies 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions.

The Action Plan stresses the need to update the treaty definition of permanent establishment (PE) in order to prevent abuses of that threshold. It notes that the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor, which has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by “*commissionnaire* arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. The Action Plan also notes that multinationals may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and auxiliary activities.

Action 7 of the Action Plan indicates the need to address these issues:

***ACTION 7 – Prevent the Artificial Avoidance of PE Status***

*Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionnaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.*

Further, the Report *Addressing the Tax Challenges of the Digital Economy* has identified issues in the digital economy that need to be taken into account in the course of the work on Action 7, namely ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment (PE) status and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status.

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1. Available at: <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

As part of the transparent and inclusive consultation process mandated by the Action Plan, the Committee on Fiscal Affairs (CFA) invites interested parties to send comments on this discussion draft, which includes the preliminary results of the work carried on with respect to issues related to the artificial avoidance of PE status and includes proposals for changes to the definition of permanent establishment found in the OECD Model Tax Convention.

The views and proposals included in this discussion draft do not represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

Comments should be sent by 9 January 2015 at the latest (no extension will be granted) and should be sent by email to [taxtreaties@oecd.org](mailto:taxtreaties@oecd.org) in Word format (in order to facilitate their distribution to government officials). They should be addressed to Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

Please note that all comments received regarding this consultation draft will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective, or the person(s) on whose behalf they are acting.”

#### ***Public consultation meeting***

Persons and organisations who will send comments on this consultation document are invited to indicate whether they wish to speak in support of their comments at a public consultation meeting on Action 7 that is scheduled to be held in Paris at the OECD Conference Centre on 21 January 2015. Persons selected as speakers will be informed by email by 16 January at the latest.

This consultation meeting will be open to the public and the press.

Due to space limitations, priority will be given to persons and organisations who register first (we reserve the right to limit the number of participants from the same organisations).

Persons wishing to attend this public consultation meeting will be able to register on line. **On line registration for the meeting will be available from 15 November 2014 to 9 January 2015.** Registrations will not be accepted before and after that period. . Confirmation of participation, including venue access details, will be sent by email to participants by 16 January at the latest.

This meeting will also be broadcast live on the internet and can be accessed on line. **No advance registration will be required for this internet access.**

#### ***Other Languages***

French and Spanish translations of this document will be available shortly. When complete, links to these versions will be made available here.

## EXECUTIVE SUMMARY

Action 7 of the BEPS Action Plan calls for the development of “changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of *commissionnaire* arrangements and the specific activity exemptions”.

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 permanent establishment 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. In doing so, the Group benefitted from the analysis contained in the report *Addressing the Tax Challenges of the Digital Economy*, which recommends that the work on Action 7 consider whether certain activities that were previously considered to be preparatory or auxiliary may be increasingly significant components of businesses in the digital economy, as well as whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.

This discussion draft describes the strategies identified by the Focus Group and includes the options that it examined. The Committee on Fiscal Affairs invites all interested parties to comment on these options. The Committee is particularly interested to learn about specific examples of unintended effects that might result from the options included in this note as well as examples of possible avoidance that could result from each option.

### **Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies**

It is clear that in many cases *commissionnaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place. Changes are therefore needed to the wording of paragraphs 5 and/or 6 of Article 5 in order to address such strategies. 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. Options A, B, C and D are four alternative options that would amend the wording of paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention in order to reflect that policy without allowing the types of avoidance strategies that have taken place under the current wording of the Article.

### **Artificial avoidance of PE status through the specific activity exemptions**

Some aspects of Art. 5(4) of the OECD Model Tax Convention, according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph, give rise to BEPS concerns.

First, some consider that the fact that some parts of Art. 5(4) do not expressly refer to preparatory or auxiliary activities does not seem to conform with what they consider to be the original purpose of the paragraph, *i.e.* to cover only preparatory or auxiliary activities. One option (option E) would therefore be to

make all the activities currently listed in paragraph 4 of Article 5 subject to the condition of being preparatory or auxiliary.

If that option is not adopted, more targeted changes could be made to address concerns

- arising from the reference to “delivery” in subparagraphs *a*) and *b*) of paragraph 4, *e.g.* where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online (option F provides for the deletion of the word “delivery”);
- arising from the exception applicable to “purchasing offices” in subparagraph *d*) of paragraph 4 (option G provides for the deletion of the exception applicable to the purchasing of goods for an enterprise whilst option H provides for the deletion of the entire subparagraph *d*)).

Second, concerns have been expressed with respect to the application of paragraph 4 where activities are fragmented between related parties. Paragraph 27.1 of the Commentary on Article 5 currently deals with the application of Art. 5(4)*f*) in the case of a single enterprise that divides a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. The paragraph does not apply, however, where such operations are carried on by related parties. Such situations could be addressed by a rule that would take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by associated enterprises at different places or at the same place (options I and J).

### **Splitting-up of contracts**

The splitting-up of contracts in order to abuse the exception in paragraph 3 of Article 5 is discussed in paragraph 18 of the Commentary on Art. 5. It is also a concern with the application of service-PE provisions, such as the alternative provision found in paragraph 42.23 of the Commentary on Art. 5 and the provision in Art. 5(3)*b*) of the UN Model. BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by paragraph 3 of Article 5 could be addressed either by an “automatic” rule that would take account of any activities performed by associated enterprises (option K) or by the addition of a new example (option L) to the Commentary on the general anti-abuse rule (*i.e.* the “Principal Purposes Test” rule) proposed as a result of the work on Action 6.

### **Insurance**

Another option included in this note (option M) concerns a provision, similar to the one found in the UN Model, that would deal with the situation of dependent agents who do not formally conclude insurance contracts. Such a provision would address cases where a large network of exclusive agents sell insurance for a foreign insurer. An alternative to such a provision (option N) would be to rely on the changes proposed to Art. 5(5) and 5(6) under options A, B, C and D.

It is acknowledged, however, that insurance (including re-insurance) raises difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed. As recognised in Actions 4 and 9 of the Action Plan, BEPS issues arise in relation to the transfer of risk within a multinational group, including through insurance and re-insurance. It might therefore be more appropriate to address the BEPS concerns related to such cases through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted. This could be done through transfer pricing or special measures as contemplated under Actions 4 and 9.

## **Issues related to attribution of profits to PEs and interaction with Action Points on Transfer Pricing**

BEPS concerns around the PE rules cannot be addressed successfully without coordination between the work on PE status mandated by Action 7 and the work on other aspects of the Action Plan. The wording of Action 7 emphasises that the question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE. Whilst the preliminary work that has been done so far on the issue of attribution of profits has identified a few areas where additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the options included in this note were adopted. It was acknowledged, however, that the work on other parts of the BEPS Action Plan, in particular Action 9 (Risks and capital), might involve a reconsideration of some aspects of the existing rules and guidance.



## ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

### Introduction

1. At the request of the G20, the OECD published the report *Addressing Base Erosion and Profit Shifting* (the “BEPS Report”) in February 2013. The BEPS Report identifies the root causes of BEPS and notes that tax planning leading to BEPS turns on a combination of coordinated strategies. The following paragraph from the BEPS Report relates to the current treaty definition of permanent establishment:

It had already been recognised way in the past that the concept of permanent establishment referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model). Nowadays it is possible to be heavily involved in the economic life of another country, *e.g.* by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere.

2. Following up on the BEPS Report, the OECD published its *Action Plan on Base Erosion and Profit Shifting* (Action Plan)<sup>2</sup> in July 2013. The BEPS Action Plan identifies 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions. It deals with avoidance strategies related to the permanent establishment concept as follows:

***(ii) Restoring the full effects and benefits of international standards***

[...]

***The definition of permanent establishment (PE) must be updated to prevent abuses.*** In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by “commissionnaire arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.

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2. Available at: <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

### **ACTION 7 – Prevent the Artificial Avoidance of PE Status**

*Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.*

3. The BEPS Report and the Action Plan recognise that the current definition of permanent establishment must be changed in order to address BEPS strategies. The Action Plan also recognises that in the changing international tax environment, a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States. The Action Plan indicates that whilst actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.

4. At its first meeting in September 2013, the Focus Group on Artificial Avoidance of PE Status, which was set up in order to carry out the work on Action 7, discussed various aspects of the permanent establishment definition that could give rise to BEPS concerns and identified a number of strategies that suggested the artificial avoidance of the PE threshold. In order to make sure that other avoidance strategies were also identified, that Group subsequently invited all interested parties to contribute examples of strategies that allegedly resulted in the artificial avoidance of PE status. A public invitation to do so was published on 22 October 2013.<sup>3</sup> The strategies that were identified were discussed at the second meeting of the Group in March 2014. At that meeting, the Group reached decisions as to which strategies required further work and identified a number of options for changes to Article 5 that would address these strategies. A number of alternative proposals for changes to Article 5 were subsequently drafted and were discussed at the third meeting of the Focus Group, which was held on 17-19 September 2014, when the Group decided on which specific proposals it would seek comments. In doing so, the Group benefitted from the analysis contained in the report *Addressing the Tax Challenges of the Digital Economy*, which recommends that the work on Action 7 consider whether certain activities that were previously considered to be preparatory or auxiliary may be increasingly significant components of businesses in the digital economy, as well as whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.

5. This discussion draft is the result of that work. It includes a number of options for changes to Article 5 on which the Committee on Fiscal Affairs invites all interested parties to comment. The Committee is particularly interested to learn about specific examples of unintended effects, or possible avoidance risks, that might result from the options included in this note as well as possible ways of addressing these problems..

#### **A. Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies**

6. 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 having a permanent establishment to which such sales may be attributed for tax purposes; since the

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3. See <http://www.oecd.org/ctp/treaties/identifying-strategies-artificial-avoidance-permanent-establishment-status.htm>.

person that concludes the sales does not own the products that it sells, it 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).

7. BEPS concerns arising from *commissionnaire* arrangements may be illustrated by the following example, which is based on a court decision that dealt with such an arrangement and found that the foreign enterprise did not have a permanent establishment:

- XCO is a company resident of State X. It specialises in the sale of medical products.
- Until 2000, these products are sold to clinics and hospitals in State Y by YCO, a company resident of State Y. XCO and YCO are members of the same multinational group.
- In 2000, the status of YCO is changed to that of *commissionnaire* following the conclusion of a *commissionnaire* contract between the two companies. Pursuant to the contract, YCO transfers to XCO its fixed assets, its stock and its customer base and agrees to sell in State Y the products of XCO in its own name, but for the account of and at the risk of XCO.
- As a consequence, the taxable profits of YCO in State Y are substantially reduced.

8. The application of the existing definition of permanent establishment to *commissionnaire* arrangements has been extensively debated over the last few years. The debate has focused on the legal interpretation of the phrase “authority to conclude contracts in the name of”, which is found in Art. 5(5). Other issues that have been debated in relation to such arrangements are

- the extent to which Art. 5(5) may apply where contracts are substantially negotiated in a State but are finalised or authorised abroad, and
- the exact scope and historical purpose of the “independent agent” rule in Art. 5(6).

9. Putting aside these interpretation issues, Action 7 requires a policy re-evaluation of the existing permanent establishment definition in relation to *commissionnaire* arrangements and similar strategies.

10. It is clear that in many cases *commissionnaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place. Changes are therefore proposed to the wording of paragraphs 5 and/or 6 of Article 5 in order to address such strategies. 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.

11. The Focus Group has discussed various alternative formulations of paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention that would reflect that policy without allowing the types of avoidance strategies that have taken place under the current wording of the Article. The following are four alternative proposals that the Group is currently considering.

A. *Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”; strengthen the requirement of “independence”*

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts

- a) in the name of the enterprise, or
- b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has 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. 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 acting on behalf of various persons 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 enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

#### *Explanation*

This option would address the issue of *commissionnaire* and similar strategies by

1. Extending the reference to “contracts in the name of” in order to cover contracts for property or services to be provided by that enterprise, thereby avoiding the issue of *who is bound by the contract* by focussing on *what is the object of the contract* and by postulating that where an enterprise mandates someone to act on its behalf and that person concludes contracts concerning property or services to be provided by the enterprise, there is a sufficient taxable nexus with the State where this is done. The specific case of a contract concluded by a *commissionnaire* is covered by the reference to a contract “for the transfer of ownership ... of property owned by the enterprise” since the object of that contract is to transfer the ownership of the property owned by a foreign enterprise even if that foreign enterprise is not one of the parties to that contract.
2. Addressing situations where contracts are not formally concluded by the intermediary who is acting on behalf of the enterprise but where that intermediary’s interactions with specific persons result in the conclusion of contracts. This would include not only cases where the contract is concluded by the intermediary but also cases where the intermediary habitually interacts with identifiable persons in a way that directly results in the conclusion of contracts. The determination of whether the intermediary’s interaction with specific persons results in the conclusion of a contract would require a direct causal connection between that interaction and the conclusion of the contract. It would not, however, require that the contract be formally concluded by the intermediary.
3. Preventing situations where a subsidiary that only acts as a *commissionnaire* for associated enterprises would escape the application of paragraph 5 even if it concluded contracts in the name of these enterprises.

The concept of “associated enterprises” used in paragraph 6 is intended to mirror the concept used for the purposes of Article 9. An enterprise would therefore be deemed to be associated to another enterprise if it participates directly or indirectly in the management, control or capital of the other enterprise or if the same persons participate directly or indirectly in the management, control or capital of the two enterprises. Unlike the wording of Art. 9(1), however, that definition would apply to enterprises of the same State or of third States.

*B. Add a reference to contracts for the provision of property or services by the enterprise; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”; strengthen the requirement of “independence”*

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, that are

- a) in the name of the enterprise, or
- b) for the transfer of 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. 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 acting on behalf of various persons 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 enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

*Explanation*

This option is similar to option A except that it addresses situations where contracts are not formally concluded by the intermediary who is acting on behalf of the enterprise by introducing the alternative test of an intermediary who concludes contracts or who negotiates the material elements of contracts.

*C. Replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts”; strengthen the requirement of “independence”*

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually engages with specific persons in a way that results in the conclusion of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk 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. 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 acting on behalf of various persons 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 enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

*Explanation*

This option is similar to option A except that it addresses the difficulties arising from the phrase “contracts in the name of” by replacing that phrase by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of”. This formulation refers to contracts that are on the account and risk of the foreign enterprise by virtue of the legal (not economic) relationship between the person and the intermediary (which would cover a relationship created, for example, by an agency contract, a *commissionnaire* contract, an employment contract, a partnership contract or even a trust deed through which a trustee would act on behalf of an enterprise).

D. *Replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts”; strengthen the requirement of “independence”*

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk 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. 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 acting on behalf of various persons 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 enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

*Explanation*

This option is similar to option B except that it addresses the difficulties arising from the phrase “contracts in the name of” by replacing that phrase by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of”.

## B. Artificial avoidance of PE status through the specific activity exemptions

12. The reference to the “specific activity exemptions” is a reference to the list of exceptions included in Art. 5(4) of the OECD Model Tax Convention, according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph.

13. The following paragraphs examine various aspects of Art. 5(4) that may potentially give rise to the artificial avoidance of the PE threshold.

### I. *The exceptions are not restricted to preparatory or auxiliary activities*

14. The October 2011 and 2012 discussion drafts on the clarification of the PE definition<sup>4</sup> include a proposed change to paragraph 21 of the Commentary on Article 5 according to which, under the current wording of Article 5, paragraph 4 applies automatically where one of the activities listed in subparagraphs *a*) to *d*) is the only activity carried on at a fixed place of business. The Working Group that produced that proposal, however, invited Working Party 1 to examine “whether the conclusion that subparagraphs *a*) to *d*) are not subject to the extra condition that the activities referred therein be of a preparatory or auxiliary nature is appropriate in policy terms”. This reflected the views of some delegates who argued that the proposed interpretation did not appear to conform with what they considered to be the original purpose of the paragraph, *i.e.* to cover only preparatory or auxiliary activities.

15. Regardless of the original purpose of the exceptions included in subparagraphs *a*) to *d*) of paragraph 4, the Focus Group considered that it was important to address situations where these subparagraphs give rise to BEPS concerns. The following is a first approach that was identified in order to do so.

E. *Amend Art. 5(4) so that all its subparagraphs are subject to a “preparatory or auxiliary” condition*

[Amend paragraph 4 of Article 5 as follows]:

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;

4 See <http://www.oecd.org/tax/treaties/48836726.pdf> (2011 discussion draft) and <http://www.oecd.org/ctp/treaties/PermanentEstablishment.pdf> (2012 discussion draft).

*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.*

*Explanation*

This option would make all the activities currently listed in paragraph 4 of Article 5 subject to the condition of being preparatory or auxiliary.

**2. The word “delivery” in subparagraphs a) and b) of paragraph 4**

16. If option E (under which activities listed in subparagraphs *a)* to *d)* would be subject to the condition of being of a “preparatory or auxiliary” character) is not adopted, it would be possible to address BEPS concerns specifically related to subparagraphs *a)*, *b)* and *d)* of paragraph 4 through the following three options.

17. The first option would address concerns arising from the reference to “delivery” in subparagraphs *a)* and *b)*. According to these subparagraphs, the term “permanent establishment” is 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

18. It is difficult to justify the application of these exceptions where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online (the exception in subparagraphs *a)* and *b)* would only apply, however, as long as these goods are owned by the enterprise).

19. The word “delivery” is absent from the corresponding provisions of the UN Model. Paragraphs 17, 20 and 21 of the UN Commentary on Article 5 explain that difference as follows:

17. The deletion of the word “delivery” reflects the majority view of the Committee that a “warehouse” used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment.

...

20. As noted above, the United Nations Model Convention, in contrast to the OECD Model Convention, does not refer to “delivery” in subparagraphs *(a)* or *(b)*. The question whether the use of facilities for the “delivery of goods” should give rise to a permanent establishment has been debated extensively. A 1997 study revealed that almost 75 per cent of the tax treaties of developing countries included the “delivery of goods” in the list of exceptions in subparagraphs *(a)* and *(b)* of paragraph 4. Nevertheless, some countries regard the omission of the expression in the United Nations Model Convention as an important point of departure from the OECD Model Convention, believing that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country.

21. In reviewing the United Nations Model Convention, the Committee retains the existing distinction between the two Models, but it notes that even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into attributing too much income to this activity if they do



not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties. Therefore, although the reference to “delivery” is absent from the United Nations Model Convention, countries may wish to consider both points of view when entering into bilateral tax treaties, for the purpose of determining the practical results of utilizing either approach.

20. Adding an overall condition of “preparatory or auxiliary” to Art. 5(4) (as proposed under option E) would address any perceived problem with the word “delivery” so that the word “delivery” could be kept in subparagraphs *a)* and *b)*. If, however, option E is not adopted, another option would be to delete the word “delivery” from subparagraphs *a)* and *b)*.

*F. Removing the reference to “delivery” from subparagraphs a) and b)*

[Amend subparagraphs *a)* and *b)* of paragraph 4 of Article 5 as follows]:

- a)* the use of facilities solely for the purpose of storage; **or** 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; **or** display ~~or delivery~~;

### **3. *The exception for purchasing goods or merchandise or collecting information***

21. Another targeted change that could be made if option E was not adopted relates to subparagraph *d)* of paragraph 4, according to which the term “permanent establishment” is deemed not to include:

- 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

22. The above exception for purchasing activities seems to have been originally justified by the view that no profits could or should be attributed to such activities.

23. That view was expressly rejected in the course of the development of the Authorised OECD Approach (AOA) which, in 2010, resulted in the elimination of Art. 7(5) of the OECD Model Tax Convention, which provided that:

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise

24. According to paragraph 57 of the 2008 *Report on Attribution of Profits to Permanent Establishments*:

There was a broad consensus among the member countries that Article 7(5) is not consistent with the arm’s length principle and is not justified. The authorised OECD approach is that there is no need to have a special rule for “mere purchase”. There should be no limit to the attribution of profits to the PE in such cases, apart from the limit imposed by the operation of the arm’s length principle.

25. Given this conclusion “that there is no need to have a special rule for ‘mere purchase’” as regards the attribution of profits, the question arises as to what would otherwise justify a specific exception to the permanent establishment threshold for purchasing activities.

26. The Group discussed that policy question on the basis of the following three examples:

*Example 1:*

- A multinational group operates four different manufacturing plants in an emerging economy (State S).
- A company member of the Group (resident in State T, which applies an exemption or territorial system) has a purchasing office in the same jurisdiction through which it purchases the output of the four manufacturing plants.
- Since it purchases large quantities, the purchasing office claims that it is entitled to purchasing discounts from the manufacturing plants.
- The purchasing discounts reduce the profits attributable to the manufacturing plants. To the extent that these profits would be attributable to the purchasing office in States S, they would also escape taxation in State S if that office did not constitute a permanent establishment. Also, the discounts would escape taxation in State T to the extent that the domestic exemption or territorial system of that country attributes the discount to State S.

*Example 2:*

- SCO is an independent company located in State S which buys locally and exports a particular agricultural product.
- Most SCO employees are experienced and well-paid buyers that visit a number of small producers, determine the type/quality of the products according to international standards (a very difficult process) and enter into different types of contracts (spot or forward) for the acquisition of the products.
- Most of SCO's exports are sold to five independent foreign buyers by telephone or emails (these buyers rely on the reputation and expertise of SCO in determining the type/quality of the products). Only a few employees are required to handle these sales.
- In this example, it is clear that SCO's profits should be taxable in State S. If, however, SCO were incorporated in a low-tax jurisdiction from which the sales to the foreign buyers would be made so that only the purchasing function would be left to the State S office to which the buyers report, it would seem difficult to argue that the purchasing would only constitute a routine function. It would equally be difficult to explain why State S should not be allowed to tax any part of the profits realized by SCO.

*Example 3:*

- RCo, a company resident of State R which operates a number of large discount stores, maintains an office in State S during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow RCO to establish stores in State S.
- During that period, employees of RCO occasionally purchase supplies for their office and these purchases are clearly preparatory and auxiliary to RCO's core business.

27. The Focus Group concluded that adding an overall condition of "preparatory or auxiliary" to Art. 5(4) (as proposed under option E) would address any perceived problem with the exception related to purchasing activities so that this exception could be kept in subparagraphs *d*). If, however, option E is not adopted, another option would be to remove the reference to purchasing activities from subparagraph *d*).

*G. Delete the exception for purchasing*

[Amend subparagraph *d*) of paragraph 4 of Article 5 as follows:]

- 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.

28. The preceding option would retain the current exception applicable to collecting information for the enterprise. Concerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, *e.g.* by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises. A broader alternative to option G that would address such concerns would be to delete the whole of subparagraph *d*).

*H. Delete the exceptions in subparagraph d)*

[Delete subparagraph *d*) of paragraph 4 of Article 5:]

- ~~*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.~~

#### **4. Fragmentation of activities between related parties**

29. Paragraph 27.1 of the Commentary on Article 5 currently deals with the application of Art. 5(4)*f*) in the case of what has been referred to as the “fragmentation of activities”:

27.1 Subparagraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. 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 etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

30. It has been suggested that the logic of the last sentence (“[a]n enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity”) should not be restricted to cases where the same company maintains different places of business in a country but should be extended to cases where these places of business belong to related parties.

31. Given the ease with which subsidiaries may be established, the Focus Group concluded that some BEPS concerns related to paragraph 4 of Article 5 could be addressed by a rule that would take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by associated enterprises at different places or at the same place. The following are alternative versions of such a rule.

*I. Provision that would address the fragmentation of activities for the purposes of paragraph 4*

[Replace the preamble of paragraph 4 of Article 5 by the following:]

4. Notwithstanding the preceding provisions of this Article **and subject to paragraph 4.1**, the term “permanent establishment” shall be deemed not to include: ...

[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 an associated enterprise<sup>1</sup> 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 permanent establishment for the enterprise or the associated enterprise under the provisions of this Article, and**
- b) **the business activities carried on by the two enterprises at the same place, or by the same enterprise or associated enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.**

*Explanation*

This draft anti-fragmentation rule would deny the application of the exceptions of paragraph 4 where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or by associated enterprises at different locations.

For the rule to apply, a group of associated enterprises must have at least one fixed place of business that satisfies the PE threshold in a Contracting State (it would be clarified that the definition of permanent establishment is not restricted to situations where an enterprise of one Contracting State carries on business in the other Contracting State and can apply to situations where an enterprise of either State or even a third State carries on business in that State).

Since the rule is intended to apply to situations where a cohesive business is fragmented, subparagraph *b*) requires that for the rule to apply, the activities that are carried on by the two associated enterprises at the same location, or by the same enterprise or associated enterprises at two different locations, must be “complementary functions that are part of a cohesive business operation”. This phrase is derived from the last two sentences of paragraph 27.1 of the Commentary on Art. 5.

*J. Variation of the provision that would address the fragmentation of activities for the purposes of paragraph 4*

[Replace the preamble of paragraph 4 of Article 5 by the following:]

4. Notwithstanding the preceding provisions of this Article **and subject to paragraph 4.1**, the term “permanent establishment” shall be deemed not to include: ...

[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 an associated 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 permanent establishment for the enterprise or the associated 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 associated 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 associated enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.*

*Explanation*

This option is similar to option I except for the fact that it also applies where none of the places to which it refers constitutes a permanent establishment but the combination of the activities at the same place or at different places go beyond what is preparatory or auxiliary.

### **C. Splitting-up of contracts**

32. The splitting-up of contracts in order to abuse the exception in paragraph 3 of Article 5 is discussed in paragraph 18 of the Commentary on Art. 5:

18. ... The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts 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. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

33. The splitting-up of contracts in order to avoid the existence of a PE is also a concern with the application of service-PE provisions, such as the alternative provision found in paragraph 42.23 of the Commentary on Art. 5 and in Art. 5(3)*b*) of the UN Model. Paragraph 42.45 of the Commentary on Art. 5 addresses this issue and includes an alternative anti-abuse provision that may be included in treaties that include a service-PE provision:

42.45 The 183-day thresholds provided for in the alternative provision may give rise to the same type of abuse as is described in paragraph 18 above. As indicated in that paragraph, legislative or judicial anti-avoidance rules may apply to prevent such abuses. Some States, however, may prefer to deal with them by including a specific provision in the Article. Such a provision could be drafted along the following lines:

For the purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are present and performing such services in that State, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals. For the purpose of the preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States.

34. The Focus Group concluded that BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by paragraph 3 of Article 5 could be addressed either by the general anti-abuse rule (*i.e.* the “Principal Purposes Test” rule) proposed as a result of the work on Action 6 or by a more “automatic” rule that would take account of any activities performed by associated enterprises. The following are proposals reflecting these alternative approaches.

**K. Provision to address the splitting-up of contracts**

[To be included in Article 5]

***For the sole purpose of determining whether the twelve month period referred to in paragraph 3<sup>1</sup> has been exceeded,***

- a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during periods of time that do not last more than twelve months, and***
- b) activities are carried on at the same building site or construction or installation project during different periods of time by one or more enterprises associated with the first-mentioned enterprise,***

***these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.***

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***1 If a service-PE provision is included in the treaty, the rule would need to be adapted in order to also apply to that provision.***

*Explanation*

This option follows the “automatic” approach put forward in paragraph 42.45 of the Commentary on Article 5.

In order to avoid the splitting-up of contracts using enterprises of different States, the provision applies regardless of where the associated enterprise is resident.

One difficulty with this approach is that it applies, for instance, to an enterprise of State A that sends specialists for only a few days to a construction site in State B where most of the work is done by a local subsidiary. A possible solution to that problem would be to add a minimum period of presence (*e.g.* 30 days in any twelve month period) that an enterprise would need to satisfy for the rule to apply to that enterprise. Another solution would be to add an exception such as “... unless it is established that obtaining the benefit of paragraph 3 is not one of the principal purposes for carrying on these activities through different enterprises”.

The opening words “For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded” emphasise the limited scope of the rule, which does not affect the attribution of profits. The time periods spent by associated enterprises are merely aggregated for the purpose of deciding whether the 12 month period has been exceeded, not for the purpose of attributing the activities of one enterprise to the other.

The reference to “different periods of time” means that any day where the two enterprises are carrying on activities at the place that constitutes the building site or construction or installation project will not be counted twice.

L. *No specific rule for the splitting-up of contracts; relying on the general anti-abuse rule proposed as part of the work on Action 6*

[Under that proposal, no specific rule for the splitting-up of contracts would be added to Article 5 but this issue would be dealt with through the addition of an example in the Commentary on the following principal purposes test rule proposed in the report on Action 6:

*Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, 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 this Convention.]*

The example could read as follows:

*Example E: 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 wholly-owned subsidiary of RCO resident of State R that is incorporated for that purpose. The contracts with RCO and SUBCO provide that both companies are jointly and severally liable for the performance of the contract concluded with SUBCO.*

*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.*

#### *Explanation*

This solution would only address cases where the splitting-up of contracts is tax-motivated, thereby excluding situations where there are legitimate business purposes for the involvement of associated enterprises in the same project.

## **D. Insurance**

35. Paragraph 39 of the Commentary on Article 5 suggests that insurance companies may do large-scale business in a State without having a permanent establishment in that State:

39. According to the definition of the term “permanent establishment” an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not

meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

36. Art. 5(6) of the UN Model includes the following provision intended to deal with that issue:

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

37. Paragraphs 28 and 29 of the Commentary on Art. 5 of the UN Model provide the following explanations:

28. Paragraph 6 of the United Nations Model Convention, which achieves the aim quoted above [*in paragraph 39 of the OECD Commentary*], is necessary because insurance agents generally have no authority to conclude contracts; thus, the conditions of paragraph 5, subparagraph (a) would not be fulfilled. If an insurance agent is independent, however, the profits of the insurance company attributable to his activities are not taxable in the source State because the provisions of Article 5 paragraph 7 would be fulfilled and the enterprise would not be deemed to have a permanent establishment.

29. Some countries, however, favour extending the provision to allow taxation even where there is representation by such an independent agent. They take this approach because of the nature of the insurance business, the fact that the risks are situated within the country claiming tax jurisdiction, and the ease with which persons could, on a part-time basis, represent insurance companies on the basis of an “independent status”, making it difficult to distinguish between dependent and independent insurance agents. Other countries see no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. They also point to the difficulty of ascertaining the total amount of business done when the insurance is handled by several independent agents within the same country. In view of this difference in approach, the question how to treat independent agents is left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.

38. A provision dealing exclusively with the situation of dependent agents who do not formally conclude insurance contracts would likely address cases where a large network of exclusive agents is used to sell insurance for a foreign insurer.

39. Existing tax treaties include a few examples of provisions dealing with insurance. A number of treaties include provisions similar to those found in the UN Model, sometimes without a specific exception for re-insurance. Other provisions exclude any form of insurance of local risks (other than life insurance)



from any limitation imposed by Art. 7 and, therefore, allow source taxation of insurance profits from insuring such local risks regardless of whether or not the profits are attributable to a PE. Such provisions may be subject to a standstill clause or may limit the tax to a certain percentage (e.g. 10%) of the gross premiums if the profits are not attributable to a PE.

40. Insurance (including re-insurance) raises difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed. As recognised in Actions 4 and 9 of the Action Plan, BEPS issues arise in relation to the transfer of risk within a multinational group, including through insurance and re-insurance.

41. Since the PE threshold relates to activities carried on in a State, a change to the PE threshold would not address cases where the remuneration of risk is shifted through the payment of insurance or re-insurance premiums to an associated enterprise that performs no functions in a State. It might therefore be more appropriate to address the BEPS concerns related to such cases through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted. This could be done through transfer pricing or special measures (e.g. addressing the deductibility of insurance or re-insurance premiums paid to related parties), as contemplated under Actions 4 and 9 of the Action Plan. In the case of transfer of risk to an independent party that can be done through *bona fide* insurance or re-insurance, the most significant BEPS concern seems to be related to the possibility that an insurance enterprise could actively sell insurance or re-insurance in a country through the use of exclusive agents without having a PE in that State.

42. Based on this analysis, the Focus Group concluded that the following two alternative approaches could be adopted in order to deal with BEPS concerns related to the artificial avoidance of the PE threshold in relation to insurance activities. The Group invites comments on these two options and on the question of whether re-insurance raises specific concerns related to the avoidance of the permanent establishment status.

*M. Provision that deems a PE to exist with respect to certain insurance activities*

[To be included in Article 5; similar to Art. 5(6) of the UN Model]

***Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 6 applies.***

*Explanation*

This provision is found in many treaties with some variations. It can be seen as merely extending the scope of the agency-PE rule in paragraph 5 of Article 5 by providing that the collection of premiums and the insurance of risks through a person other than an agent of independent status results in a PE even if insurance contracts are not concluded by that person.

*N. No specific rule for insurance enterprises; relying on the changes to Art. 5(5) and 5(6)*

[Under that proposal, no specific rule for insurance enterprises would be added to Article 5 and the issue of insurance enterprises would be dealt with through the more general changes proposed to Art. 5(5) and 5(6) (see options A to D above).]

## **E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing**

43. BEPS concerns around the PE rules (outside the digital economy issues) relate primarily to situations where one member of a group (*e.g.* a *commissionnaire*) clearly has a physical presence and tax nexus with the jurisdiction but is allocated limited profits because of low risk, whilst another member of the MNE group is shielded from tax by the technical operation of the PE rules and is allocated a large share of the relevant group income (*e.g.* by virtue of assuming or being allocated business risk, of holding valuable assets, etc.).

44. Whilst there are a number of different ways of approaching these issues, they cannot be addressed successfully without coordination between the work on the PE status mandated by Action 7 and the work on

- Action 4 (Limit base erosion via interest deductions and other financial payments), in particular the work on captive and other insurance arrangements;
- Action 8 (Intangibles), in particular the work aimed at ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
- Action 9 (Risks and capital), which involves the development of rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members.

45. This is why the wording of Action 7 emphasises that the question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE. The preliminary work that has been done so far on the issue of attribution of profits has focussed on the determination of additional profits that would be allocated to the State of the PE as a result of the changes that could be made to the definition of PE as a result of the work on Action 7 compared to the profits that would be allocated under the existing definition of PE. That work has also examined other interactions between the work on the PE threshold and ongoing work on other parts of the Action Plan dealing with transfer pricing, in particular the work related to risk referred to in Action 9. Whilst that preliminary work has identified a few areas where additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in this note were adopted. It was acknowledged, however, that the work on other parts of the BEPS Action Plan, in particular Action 9 (Risks and capital), might involve a reconsideration of some aspects of the existing rules and guidance.