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Tax Alert

Commissionnaires and Other PE Structures under Scrutiny as Part of BEPS

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The OECD has recently published a discussion draft on the portion of its BEPS action plan dealing with permanent establishments and has titled this paper, "Preventing the Artificial Avoidance of PE Status."[1] The title itself illustrates the OECD's view on the matter: taxpayers have taken actions to "artificially" avoid PE status and thereby deprive source countries of deserved tax revenue.

Characteristic of the BEPS project as a whole, the OECD's views on permanent establishments reflect its desire to change long-established tax rules while simultaneously stating that it is not changing these rules. In paragraph 3 of its discussion draft, the OECD states on the one hand, "The BEPS Report and the Action Plan recognize that the current definition of permanent establishment must be changed in order to address BEPS strategies," but, on the other hand the draft states, "…these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."

The connective tissue between these two seemingly contradictory statements is a profession by the OECD that all the OECD is trying to do is cure abuse.

A main target of this so-called abuse is "commissionnaire" arrangements, whereby an agent in the source country signs contracts on behalf of an undisclosed principal. These structures are a longstanding way of doing business in civil law countries, which have generally determined that a commissionnaire does not cause the principal to have a permanent establishment. In countries where commissionnaire structures do give rise to a PE, taxpayers routinely use a different structure, such as a commission agent (which does not sign contracts) or a buy-sell entity (which concludes contracts in its own name).

Despite the fact that a commissionnaire is just one of a number of ways of making sales to customers in a source country, the OECD detects tax avoidance, stating, "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."

And as with virtually all measures designed to cure a perceived abuse, the remedies proposed by the OECD would capture more than just commissionnaire arrangements.

One alternative proposed by the OECD would be an amendment to its Model Treaty to state that a permanent establishment arises when a dependent agent is acting in the source 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

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1 This new discussion draft was released on October 31, 2014 and is available at: http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf.

b. for the transfer of the ownership of, or for the granting of the right to use, property owned by the enterprise or that the enterprise has the right to use, or

c. for the provision of services by that enterprise.

This language is very broad and ambiguous. It could give a source country justification to tax a principal if a commission agent's activities simply "result" in the conclusion of a contract with the principal. For example, what if a commission agent is a top notch salesperson and habitually convinces customers that the principal's product is superior? That activity alone perhaps could give rise to a permanent establishment under the language quoted above. This would signal a departure from nearly a century of international tax rules.

Another alternative proposed by the OECD would deem a PE to exist if the agent habitually concludes contracts, or "negotiates the material elements of contracts," in the name of the enterprise. Under current rules the agent has act in a manner legally binding on the principal in order for a PE to exist. Therefore, if an agent actually signs a contract in the name of the principal or the principal's signature is a mere formality, the agent's activities could give rise to a PE. Under the language quoted above, however, a more than merely formal assent by the principal would not be sufficient inoculation against PE status. A PE would arise merely because the agent negotiates the material elements of the contract. Again, this would be a major departure from longstanding international tax rules.

The discussion draft also proposes other sweeping changes under the rubric of "fragmentation of activities." Under the current treaty, a subsidiary is not itself a permanent establishment of its parent company. Thus, under the current treaty, the parent may qualify for the PE exceptions for preparatory or auxiliary activities, such as storage of inventory for processing by another enterprise or display and delivery, even if a local affiliate is engaged in related manufacturing or selling activities. The report describes this longstanding business structure as an abuse of the Treaty.

The remedy applied by the OECD in such a "fragmentation" case would be to pierce the subsidiary's corporate veil and analyze the parent and subsidiary as a whole in testing for a PE. Specifically, a new paragraph would be added to Article 5 of the Treaty, denying the preparatory or auxiliary exemptions where "the same enterprise *or an associated enterprise* carries on business activities" at a place of business in the source country that (a) constitute a PE of the enterprise or the associated enterprise and (b) the two sets of constitute "complementary functions that are part of a cohesive business operation." For example, if the foreign principal used a local subsidiary to contract manufacture inventory as part of a "cohesive business operation," the principal could no longer rely on Article 5(4) to exempt its local storage of inventory for processing from being a PE.

If a PE were deemed to exist under these new, substantially broader, views of what constitutes a permanent establishment, then the source country would be able to tax the profits of the principal. The discussion draft on permanent establishments does not directly address the amount of the principal's profits subject to tax. It refers to three other separate BEPS workstreams: Action 4 (Limit base erosion via interest deductions and other financial payments); 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; and 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). These separate components of the

BEPS project reflect a desire to attribute significant profits of the principal to the source country.

Therefore, if the advocates of the BEPS project were to have their way, enterprises would be at far greater risk of having permanent establishments in source countries, and the source countries would have many more tools at their disposal to tax significant amounts of these enterprises' income.

For those taxpayers who have relied on longstanding international rules, the BEPS project certainly raises concerns. However, international tax rules derive their force from the legislation of sovereign nations and the network of bilateral income tax treaties. For the moment, at least, there has not been a stampede to change sovereign tax laws or bilateral treaties.

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