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BEPS 7

New criterias for determining PE status

Purpose of BEPS 7

- The globalized ecomony and the dramatically changed commercial methods (like webshops, downloads) require globalized tax policy and provisions to avoid corporate income tax base erosion and profit shifting to low tax rate or tax free regions
- The profit should be taxed where the real economic activity that generates profitability are carried out and as appropriate to its contribution to the value creation
- For implementing recommendations a) national provisions will be harmonized in case of cross-border transactions, b) existing basic international standards should be substantially confirmed and c) transparency and certainty should be improved

BEPS 7: preventing the artificial avoidance of PE status

- BEPS-recommendations are expressed as they can be implemented to the national jurisdictions or via treaty provisions, with negotiations for a multilateral instrument
- For taxing profit a permanent establishment (PE) is required. Intentions for avoiding PE are recognised especially in the methods of creating commissions and – mainly relevant in the digital economy – in the abusive application of the exemptions.
- Therefore BEPS 7 concentrates on the following areas:
  - preventing the useage of artificial or hidden commissions
  - restrict the exemption rules of the „preparatory or auxiliary" activities
  - avoid artificial splitting-up of contracts in order to abuse twelve month threshold

HIDDEN INTERMEDIARIES

Problem: the intermediary – if neither the owner of the product, nor possesses it in its own name – can be taxable only after the commission as his intermediary services in his own country. His principal is not required to settle down there, if:

- the statements made by the intermediary are not obligatory for the principal (according to the Art. 5(5) of the OECD Model Convention [MC]) or
- the intermediary applied by the principal runs an independent agent business (according to the Art. 5(6) of the OECD MC)

The principal's profitability based on its commercial activities can not be taxable in the sales country, while the market risk should be taxable in the place of supply, ie. the sales country.

Taxpayer's formalized approaches have been confirmed by courts. The avoidance strategy of taxpayers have strengthened: intermediary literally has not signed anything, but essentially everything was arranged by him (para (5)) or the intermediary was treated as an independent agent while he was strictly instructed by the principal (para (6)).

cont.

- **Solution:** modify the Art. 5(5), Art. 5(6) of MC and changing related parts of the Commentary according to the followings: PE is not required for principals in the country where sales took place by intermediaries that operate independently indeed and for those persons, who entrust really independent agents. (An additional guidance on the attribution of profits to the PEs will be also issued during 2017.)

How many kind of intermediaries are there?

- Intermediaries can be:
  - **independent** agent: bringing the principal and the customer together, the contract is signed directly between the principal and the customer. In this case only commission is deserved, principal is not settled down in the country where sales take place, because the main business activities (negotiation, contracting, risks of sales) of the principal are carried on in the name and in the place of its own business.
  - **dependent** agent: not independent from the principal. The agent acts regularly and commercially in the name and on behalf of the principal, concludes contracts which are obligatory for the principal. In such a case principal must settle down in sales country because the actual business activities (via intermediary) take place there, too.

An agent may be independent, if he

- operates on behalf of another enterprise (whether as an employee or not) and does not qualify as an independent agent
- exclusively or almost (exceeding 90 %) exclusively acts for a closely related party („closely related" means that one possesses directly or indirectly more than 50 % of the beneficial interest in the other or both are under the control of the same person or enterprise, so parties belong to the same group of interest).
- commercially acts as an extension of an other enterprise (ie. the principal) which means that the agent
  - regularly concludes contracts in the name of the other enterprise or concludes contracts that are to be performed by the enterprise or
  - habitually plays the principal role leading to the conclusion of such contracts which are concluded without material modification by the enterprise.

cont.

- These contracts are concluded in the name of the other enterprise or ensure rights/ obligations to the other enterprise (Only accepting an offer is also a contract, and it also does not matter whether contracts will be signed by other persons, or abroad, or effectively will be performed by others.)
- There is not only about a single example, or temporary character, rather an regularly repeating case. (Exact number of items cannot be determined: it depends on the character of the principal's business or the nature of contract concerned.)
- Intermediations are also computed whether or not the relevant property existed or was owned by the enterprise at the time of conclusion of the contracts between the person who acts for the enterprise and the third parties.
- Expression of „in the name of…" is fulfilled, even if the name of the principal finally remains disclosed in the contract concluded.

Has the agent an independent or a dependent character?

- If the intermediary is instructed, monitored, controlled during his performance, he can not be independent. (Nevertheless passive ownership control does not treated as such an influence of the principal.)
- Another criteria may be: who owns the risk of the course of business (in case of a dependent agent core risks belong to the principal).
- Dependent character may be confirmed when depending situation lasts for a long time or for the lifetime of the agent's business.
- A dependent agent reguarly informs his principal about the progress of the course of carrying on the business.
- If we can not decide whether the agent is dependent or independent in spite of the above mentioned criterias, we must consider how much the agent is controlled by the principal.

Specific examples for having a PE as an agent

- an intermediary regularly convinces third party or parties to enter contractual relationship with the represented enterprise
- an intermediary habitually makes or accepts offers (even if these actions will be confimed formally by someone else), and – as a direct consequence – a delivery will take place from a warehouse
- an X Co established in X country distributes various products worldwide through its websites. Y Co resident in Y country is a wholly-owned subsidiary of X Co. Y Co's employees (as operators) convince customers to buy these products, they indicate the prices, explain standard terms and conditions of the contract, help order procedures even if online contract is concluded between X Co and the customers. (Y-operators play key role as they dispute all of the crucial point of the contract.)
- marketing and promoting of drugs does not directly result in the conclusion of contracts between the doctors and the pharmaceutical enterprise, so representatives cannot be treated as PE of that enterprise even though the sale of drugs may significantly increase as a result of that marketing activity
- a subsidiary acts on behalf of its parent company in such a way that the parent will be deemed to have a PE under the above mentioned principles and less of the 10 % of the subsidiary's sales are originating from independent principals. If that is the case the subsidiary cannot be treated as an independent agent, and it does not imply that the parent-subsidiary relationship eliminates the analysis of having a PE of the parent co or not.

Supplementary remarks

- if other conditions for exemptions are met (according to other paragraphs in the Article of the MC) establishment liability may be avoided (for example: a dependent agent acts solely as a buying agent who habitually concludes purchase contracts in the name of the principal but such activities are preparatory or auxiliary in the course of business of that enterprise)
- if PE criterias are fulfilled due to other provisions of the MC it is unnecessary to improve that the PE should be qualified as a dependent agent, too
- if a dependent agent is identified as a PE this cannot be restricted only for its activities of concluding contracts
- whether the services supplied by an individual constitute employment services or services rendered by a separate enterprise also should be analysed. (Independent status is less likely if the activities of that individual are performed exclusively or almost exclusively on behalf of one enterprise or closely related enterprise.)
- changes have no retroactive effect
- having a PE does not mean that the entire profits resulting from the performance of these contracts should be attributed to the PE, and – similarly - the profit of the agent cannot be taxed at the principal

RESTRICTIONS IN EXEMPTION RULES FOR „PREPARATORY OR AUXILIARY" ACTIVITIES

- **Problem**: Art 5 para (4) of the MC includes a list of specific exceptions according to which a PE is deemed not to exist where the place of business is used solely for preparatory or auxiliary activities (like warehousing, maintenance of a stock of goods solely for the purpose of storage, collecting information). As MNEs can easily alter their scructures to obtain tax advantages BEPS 7 clarifies that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities. And what's more, these activities – thanks to the dramatically changed methods of doing business (like e-commerce) - nowadays correspond to the core business activities, and fragmentation of a business might lose its cohesive character. As a result an activity having preparatory or auxiliary character cannot be taxed in the place where related profit is emerged.
- **Solution**: restricted meaning of preparatory and auxiliary activities, new anti-fragmentation rule

Outlines of the solution

- Two types of the solution: implementing a general anti-fragmentation rule and/or modifying definition of preparatory or auxiliary services to ensure that each of the exceptions included therein are restricted to activities that have truly „preparatory or auxiliary" characters - which constitute complementary functions compared to the cohesive business operation. (Some states consider that some of specific activities are intrinsically preparatory or auxiliary and take the view that they can be listed one by one.)
- In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise does not exercise a preparatory or auxiliary activity.
- A preparatory activity will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. However it is possible to carry on an activity for a substantial period of time in preparation as the activity by its nature has preparatory character (for example training to work).

Specific examples for being a „preparatory or auxiliary” character

- It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having a preparatory character.
- If a fixed place is deemed not to be a PE due to its preparatory or auxiliary character, this exception applies likewise to the disposal of assets at the termination of the enterprise’s activity at that place. (For example the sale of the displayed during a trade fair merchandise at the termination of the trade fair is merely an auxiliary activity.)
- If a fixed place of business is also used for other activities that go beyond what is preparatory or auxiliary, that place of business constitutes a single PE.

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- The mere presence of goods or merchandise belonging to an enterprise does not mean a PE for example if it is maintained by an other enterprise's warehouse. However if the enterprise-owner of the stocks is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, it should be considered whether these activities still constitute a preparatory or auxiliary activity.
- A stock of goods belonging to a customer is maintained by a toll-manufacturer for the purpose of processing. The place where the stock is kept cannot therefore be a PE of the customer. If, however, the customer has an unlimited access to other facilities of the toll-manufacturer in order to inspect the goods stored therein, it is questionable whether the maintenance of that stock constitutes a PE. If the customer is merely a distributor of products manufactured by others it may be a preparatory activity, too.

cont.

- Where premises are used solely for the purpose of purchasing goods or merhandise it is not deemed as a PE. Nevertheless this rule is applicable only for preparatory or auxiliary activities, and tipically not apply for a distributor's purchasing office of agricultural products at the place of the purchasing. (The purchasing function forms an essential and significant part of the distributor's profitability, as acquiring agricultural products requires special skills.)
- Maintaining an office for collecting information is not deemed to be a PE for an investment fund or an insurance company or a news agency if the office purely gets a line on investment possibilities, statistics and news (until engaging in any advertising activity).
- As management activity is never treated as preparatory or auxiliary character (it is always an essential part of the business activity), maintaining a management office constitutes a PE.

Anti-fragmentation rule

- It is not acceptable to fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity even if dissection results organisationally or geographically separated units in the same state.
- Cohesive activities will take account not only for activities carried on by the same enterprise at different places but also of the activities carried on by closely related enterprises at different places or at the same place.
- As a result of the adding rule at least one of the places where these activities are exercised must constitute a PE or the overall activity resulting from the combination of the relevant activities will go beyond preparatory or auxiliary character, so an establishment is required.

Specific examples representing the anti-fragmentation rule

- If a bank has several branches in different states meanwhile it also maintains an information office in one of the relevant states in order to verify information provided by clients that have made loan applications at these different branches, the office constitutes a PE, as the office and the relevant branch have complementary functions that are part of a cohesive business operation (ie. providing loans to clients).
- Let's suppose X company resident of state X who manufactures and sells appliances. Y Co (a resident of state Y) that is a wholly-owned subsidiary of X Co, ownes a store where these appliances are sold. X Co also maintains a warehouse in state Y where large items (displayed at Y Co's store) are kept. The ownership of the item is only acquired by Y Co when the item leaves the warehouse (as Y Co sells it to the customer). In this case the warehouse is deemed to be a PE of X Co as X Co and Y Co are closely related enterprises, and storing and distributing activity (for large items) constitute complementary functions that are part of a cohesive business operation.

AVOID ARTIFICIAL SPLITTING-UP CONTRACTS IN ORDER TO ABUSE TWELVE MONTH THRESHOLD

- **Problem:** According to Art 5 para (3) of the MC a place that constitutes a building site or construction or installation project results a PE if these activities are carried on during periods of time that last more than twelve months. The twelve month thershold has given rise to abuses: enterprises divided their contracts up to several parts, each covering a period less than 12 months, and they avoided establishment liability.
- **Solution:** a specific example will be added to the MC prohibiting the abusive splitting-up of contracts. (In the light of the principal's original purpose should splitting-up of contracts be acceptable? This will be the „Principal Purpose Test" or „PPT".) Please note applying PPT is reasonable only where domestic anti-abuse rules (like principle of „using rights as intended") are not in advance in conflict with the conduct of the enterprise.

Outlines of the solution

- If states wish to deal expressly with such abuses, a provision can be implemented into the double taxation treaties: where an enterprise carries on activities in the other contracting state at a place that constitutes a building site or construction or installation project and these activities last less than 12 month and connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time shall be added to the period of time of the first-mentioned enterprise.
- Splitting-up of contracts should be rejected not only where different activities were concluded but if contractors were the same persons or related persons as well.
- The twelve month test applies to each individual site or project, but no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it.

Aspects which are worth considering

- Did contracts covering the different activities conclude with the same person or related persons?
- Is the conclusion of additional contracts with a person a logical consequence of a previous contract concluded with that person or related persons?
- Would the activities have been covered by a single contract absent tax planning considerations?
- Is the nature of the work involved under the different contracts the same or similar?
- In spite of different contracts will the same employees perform the activities?

Specific examples how to calculate 12 month threshold

- A construction of a row of houses forms a single unit even if the orders have been placed by several persons and in several different contracts.
- A construction of a power plant in state Y is expected to last 22 months. During the negotiations the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with X Co (resident in state X), the second contract is signed by a recently incorporated wholly-owned subsidiary of X Co (SubCo, resident of state X). As the principal wanted to ensure that X Co would be contractually liable for performance of the two contracts, arrangements declare that X Co is jointly and severally liable with SubCo for the performance. Granting the benefit of the 12 month threshold in these circumstances would be contrary to the object and purpose of this provision.

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