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January 9, 2014

Ref: PROPOSED DISCUSSION DRAFT: PREVENTING THE ARTIFICIAL AVOIDANCE OF Permanent Establishment (PE) STATUS

Dear Marlies,

BIAC thanks the OECD for the opportunity to provide comments on its Discussion Draft on Action 7 (*Prevent the Artificial Avoidance of PE Status*) of the Base Erosion and Profit Shifting (BEPS) Action Plan issued 31 October 2014 (the Discussion Draft).

The current PE rules have worked well for the past fifty years, in that they provide a level of certainty and stability which has encouraged business to engage in long-term cross-border trade and investment. Many of the major principles, such as the authority to conclude contracts, are well-understood legal concepts with broadly agreed meanings. We understand, however, that in recent years some governments have discerned planning techniques, which they believe seek to exploit elements of the current rules, for example, those on the conclusion of contracts and the preparatory or auxiliary rules.

We understand that the PE rules are likely to change, but we would make three observations. First, any rule which makes it easier to establish the presence of a PE will almost certainly increase the substantive and administrative costs of doing cross-border business for companies. Second, if the rules are changed, then it is crucial that any new rules be clear, and at least as well understood as the rules that they replace. If there is any vagueness and ambiguity in the new rules, then that will inevitably increase disputes between countries with a resultant increase in double taxation, and this second problem will be exacerbated if it proves difficult to make substantial progress on dispute resolution under Action 14. Finally, in its current form, this project does, at some level, implicate the balance between source and residence country taxing rights that is, explicitly, not a part of the BEPS project. It might, however, be better to have that conversation directly rather than through the proxy of the PE rules.

We look forward to working with you on this, but we would ask you to be very attentive to the dangers of changing the PE rules without broad agreement (including some tacit understanding on a reallocation of taxing rights between source and resident countries), and of doing so in a way that broadens rather than narrows ambiguity surrounding the presence of a PE.

Sincerely,



Will Morris, Chair, BIAC Tax Committee

Introduction

1. Treaties have historically clarified the right to tax to avoid the negative impact that multiple assertions of taxing jurisdiction can have on cross-border trade and investment. This has greatly supported the growth in such cross-border trade and investment.
2. The proposed rules would significantly lower the threshold at which an enterprise of the state of residence would be considered to have a PE in the other state. BIAC is concerned that adoption of the proposed rules could result in the proliferation of PEs. Furthermore, although BEPS has been defined as relating to double non-taxation, lowering the threshold for the creation of a PE will not specifically target double non taxation, but will instead inevitably lead to a change in the balance between source and residence taxation. The proposals may instead lead to double-taxation in cases that are not the intended target of the BEPS project.
3. The burdens of complying with corporate income tax obligations (as well as indirect tax obligations), including the administrative burdens, like filing tax returns or audited accounts, bookkeeping, invoicing and other reporting obligation, are significant, and companies consider these obligations in deciding whether to and how much of an investment to make in another country. The administrative costs are primarily those associated with creating systems that generate the data specific to each PE as well as advisory costs --- these can run into multiple millions of dollars.
4. To provide an example, in many jurisdictions, corporate tax and VAT registrations go hand in hand i.e. enterprises are automatically registered for corporate tax and VAT. Lowering of the PE threshold will therefore trigger additional VAT registration and compliance obligations and consequential administrative costs,¹ particularly in those jurisdictions which do not allow the application of the reverse charge mechanism to keep foreign suppliers out of the local VAT net. The recognition of a PE can also have customs implications in some jurisdictions.
5. Businesses may decide that an investment is not worth the administrative and tax cost, and take additional steps to limit PE exposure. Taxpayers may also take such steps to avoid other risks, such as the prospect of criminal sanctions from certain countries with respect to accusations of fraudulent income declarations or having never submitted a tax return for a deemed PE. Decisions to limit PE Exposure will reduce the global footprint of a business, which would impact local employment and investment. For each individual company, these decisions may not have a significant impact, but replicated globally, such decisions in the aggregate, could have an important, negative impact on cross-border trade and investment. Thus, the significant expansion of the PE concept will likely create a concerning trade barrier, and may restrict the level playing field between foreign and local investments that is encouraged through Trade Agreements, Bilateral Investment Treaties and the EU freedom of establishment.
6. If the proposed rules are adopted as they stand, many of the PEs created would be the result of little, if any, activity in the “source” jurisdiction. Such limited activities would often not generate significant taxable profit. In response to the expected proliferation of PEs, BIAC expects companies would make fundamental changes in their business models to mitigate the negative consequences as far as possible For example, the proposed rules on extending

¹ We are attempting to gather information relating to these costs and will provide such data as soon as possible.

the fragmentation of activities to activities of associated enterprises might cause companies to disaffiliate portions of their operations. If, for example, a Multinational Enterprise (MNE) owns a contract manufacturing facility in country A, and another affiliate maintains a stock of goods solely for the purpose of processing by that enterprise, it would seem, under the proposed rules, that the second enterprise would now have a PE in country A. On the other hand, if the contract manufacturer were unrelated, then the PE would not exist. Thus, one response to these rules would be to decontrol the contract manufacturing affiliate. Alternatively, MNEs may consolidate manufacturing in a jurisdiction that does not apply that particular rule.

7. Another possibility is that, in response to the broad proposals, companies will move to distributor business models in order to have certainty and to mitigate the risk of double taxation, or close down rep offices for the fear of challenge, which could have a negative impact on cross-border trade. To mitigate this risk, we believe that greater clarity is required over the specific arrangements or structures that are being targeted.
8. When MNEs own local facilities, particularly in developing countries, there are benefits to the local economy. MNEs are more likely to pay higher wages, provide better benefits and apply tougher safety and environmental standards. This has been evidenced as being achieved through rises in productivity as a result of restructuring, where acquired plants increase investment outlays, employment and wages². Creating effective tax penalties for MNE ownership of local facilities will discourage such ownership.
9. The Discussion Draft dismisses³, as insubstantial, the issues relating to attributing profits to the newly created PEs. To the contrary, BIAC believes that profit attribution is the most significant issue in a PE controversy, and also, that the attribution of losses to newly created PEs will also need detailed consideration. Countries are often motivated to create more PEs in order to attribute profits to them - There would be little point in creating the additional compliance burden for both taxpayers and tax administrations if there was little expectation of a related shift in the attribution of profits. We also note that the practical application of the Authorized OECD Approach (AOA) for the attribution of profits to dependent agent PEs for industrial business is already extremely challenging, with the result that arbitrary formulary apportionment methods continue to be the norm where PEs are determined to exist. In the Financial Services sector, the practical difficulties of attribution where an asset of an enterprise is considered to be split between two (or more) jurisdictions are already substantial, and will increase if the proposed changes are made. Many tax administrations will recognize that even in sophisticated financial businesses, it is too complex to expect systems to accurately allocate profit in the event of "split" assets. Such existing difficulties highlight the importance of addressing attribution issues.
10. To the extent that a PE is "virtual," or essentially "virtual," because functions, assets and risks of that PE are minimal, no significant profits should be attributed to that PE. Countries may, however, attempt to use such 'marginal PEs' to attribute significant profits based on the value of the market or some other attribution theory. The Discussion Draft notes that *"these actions are not directly aimed at changing the existing international standards on the*

2 Matthias Arnold, Jens & Javorcik, Beata S., 2009. "Gifted kids or pushy parents? Foreign direct investment and plant productivity in Indonesia," *Journal of International Economics*, Elsevier, vol. 79(1), pages 42-53, September.

3 Whilst the preliminary work has identified a few areas where (sic) 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. Paragraph 45 of the Discussion Draft.

allocation of taxing rights on cross-border income.”⁴ Broad PE rules, combined with a lack of clear guidance on profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed. Other countries may not share this view and the lack of clarity may cause companies to be caught in the middle with profits attributed to both jurisdictions, resulting in double taxation. Even where there is no assertion of a fundamental change in international standards, double taxation is a real risk as new PEs are determined and MAP processes are required to resolve disputes. This will result in significant additional compliance burdens for both taxpayers and tax administrations.

11. There are many function-specific profit attribution questions. For example, some assert that warehouses generate significant profits, even though warehousing and delivery functions are routinely outsourced and third party comparables demonstrating low profit margins may be readily available. It is not difficult to imagine disputes on the value of this function.
12. BIAC expects that the value of raw data to be very controversial. As BIAC pointed out in its comments on the Discussion Draft on the Digital Economy:

The Discussion Draft provides that data gathered from various sources is a primary input into the process of value creation in the digital economy. (Paragraph. 183) A key challenge is the attribution of value to this data and the extent of value relative to other sources of value – systems, software and people. It may be challenging to assign an objective value to raw data (Paragraph. 183) and determine the ownership of that data. Personal data is generally considered to be owned by the individual to whom it relates, rather than by a company. (Paragraph. 183)

BIAC believes that raw data has little or no intrinsic value, especially generally available raw materials such as usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources.⁵

13. The amount of raw data is exploding, particularly in connection with the internet of things. If countries take significantly different views on value of data that is collected, then the likely outcome is increased disputes and double taxation.
14. Another area of likely contention and likely dispute relates to the customer support functions. Countries take substantially different views as to whether such activities add significant value to marketing arrangements.
15. The Discussion Draft does not address the potential interaction of these rules with the limited force of attraction principle that forms part of the UN Model - The proposed rules are intended to only affect the OECD Model. However, if the proposals are implemented through the adoption of a multilateral instrument that would amend bilateral treaties that contain both OECD-based business profits articles and UN-based business profits articles, then it is necessary to consider the impact of the force of attraction principles on profit attribution. Significantly expanding the PE rules has the potential to also significantly expand the application of the force of attraction rules.
16. The PE proposals also do not fully recognize the bilateral nature of tax treaties. PE rules that restrict the ability of a “source” country to impose tax are particularly appropriate in the

⁴ Discussion Draft, paragraph 3, page 10.

⁵ Comment letter on OECD’s Discussion Draft on the Digital Economy, page 26.

context of trade relationships where the flow of foreign direct investment goes both ways. The source and residence country would be both benefitted and burdened by rules restricting the creation of PEs. The proposed rules therefore create significant burdens with no likely significant net tax impact between treaty partners. The proposals are, therefore, particularly inappropriate in the context of economies where FDI is reciprocal.⁶ Countries may be willing to agree to a PE provision that permits more “source” country taxation in the context of a relationship where the FDI is more one-way, or in exchange for other concessions by the “source” country in the bilateral relationship, but that should not become the benchmark model.⁷ The PE proposals would be better focused on tightening and clarifying the PE threshold in order to prevent abuse, rather than the simply lowering the threshold across the board. Lowering the threshold could have the perverse effect of increasing the prevalence of activities designed to avoid PE status, particularly if the thresholds involve subjective criteria.

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

General Considerations

17. BIAC firmly believes that any review of the Permanent Establishment (PE) definition designed to prevent abuse should be carefully considered in order to avoid any unnecessary burdens, further complexity and uncertainty for taxpayers and tax administrations. The creation of new PEs will likewise place additional burdens on tax administrations, which will also need to manage the compliance, audits and MAP processes. If complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.
18. In addition, tax administrations are carrying out more stringent audits and implementing tighter controls, often targeting PEs more frequently (and challenging the taxpayers PE determination). As such, extra provisions and clear guidance are needed, so as to create greater certainty and reduce the potential for disputes between taxpayers and tax administrations.
19. It is our concern that the suggested changes will not contribute to achieve the desired clarity, but instead, will lead to more uncertainty and disputes, due to the increased use of subjective tests. Without useful dispute resolution tools, like mandatory binding arbitration, MNEs will face protracted disputes, uncertainty, and no recourse to resolve such disputes.
20. BIAC understands that some Governments believe that the PE threshold must be lowered to tackle cases of abuse. We agree that real cases of abuse do exist and should be targeted, but we also believe that any amendments to the existing framework require careful assessment and analysis, so as to not jeopardize one of the very important building blocks of the international tax system. This can only be achieved in the time available with a very targeted

⁶ After 5 years of rapid growth, Chinese annual FDI in the US now exceeds FDI by US companies into China by most measures — including China’s own official statistics. **New Realities in the US-China Investment Relationship** by [Daniel H. Rosen](#) and [Thilo Hanemann](#) | April 29, 2014. <http://rhg.com/notes/new-realities-in-the-us-china-investment-relationship>. See also, U.S. - India Economic and Trade Relationship: Indian Investment in the U.S. http://www.whitehouse.gov/sites/default/files/rss_viewer/fact_sheet_indian_investment_us.pdf.

⁷ To the extent that countries might agree to a more expansive PE rule in a bilateral agreement based on the one-way nature of FDI or in exchange for other concessions, addressing the PE rules in the MLI will be extremely difficult because taking these bilateral aspects into account will be difficult.

scope, and the use of objective criteria and agreed legal terms wherever possible. Limiting the scope to clear cases of abuse will avoid inadvertently penalizing perfectly legitimate business practices.

21. We believe that the emphasis of the Discussion Draft should be to tighten the PE threshold to prevent abuse (i.e. “artificial avoidance” as noted in the BEPS Action Plan), but we note that the lowering of the threshold in so many areas may not prevent abuse. Such a broad lowering of the threshold may arguably increase the prevalence of activities designed to circumvent the finding of a PE, particularly where the thresholds applied involve subjective criteria. Tightening or targeting is the key.

Paragraph 6 – 11 of the Discussion Draft – Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies

22. The Discussion Draft broadly defines a commissionaire arrangement 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 arrangement, a foreign enterprise is able to sell its products in a State without having a PE to which such sales may be attributed for tax purposes; since the person that concludes the sales does not own the product that 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)”⁸”

23. The main tax issues arising in connection with such agreements are due, mainly, to the differences in their treatment among between and civil law countries.
24. As noted above, the differences in interpretation by tax administrations or case-law can result in interpretations that span legal and economic issues. Moreover, the guidance included in the Commentary does not provide much clarity as to how to best address the issue of dependent versus independent agents.

Proposed options for changes to Art. 5 of the OECD Model included in the Discussion Draft

25. The Discussion Draft, in paragraph 10, states that:

“as a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business.”

26. In our opinion, this policy statement is overly broad and clearly goes beyond the intended target of commissionaire arrangements or other arrangements that are designed to artificially avoid the creation of a PE. Based on such subjective principles, activities across the full spectrum of functions (including high and low value activities) could be considered to ultimately result in the regular conclusion of contracts. Indeed, for what purpose is any activity of an MNE undertaken, even the most routine, if not to indirectly or directly contribute to a broader process that will result in the conclusion of a contract?
27. We note in this regard that the financial services sector has particular concerns. Parts of financial services regulations are restrictions that directly affect the chain of distribution of

⁸ OECD Discussion Draft on BEPS Action 7, Sep. 2014, Page 10-11

services and products across borders. Active distribution (soliciting) of products and services is, in most countries, only possible with an authorization from the competent authority at the place of distribution. This refers, in particular, to the financial products that are not traded on a stock exchange, to mutual funds and to insurance policies. Therefore, most of the activities performed are based on a concept of remote solicitation i.e. customers seek contact and ask for services. Remote solicitation of financial services products should not fall under the concept of a PE.

28. Businesses require certainty over tax issues, and that certainty is best achieved when principles and guidance are developed in an objective, rather than subjective way. BIAC believes that the high level and unclear nature of the OECD's proposals under Options A-D will introduce significantly more subjectivity into the PE test. Due to the consequences of "triggering" a PE (including compliance requirements and potential for penalties for inadvertent failure to file), it is important for business to understand as clearly as possible with sufficiently "bright line" tests when a PE might arise.
29. The Discussion Draft identifies *commissionaire* structures and "*similar arrangements*" as one of the causes of BEPS in a State where sales take place. To improve the clarity of the proposals, examples should be provided to objectively identify the "*similar arrangements*" that the OECD is targeting. There are a number of legitimate commercial arrangements that could not be considered "*similar*" to commissionaire arrangements but the target is not clear from the text. It is our understanding that the intent of the OECD is not to bring limited risk distributors into the scope. It would be helpful for the Discussion Draft to clarify that understanding.
30. In relation to **Options A** and **C**, the Discussion Draft proposes to replace "*conclude contracts*" with the wording "*engages with specific persons in a way that results in the conclusion of contracts.*"
31. BIAC believes that to improve the clarity of this proposal, the existing guidance in the Commentary (Paragraph 33) to the OECD Model should be developed, to add additional guidance to clearly identify the necessary elements to assess whether there has been engagement with specific persons "*in a way that results in the conclusion of contracts.*" It should also be clarified whether the circumstances should be assessed internally⁹ (i.e. whether authorization formally granted by the enterprise to an intermediary is assessed internally and is decisive to bind the enterprise) or externally⁹ (i.e. such authority of the intermediary to conclude contracts is assessed externally, based on what a bona fide third party would presume to exist).
32. The OECD Discussion Draft states on page 12 that:

"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".
33. BIAC believes that the wording of **Options A** and **C** goes far beyond directly binding the principal. The proposed wording seems to target all sales arrangements where a local entity provides support services to a foreign sales entity that directly concludes contracts with local

⁹ 'Internal assessment' and 'external assessment' correspond to the recognized U.S. legal concepts of 'actual authority' and 'apparent authority.'

customers. Such support services could include marketing, customer relationship management or negotiating certain limited contract terms etc. It would seem that such services are targeted, even if the service provider is already properly compensated for its services in accordance with the Arm's Length Principle. We are concerned that any such services, regardless of how routine they are, may be seen, under the proposals, as having a direct causal connection to the conclusion of a contract. This could substantially increase the number of disputes between states, and substantially increase the cost to taxpayers tax administrations.

34. BIAC is concerned that without clear limitation, almost any local support activities in a sales transaction would lead to a PE exposure. The proposed amendments to Art. 5 (5), extending the test beyond the conclusion of contracts in the name of the principal, could also lead to risk for shared service companies, particularly as they may not be able to continue to rely on the independent status exemption based on other proposals in the Discussion Draft. We also note that the preamble to options A-D states that, "*activities that ...[]... are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise*" should provide a sufficient taxable nexus. We believe that the phrase "performed by a foreign enterprise" is ambiguous, and that further clarity should be provided as to what this means. In addition, we do not believe that a mere offering over the internet should automatically be considered as an activity that results in the conclusion of contracts.
35. **Options A and C** do not require any level of authority from the intermediary to bind the Principal, but only that the activity in question merely contributes to the circumstances which result in the conclusion of the contract. It could be interpreted that the mere existence of any relationship between an intermediary and a customer could be considered to result in a PE where a particular country is of the view that any customer relationship is a key component of the contractual negotiation. These proposals are a significant concern for BIAC.
36. Paragraph 33 of the 2010 OECD Commentary on Art. 5 provides that: ***all*** elements and details of a contract must be negotiated by the intermediary, ***in a way binding on the enterprise*** in order to create a PE [***emphasis added***]. Notwithstanding this provision, Courts have not always followed this principle, as is illustrated by an Italian decision relating the Philip Morris case: The Italian Supreme Court held that the simple attendance of representatives of an Italian enterprise at some stages of the negotiation, or closing of contracts, with no power of representation, should be sufficient evidence of the authority to conclude contracts in the name of a foreign enterprise, so as to assess the existence of an agency PE in Italy. BIAC disagrees with this decision and has identified this case as an example of where the current rules have led to differing interpretations. It is very important that the language of the OECD's proposals be as clear and specific as possible to avoid such conflicting interpretations to the greatest extent possible in the future.
37. We do not favor **options A and C** due to the vagueness of the notions that they include, for example, "*in a way*" and "*results*", but if such options are to be pursued, their legal certainty should be improved by expanding the Commentary to include further examples and to address specific situations such as:
- What does the phrase "*engages with specific persons in a way that results in the conclusion of contracts*" imply? Is it restricted to engagement that results in the conclusion of a binding contract by the intermediary, or is it broad enough to cover any engagement (e.g. participating in negotiations without exercising decision-making authority) by an intermediary, while not binding, could arguably contribute to the

conclusion of contract by the foreign company? In our opinion, the latter engagement may, in some circumstances, to fall short of the “*engaging with specific persons in a way that results in the conclusion of contracts*” threshold, and should therefore not constitute a PE.

- What would be the outcome for PE purposes if a contract negotiated by an intermediary explicitly includes a clause subjecting acceptance of the contract to further approval by the Principal (and where that requirement is specifically explained and communicated to the client)? In our opinion, we believe that such activity should also not breach the “*engaging with specific persons in a way that results in the conclusion of contracts*” threshold, and should therefore not constitute a PE of the foreign enterprise.
 - What would be the outcome for PE purposes, if an intermediary received specific and detailed instructions from a foreign company to negotiate a contract and assumed a role of a mere “*spokesperson*” (and actually has no “*authority*”)? In our opinion, this should not constitute a PE.
 - What would be the outcome for PE purposes, if an intermediary has been delegated a narrow band of authority by the foreign company for a small number of contract terms? As an example, what if an intermediary is delegated the authority to negotiate and agree only price discount within a specified percentage range of the List Price on behalf of the foreign company, and the foreign company retains the authority for Price discount beyond the specified range and for all other critical terms and conditions of the contract e.g. delivery schedule, payment security, performance guarantee, liquidated damages, etc.? In our opinion, this should not constitute a PE.
38. **Options B and D** of the Discussion Draft propose to replace “*conclude contracts*” with the wording “*concludes contracts or negotiates the material elements of contracts*”. In our opinion, it is essential to include a clear definition of the “*material elements*” of a contract to allow a better assessment by taxpayers and tax administrations, and to avoid increased uncertainty and subjectivity. Paragraph 33 of the 2010 OECD Commentary on Art. 5 clearly sets out that mere participation in negotiations, without the authority to conclude contracts binding on a foreign company, will not be sufficient, by itself, to trigger a PE. We suggest that the mere participation in negotiations, without the exercise of decision making authority, or negotiation and conclusion of a “*few*” material elements should not be sufficient to trigger a PE. If option B or D is to be adopted, then very clear rules are needed on what is necessary to be considered to have concluded or negotiated the material elements of a contract.
39. In addition, **Options A and B** propose to add the language; “*to contracts for the provision of property or services by the enterprise*”. The Discussion Draft does not limit the article to the conclusion of contracts for the sale of goods (such as commissionaire agreements), but goes substantially beyond that to include the conclusion of leasing contracts or the provisions of services.
40. In addition, the Discussion Draft also proposes to add some clarity to the meaning of “*(...) in the name of the enterprise*”. In our opinion, the most appropriate solution to reduce the controversy surrounding the interpretation of “*(...) in the name of the enterprise*” would be subjecting the intermediary to the condition that it must have authority to conclude contracts that are legally binding on the enterprise. The fact of whether a contract is legally binding or not should be examined under the law ruling the contract. This solution would reflect the original intent of the OECD Model Convention on this matter, also supported in

leading case-law such as the *Zimmer Ltd.* or *Dell (Norway)* cases. The latter solution would allow for a more effective application of the wording “(...) *in the name of the enterprise*” and would reduce the probability of disputes.

41. **Options C and D** propose to replace the expression “*contracts in the name of the enterprise*” with the wording “*contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise*”. BIAC believes that these proposals will add excessive complexity and subjectivity to the PE test for both businesses and tax administrations, and are, therefore, not desirable.
42. We are also concerned that the wording “*contracts which [...] are on the account and risk of the enterprise*” included in Section A, paragraph 11, page 13 of the OECD Discussion Draft will not only lead to commissionaires becoming PEs in source countries, but will also increase the PE risks for other limited risk activities, including limited risk distributors (“LRDs”), toll and contract manufacturers, contract R&D providers, service providers etc. which would go substantially beyond the scope of the BEPS Action Plan.
43. Moreover, the Discussion Draft also strengthens the requirement of “*independence*”, proposing to remove the possibility that an agent can still be considered to be independent, even though it acts exclusively on behalf of one party, as long as specific requirements are met. In this regard, we note that Paragraph 38.6 of the OECD Commentary to the OECD Model states:

“Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent’s activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.”

44. BIAC believes that, although “*independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise*”, as expressed in Paragraph 38.6 above, this fact is not “*by itself determinative*”, and all facts and circumstances of the case at hand should be taken into consideration.
45. Automatic denial of independent agent status where an enterprise works exclusively or almost exclusively for associated enterprises disregards the fundamental concept of independence of legal entities and is not warranted, especially where the agent is remunerated at arm’s length, and economic and legal independence can otherwise be demonstrated.

Simplification

46. Complexity in international tax rules continues to increase and compliance with those rules becomes ever more difficult. BIAC is hopeful for clarity and simplicity in new principles and rules being developed by the OECD. In addition to tackling legitimate abuse, one of businesses’ primary concern is that double taxation is avoided, and that Governments can agree to consistent international principles as to what profits should be subject to tax and where. The lowering of the PE threshold will significantly increase *red tape* for companies

and tax administrations. The mere creation of a PE leads to considerable administrative burdens on both sides.

Preliminary Conclusions on Section A of the Discussion Draft

47. BIAC believes that a balanced approach should be favored by the OECD. In this regard, the least damaging proposal identified in the Discussion Draft is likely **Option B**.
48. Nevertheless, in our opinion, all of the suggested proposals seem to go substantially beyond commissionaire arrangements and similar structures and they are likely to impact other fact patterns that may not have been envisaged. If it is the intention of the OECD to implement such broad proposals, a clear articulation is required that sets out what abusive transactions or structures are being targeted.
49. **Option B**, if developed appropriately, does have the potential to provide some certainty and clarity, while limiting the risk of inconsistent application and creating significant double taxation and the artificial avoidance of PE status. In any case, further clear and objective guidance should be provided in the OECD Model Commentary on **Option B**.
50. Although we do not favor **Options A** or **C**, if they are to be pursued then further guidance should be provided in the Commentary (Paragraph 33) to the OECD Model to clarify what are the necessary elements to determine when there has been engagement with specific persons in a way that results in the conclusion of contracts. This should include whether it should be assessed internally or externally (depending on what *a bona fide* third party would consider to exist whenever it is concluding a contract, which creates an obligation vis-à-vis a foreign enterprise). BIAC is concerned that even with additional guidance, such options will likely create great uncertainty which will, in turn, lead to an increasing number of disputes between the States and increasing costs for solving such disputes.
51. For **Options B** and **D**, it would be essential to include a clear definition of the “*material elements*” of a contract in order to allow a better assessment by taxpayers and tax administrations, and avoid a further increase in legal uncertainty.
52. In determining whether *independent status* exists, we continue to support the ‘all facts and circumstances’ test, as expressed in Paragraph 38.6 of the Commentary to the OECD Model.
53. Finally, any changes to be made to the existing rules on PE status should take into consideration that simplification and objectivity are helpful for businesses and tax administrations alike, that excessive burdens for both parties should be avoided, and that effective dispute resolution mechanisms should be available. As the creation of a PE leads to significant consequences for enterprises, it is desirable that it should be as clear as possible when such consequences arise.

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

54. The purpose of the specific activity exemptions in Art 5 (4) of the OECD Model Convention is to provide relief from filing and tax payment obligations for activities that are generally preparatory or auxiliary in nature, and that do not contribute significantly to the profits of an enterprise. Filing and payment obligations can create significant cost for a non-resident enterprise, and can discourage investment in smaller and emerging markets. In revising the

exceptions, the OECD and member countries should keep these fundamental principles in mind.¹⁰

The exceptions are not restricted to preparatory or auxiliary activities

55. **Option E** of the Discussion Draft would not delete any of the activities from the list, but would make all of the activities subject to the condition that the activity is preparatory or auxiliary in nature.
56. Business believes that activities that are not preparatory or auxiliary in nature should indeed be considered to possibly create a PE, and we can understand the principled intentions of the OECD in proposing the preparatory or auxiliary override to the exemptions. However, as set out below, we have substantial concerns about the practical impact of such an override, and the likelihood of being able to develop clear and objective rules that do not create substantial additional burdens and/or disputes. On balance, we believe, at this stage, and with the tight time constraints of the BEPS process, that it would not be possible to develop a sufficiently robust framework to implement this proposal on an internationally consistent basis.
57. We do recognize that this option may have the advantage of recognizing that the all of the items on the list can, in many circumstances, be preparatory or auxiliary in nature, and would leave the delivery, purchasing and data collection exemptions partially intact. If this option is developed further, it would be essential for all countries to clearly accept and state that all of the activities on the list are still capable of being preparatory or auxiliary in nature. Otherwise, the proposal will likely confuse and mislead taxpayers and tax administrations. Also, if pursued, further detailed practical guidance and examples would be needed to assist taxpayers and governments to identify which activities are and are not preparatory or auxiliary in nature. Such guidance would have to be as objective as possible and take into account the wide spectrum of functional fact patterns that exist across the different activities. This would seem to be a very difficult task to undertake. We note in this regard that paragraph 24 of the Commentary on article 5 states that *“It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.”* We encourage the OECD to further clarify this concept if all the activities are to be subject to this condition.
58. As suggested already, the primary disadvantage of this option related to the practical challenge of subjecting all of the listed activities to possible challenge. Certainty of outcome is critically important for business. Subjecting all the items on the list to potentially subjective tests would increase uncertainty. We also strongly believe that the preparatory or auxiliary override would impact the majority of situations where the preparatory or auxiliary test is legitimately relied upon, increasing the burden faced by compliant taxpayers.

The word “delivery” in subparagraphs a) and b) of paragraphs 4 of Article 5

59. **Option F** would delete delivery from subparagraph a) and b) of paragraphs 4 of Article 5. Whilst we do not favor this deletion, this option would be more appropriate if countries believe that maintaining a fixed place of business through which delivery activities are conducted cannot be preparatory or auxiliary. If this option is adopted, then it is important

¹⁰ Please see the appendix for some examples of costs associated with this. If the costs associated with setting up financial systems and annual accounting exceed the profit that would be attributable to the PE, then the business will find another way to accomplish this function.

to be clear about a number of points.¹¹ First, a shipper of goods using an unrelated shipping company to deliver goods from a warehouse controlled by the unrelated company would not create a PE. This would be the result because the enterprise would not have a place of business in the “source” country. The unrelated company’s warehouse would not be a place of business of an unrelated shipper.

60. Second, on determining profit attributable to a warehouse that would be a PE under the proposed rules, the OECD should make it clear that the only profits that are attributable to the PE are those relating to sales into that country. For example, assume that an MNE makes sales into countries A, B, and C, that a warehouse is located in country A, and that products are delivered from that warehouse to purchasers in countries A, B, and C. Assuming no other presence in country B or C, there would be no PE in Countries B and C and those sales could not be attributed to the PE in country A.¹² If there is otherwise a PE in B and C, is there a service fee attributable to the PE in Country A that should be deductible by the PEs in countries B and C?
61. Third, countries should recognize that these new PEs ought to share in the expenses of the enterprise. For example, PEs arising from warehouse activity should bear a share of management costs and a share of interest expense among others.
62. In addition to the above, we are concerned that the focus of countries in examining the delivery exception has been on marketing to ultimate consumers and that not enough thought has been given to the exception in the context of business-to-business transactions where BEPS concerns would be significantly less. For example, it might continue to be the case that maintaining a warehouse for the ultimate delivery of heavy equipment should be preparatory or auxiliary to the manufacture and sale of such equipment. In the oil and gas industry, storage and distribution raises special issues that are described in detail in the appendix to this submission. These issues ought to be explicitly considered before substantial changes are adopted. If, after such consideration, it is concluded that these business-to-business transactions do not raise BEPS concerns, we would encourage the OECD to include examples in the Commentary that make it clear that the delivery exception remains available under Article 5(4)(e) in these cases. Since the UN Model does not contain an explicit exception for delivery, it should be considered what impact the absence of this exception has had on the jurisdictions that have adopted the UN Model on this point and on the MNEs doing business in those jurisdictions.
63. If the word “delivery” is removed from paragraph 4 of Article 5, the OECD should provide clear guidance as to when “storage” and “display” end, and “delivery” begins in order for consistent approaches to be taken by Tax Authorities.

The exception for purchasing offices

64. **Option G** would eliminate the preparatory or auxiliary exception for purchasing goods. BIAC believes that the exception for purchasing should be retained. Narrower solutions are available for cases that are considered problematic. In most cases the mere purchasing of goods is too attenuated from the earning of profit to justify the creation of a PE. The PE rules are attempting to find a balance between:

¹¹ It would probably also be necessary to provide this guidance even if Option E is adopted, if countries intend that the delivery would rarely be preparatory or auxiliary.

¹² Companies sometimes maintain regional warehouses from which delivery is made to multiple countries. It does not seem inappropriate to treat all the deliveries to all the countries the same, that is, there would not be a PE in any of the countries regardless of the location of the warehouse.

- a. the activity threshold that ought to require a non-resident enterprise to comply with the tax burdens imposed by the state; and
- b. the revenue implications of foregoing that revenue by the taxing jurisdiction.

No business can function without purchasing goods, whether for internal consumption or processing and ultimate resale. The issue is not whether a purchasing function does or does not contribute to profit or loss; it clearly will. The issue is whether that contribution is sufficient to justify the creation of a PE? BIAC believes it is not.

65. The reason for this is that generally, the tax and compliance burdens to business and potential negative impact on cross border trade will likely outweigh the tax benefit to Governments. As pointed out above, the costs of setting up the structure to collect data to implement PE reporting can be multiple millions of dollars. If the profit attributable to the purchasing of goods is minimal, then the cost of implementing the PE structure could eliminate all of this profit, resulting in no benefit for the taxing jurisdiction to justify the time and expense of a finding a PE, attributing profit to the PE, and auditing the result. Given that possibility, businesses may restructure their purchasing functions to minimize PE risk. Purchasing will become even more centralized than it already is and purchasing offices may be closed.
66. Countries should also consider this burden in light of the reciprocal nature of these rules. That is, if purchasing is ordinarily an activity that generates little profit, the balance between administrative burdens on taxpayers versus revenue concerns of the countries should be resolved in favor of minimizing the burden created. In cases of reciprocal trade, goods will be purchased in all countries, so exempting purchasing activity will continue to benefit cross-border trade.
67. Local purchasing activities are mainly driven by businesses desire to be closer to their sources of supply, and therefore to optimize procurement activities (supply and quality) within the MNE. Most local activities will be preparatory or auxiliary in nature and the profit attributable to such activities would be minimal. If the exemption is not retained, business might adopt inefficient procurement structures to avoid PE status.
68. If countries intend for purchasing activities to create PEs, it should be accepted that purchasing can, in addition to contributing to profits, also contribute to losses. Sometimes, this contribution may be direct: a company may overpay for its inputs, and therefore would not be able to sell its products at competitive prices, ultimately suffering losses. Alternatively, companies may misjudge the demand for a particular product and purchase too much, ultimately not being able to resell the product at a profit.
69. The three examples in the Discussion Draft seem to ignore that the fact patterns arise in the context of a bilateral treaty relationship. That is, the “source” country is giving up its right to tax based on negotiations that allocate taxing jurisdiction to the other state. As part of such bilateral negotiations, the two countries determine whether the other state will impose tax.¹³ Residence countries frequently condition exemptions for business profits on the existence of a PE in the source jurisdiction. So, this interaction between the “source” and “residence” country goes directly to the issue of conflicts of qualification (i.e. where the

¹³ This is one of the difficulties inherent in the MLI approach. Income tax treaties should reflect the bilateral relationship between the countries negotiating the agreement and the MLI will complicate this, if it does not make it impossible.

source country exempts income, but that income is not taxed in the corresponding residence country). Business does not object to rules that resolve the issue of conflicts of qualification where the territorial or exemption system is only applied in cases where the “source” state imposes tax. Encouraging states to clarify their intentions with respect to the imposition of taxation in bilateral treaty relationships would be a narrower and more appropriate solution to address any unintended double non-taxation arising in the first example.¹⁴

70. Eliminating double non-taxation through the proper resolution of the conflicts of qualification would, consistent with current norms, eliminate double non-taxation by ensuring that the country of residence imposes tax. This narrower solution is therefore consistent with the BEPS Action Plan and the Discussion Draft which state *“these actions are not directly aimed at changing the international standards on allocation of taxing rights on cross-border income.”*¹⁵
71. In recent UN discussions some delegates have objected to rules implementing the proper resolution of the conflicts of qualification, despite the fact that it would only limit unintended double non-taxation and would not limit the ability of a country to adopt tax incentive legislation. The only reason to object to the principles set forth on conflicts of qualification would be that such principles are inconsistent with more “source” taxation (even if it is not exercised). As part of the OECD’s proposals we believe further consideration should be given to this potential solution.
72. Another narrower solution to the problem posed by the first example would be to adopt appropriate Controlled Foreign Company (CFC) rules dealing with foreign base company sales transactions. Again this would preserve the current allocation of taxing rights between source and residence states.
73. In the second example, it is not clear why SCO is not also considered to be selling in State S. A more appropriate solution might be to make clear that SCO is both purchasing and selling, that is to say that the buyers are also conducting selling activity in State S, so that the PE is not merely purchasing goods but also is considered by the authors to be substantially participating in the sale of those goods.
74. BIAC agrees with the conclusion of the third example.
75. In most cases, purchasing will make only a minor contribution to the overall profitability of the enterprise. The profits attributable and the corresponding amount of tax due in relation to these minor contributions will not justify the cost of establishing the structure necessary to produce the financial information to comply with PE rules, or the annual compliance burden. It may well therefore cause MNEs to consider closing purchasing offices. We believe that simpler solutions for abusive cases should be pursued and the exception for purchasing should be retained.
76. **Option H** would delete subparagraph d) of paragraph 4 of Article 5. The proposal would delete both the exception for purchasing and the exception for data collection. The only justification offered for deletion of the data collection exception is that

“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

¹⁴ See the OECD commentary on Article 23 A and 23 B paragraph 32.1 et seq.

¹⁵ Action Plan page 11 and Discussion Draft paragraph. 3 page 10.

for other enterprises by repackaging the information collected into reports prepared for those enterprises.”¹⁶

77. Before considering adopting changes that would have a significant impact on taxpayers and tax administrations, we encourage the OECD to first confirm that the above concerns are well-founded. As an initial matter, we are not sure what the term ‘repackaging means’. If it is intended to simply mean the collection of data and the forwarding of that data, then we believe that this has no intrinsic value (and such activities should not be considered to breach the PE threshold). If, however, ‘repackaging’ is intended to mean the sifting, analysis and interpretation of enormous quantities of data into something that is commercially useful, then that is a different issue. We believe, in the latter case, that traditional transfer pricing guidelines should be sufficient to price such services.
78. BIAC believes that the exception for data collection should be retained.

Fragmentation of activities between related parties

79. **Options I and J** propose to address fragmentation of activities among associated enterprises, rather than among separate parts of the same enterprise. Most of our concerns in relation to these rules apply equally to both options, since our concerns relate to the basic application of the anti-fragmentation rule. Both options would significantly undermine the concept of separate entity reporting. As discussed in the general comments section of this letter, this may cause some unintended consequences, with companies reconfiguring their operations in ways that might be inefficient, therefore potentially harming global trade and investment.
80. The proposed rule seems to be limited to activities that would otherwise be within the scope of Article 5, paragraph 4, and does not seem to cover other activities that would not create a PE. If, for example, an MNE owns an affiliate established in country A that operates a contract manufacturing facility in country B and another affiliate maintains a stock of goods at that manufacturing facility in country B, solely for the purpose of processing by that the first affiliate, it would seem, under the proposed rules, that the second enterprise would now have a PE in country B. If, however, the two entities were unrelated, no PE would exist. If the contract manufacturer is a low-value activity, this may discourage the MNE from maintaining ownership of that manufacturing operation. The only activity that the second affiliate is engaging in is “maintaining a stock of goods for purposes of processing by another enterprise.” We question how much profit should be attributable to that PE? What are the functions, assets and risks that will be analyzed in determining the amount of that profit? And is the attributable profit, and associated tax revenue, greater than the costs faced by both taxpayer and tax administration?
81. Assuming that the purchasing exception is retained, if a State R enterprise purchases goods through a local purchasing office established in State S on behalf of many of the associated enterprises in the affiliated group, and any of the goods purchased by the State R enterprise through that purchasing office were used by an affiliated enterprise with a PE in State S, the State R enterprise would have a PE in State S. What profit would be attributed to that PE? Would it only be profit attributable to the goods sold to State S customers or also a portion of the profits of the State R enterprise on resale to all customers of products purchased in State S? How would the UN force of attraction principle apply? As we understand the proposal, there would be a PE of the State R enterprise in State S. We believe this result is

¹⁶ Discussion Draft paragraph 28.

inappropriate given the difficulty of attributing any profit to this activity. The tax gained would very likely not justify the burden.

82. As another example, if a nonresident enterprise of an MNE group purchases the output of a local manufacturing affiliate, and does not maintain a stock of goods at the affiliate's premises (the affiliate owns its own inventory), but the nonresident enterprise sends an employee to the manufacturing facility to inspect and perform quality control functions, is the anti-fragmentation rule applicable? As we read the proposed rule, it should not apply because there is no fixed place of business that is maintained by the nonresident solely for the purpose of carrying on an activity of a preparatory or auxiliary character. That is, the fixed place of business (the manufacturing facility) is maintained by the local manufacturing affiliate, so the nonresident member of the MNE group would not have a PE because it does not have a fixed place of business to begin with, and therefore, the exceptions of paragraph 4 do not apply. If the proposed rule is intended to apply in such a case, then we believe that the rule would be unadministrable, especially in today's business environment where employees are globally mobile. Virtually any time an employee of one company visited the offices of another associated enterprise, it would at least create the possibility that a PE would be created.
83. BIAC does not believe that either option I or J ought to be adopted as they will both pose issues where MNEs have existing companies in countries where preparatory or auxiliary activities are undertaken. Option I is, however, narrower than option J, so between the two it is the less objectionable version.

C. Splitting-up of contracts

84. Article 5(3) of the OECD Model Convention provides that building sites give rise to a PE if they last for more than a 12 month period. The Discussion Draft raises a concern that is already adequately considered in existing Commentary to Article 5 of the OECD Model Tax Convention: that is, companies could divide up contracts in order to avoid a PE. This could happen in the case of Article 5(3), by dividing up contracts into several construction phases, each covering a period shorter than 12 months, and each of those phases being performed by a different legal entity.
85. Furthermore, the Discussion Draft identifies a similar concern regarding the application of the provision for service PEs as described in the Commentary to Article 5.

General comments on the “automatic rule” and the general anti-abuse rule

86. A general anti-abuse rule (page 23, box L of the Discussion Draft) intends to address only 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. Although there is a suggestion to insert a (specific) example in the Commentary, we are concerned that the consequence may be that tax administrations will be encouraged to generally make use of the new Principal Purpose Test. This would further reduce any certainty remaining in the PE rules.
87. On the contrary, the Discussion Draft itself mentions that the “automatic rule” (page 22, box K), which adds up the activities performed by associated enterprises, may be too broad. We indeed believe it would catch legitimate cases where there is no tax avoidance motive.

Narrowing down the “automatic rule”

88. The Discussion Draft therefore proposes two solutions to narrow the very broad “automatic rule” (page 22, box K).

89. One approach is to require, for each company, a minimum presence of 30 days. In our view, this period of time would be much too short. Considering the case of a diversified and decentralized MNE, undertaking international outbound business not only from the headquarters but also from subsidiaries; the proposals would be very difficult to administer and to monitor, as all parts of an MNE may not be fully aware of all the activities of the group as a whole.
90. Furthermore, it should be clarified in b) which “activities” are intended to trigger the creation of a PE. In our view, this should only be substantially similar activities related to the construction site, and not any other activities – this would be consistent with the language in the provision suggested in Paragraph 42.45 of the 2010 OECD Commentary on Article 5. Paragraph 33 of the Discussion Draft, in fact, makes a reference to Paragraph 42.45 of the OECD Commentary on Article 5 as justification for considering an anti-abuse provision to address splitting-up of contracts. However, the “substantially similar” criteria appearing in the provision suggested in the OECD Commentary is not incorporated in the proposal (box K of the Discussion Draft). The alternative proposed approach would allow a taxpayer to demonstrate that avoiding the 12 months presence of one single enterprise was not the principal purpose of using more than one enterprise. We believe that for day to day practical application, it will be very difficult to rebut the assumption of abuse, which would derive from fulfilling the “automatic rule”. We believe that the “automatic rule” should be further narrowed to only permit that one PE would be created per country through aggregation (i.e. in the event that more than one entity fails the 30 day test).

Service PE

91. The Discussion Draft only notes that it would be necessary to provide a similar rule for treaties that contain the service PE concept. A discussion of how such a rule would work is not included. We believe that this would be a much more difficult rule to implement, because there is no obvious way in which services would be connected. The rules applying for construction sites (which are fixed places) cannot be compared/adapted to the offering of services without any fixed presence in a country. If the rule simply aggregated all the days of services provided in a country by the worldwide group, this might create many PEs that would be extremely hard, if not impossible to monitor. Therefore, we strongly advise against the application of any such rule to service PEs.

Conclusions on Section C of the Discussion Draft

92. Careful consideration will be necessary, taking into account the above mentioned concerns. Any solution should be balanced in the way that it:
- Effectively deals with legitimate concerns of tax administrations; and
 - Is practically feasible and provides legal certainty for businesses.
93. On the basis of these criteria, the proposals provided in the Discussion Draft do not appear to be sufficiently balanced. The “automatic rule” seems to be very hard to monitor, and, therefore, it is not practically feasible. On the other hand, the Principal Purpose Test would lead to an increase in legal uncertainty. If the OECD does pursue a purpose based test, clear guidance will be necessary so that taxpayers can understand what documentary evidence is needed to meet the purpose threshold. We believe that the extension of service PEs should not be pursued, as it would present substantial practical difficulties, and at the same time, it would substantially increase legal uncertainty.

D. Insurance

94. With regard to related party cross border insurance transactions, we do not believe that the Discussion Draft provides any rationale as to why additional special treatment is needed for this sector of the economy. It should be clearly articulated as to why insurance should be considered a 'special case' before any proposals can be considered in detail.
95. The non-tax regulatory rules associated with how agents may interact with principles, provides the basis for tax purposes as to whether such agents are of independent status. Adding additional tax considerations is unnecessary. The current definition of a PE in Article 5 of the OECD's Model Tax Convention correlates well with the definition of PE for regulatory purposes. This ensures that the tax and regulatory definitions of the term "Permanent Establishment" are broadly consistent, which has clear benefits, e.g. accounting information reported for regulatory purposes can also be used to determine taxable profits. The applicable regulations concerning PEs in tax and regulatory matters should continue to be as closely aligned as possible. If this is not the case, a substantial number of tax PEs will likely be created, without a corresponding regulatory PE, generating additional compliance burdens and the potential for double taxation.
96. The taxation of insurance PEs is considered in detail in Part IV of the OECD Report on the Attribution of Profits to Permanent Establishments. This has provided a framework that is generally considered to work by both tax administrations and taxpayers. Therefore, anything that substantially changes the application and effectiveness of Part IV should be approached with caution.
97. The Key Entrepreneurial Risk-Taking (KERT) functions (e.g. assessment, assumption and management of risk) are generally undertaken in the underwriting location. The agent will generally act as the contact point for the customer but will not manage the risk associated with the insurance. Article 5 of the OECD Model Tax Convention, as it is currently written, does not require a tax PE if the agent is active in another state or the risks are situated in another state. The agent receives an arm's length fee for its services, and the profit associated with that fee should be taxed accordingly. The profit associated with the KERT function (the acceptance and management of risk) will be taxed in the underwriter jurisdiction.
98. Since the income of the underwriter is already subject to tax in its home country, double taxation would be likely under option M unless the home country offers appropriate relief.
99. Based on the above, we do not believe there is need for an insurance-specific provision as proposed under option M. We believe that Option M would require that overseas dependent agents would create tax PEs whilst performing no KERT functions. This would result in minimal, if any, additional profit to tax, but would create substantial risk of double taxation, in addition to an increased compliance burden. This may increase the cost and/or reduce the availability of insurance products.
100. Considering the proposals within the Discussion Draft, Option N should be preferred over Option M as it would place the insurance industry on the same footing as other sectors.
101. Insurance (or any other sector) specific proposals should only be made where they provide greater legal certainty to taxpayers and tax administrations to determine when a PE is and is not created.

E. Profit attribution to PEs and interaction with action points on transfer pricing

102. The Discussion Draft recognizes (paragraph 45) that the question of the attribution of profits must be a key consideration in determining which changes should be made to the definition of PE, and also states that no significant changes to the attribution rules have been identified as necessary if the proposals are adopted, though it notes that some additions or clarifications to the attribution rules would be useful. However, the Discussion Draft makes clear that the work on risk and capital in particular may lead to a further 'reconsideration' of some aspects of the existing attribution rules and guidance.
103. The discussion in the PE paper seems to imply, without any analysis, that the measure of profit attributable to a PE would typically be greater than the corresponding result under the TP rules (see for example the specific example in paragraph 7) when applied to determine the income of the source country entity whose activities created the deemed PE. We are also concerned that, as a practical matter, the Discussion Drafts raises an expectation on the part of tax administrations that there are greater profits to be attributed to a PE (since it is otherwise hard to explain why the OECD has gone to such trouble to change the relevant PE definition) in addition to the profits recognized by the source state dependent person. However, whilst we would recognize that there will be some situations where the relevant profit attribution to a PE is greater than the measure of profits that would be achieved by the application of the TP rules, in very many cases, this result would not be obtained. Rather, there would be no additional profit attributable to a PE beyond what is reported by the local dependent person under Article 9. Based on these comments, we would encourage an exploration of whether a rule or exception could be developed so that a PE would not be created if such a PE would not lead to an increase in overall attributable profits. This could assist in mitigating some of the administrative burden and double taxation that will accompany the proposals.
104. On the basis of the above, we consider it important for the OECD to explain and clarify the factors that lead to profit attribution to a PE in excess of the arm's length payment to the source state dependent person.
105. There is also a more fundamental point. Experience of business in dealing with the attribution rules (including in the financial services sector, where the rules should be materially easier to apply given that they were initially developed with that sector in mind) is that the application of the rules, in practice, is very often subjective and uncertain. Coupled with the proposals in the Discussion Draft which have the practical effect of significantly lowering the PE threshold in many situations, this inevitably means that there will be significantly more cases where attribution issues arise and where uncertainty may therefore arise. It is therefore inevitable that further material areas of dispute will be opened up by these PE proposals and in turn re-emphasizes the very significant need for the BEPS work to deliver materially improved dispute resolution practices. We are also concerned that the subjectivity arising as a result of the application of the attribution rules will continue to lead to formulary apportionment approaches by the back door as the only means to settle these disputes.
106. The Action Plan identifies BEPS concerns in the context of sales attributable to a Dependent Agent PE by comparing the taxable profits from these sales with the profits that would have been taxable had the sales been made by a Distributor, and not a foreign enterprise. The AOA for profit attribution to Dependent Agent PEs does not, however, mention profits made by a distributor as any benchmark relevant for determining profit attribution to a Dependent

Agent PE. As a result, in practice, in the industrial sector, MNEs sometimes encounter examples where Tax Authorities use formulary apportionment type approaches to determine profit attribution to Dependent Agent PEs. The use of such approaches could be mitigated by providing further practical guidance for the application the AOA for profit attribution to Dependent Agent PEs in the industrial sector. An approach similar to that laid out in guidance issued by the Australian Tax Office and by HMRC in the UK, should be incorporated in the practical guidance on profit attribution. This would include that

- a. Profits made by Comparable Distributors in the Source Country encompass the maximum profit which can be attributed for sales related activities in the combined hands of the intermediary, the Dependent Agent PE and the foreign enterprise.
- b. Profits made by Comparable Distributors should be allocated between the intermediary, the Dependent Agent PE and the foreign enterprise using appropriate transfer pricing methods, considering the functions, assets and risk profiles of each of these taxable units.

Other Comments

107. Many of the comments made within this document refer to the additional difficulties that will be faced by MNEs in cross-border situations if the threshold for PE status is substantially lowered. We are concerned that the additional burdens and likelihood of disputes could have a negative impact on cross-border trade.
108. An area, perhaps outside the direct scope of the OECD's Discussion Draft that causes MNEs great difficulty, is the interaction between VAT and PE status.
109. As indicated above, one impact of businesses having PEs where previously they did not exist is the likelihood of additional VAT registrations. In some countries, the two go hand in hand (i.e., an MNE will be automatically registered for both corporate tax and VAT together), whilst other countries might increasingly seek to argue that a VAT registration is required if there is a PE.
110. In addition to these extra compliance burdens, there is also the risk that such an approach might lead to further complexities for both business and governments through the increased use of force of attraction rules. For example, many countries deem that if there is a PE then all charges to local customers must be subject to local VAT and reported in the local VAT return, even where the local PE does not intervene in the transaction. Such treatment leads to costly ERP systems changes for VAT accounting and invoicing purposes and, moreover, being obliged to report these transactions through the local VAT return also leads to mismatches with the PE's corporate tax return – i.e., the VAT return would almost certainly contain higher transaction volumes than the corporate tax return, and this fact alone can lead to challenges from the tax administrations as to whether the amount of corporate tax payable should also be increased.
111. Additionally, there is also an increased risk that conflicting 'establishment' definitions for VAT purposes may create instances of unintended double taxation and double non-taxation, particularly if the International VAT/GST Guidelines are not implemented and applied consistently (i.e., the general rule and specific rules) across the world.
112. Although it may be considered that these issues are only indirectly related to PE status, we would welcome further consideration from the OECD on the interaction with VAT and other compliance issues.

Appendix A: Cost of compliance

In this appendix we set out a number of comments from BIAC members in relation to the cost and burden of complying with the OECD's proposals.

Profit Attribution and Transfer Pricing

One of the key burdens associated with the proposals will be the compliance cost associated with determining the profit attributable to the PE – there will likely be a multiplier effect with the action items on TP, in that the proliferation of PEs will result in the proliferation of additional TP exercises, the associated documentation and analysis required and the resulting liaison between both the country in which the newly created PE arises and the country in which the profits on the relevant transactions have historically been reported. This is likely to be extensive in order to mitigate the anticipated risk of double taxation that could arise from these new PEs

Artificial avoidance of PE status through commissionaire arrangements.

The OECD proposed options to address commissionaire structures as laid out in options A to D will have an adverse impact on international business models. To use an aviation fuel supply business as an example, Group X operates through 50 entities (at 50 airports) in 50 countries around the world. The UK company (operating out of a UK airport) negotiates a global contract to provide fuel to a UK headquartered airline, at whichever of the 50 airports it is needed. The benefit of this type of contract is that the fuel supplier and airline do not have to enter into separate contracts in each country that there is a refueling need.

In the example, when the UK airline is refueled by the Group X entity the UK, the profit or loss of delivering jet fuel to the customer is taxable income of the UK company. Similarly, when the UK airline is refueled in another jurisdiction, it is the affiliate established in that country that enjoys the taxable profit between the cost of fuel and the price earned with the customer. This is because the non-UK delivery rights of the sales contract is assigned to the supply companies around the world in return for an arm's length marketing fee.

Under OECD options A to D the model described above will mean that every supply company will have a PE in the country where the umbrella sales contract is negotiated. This could lead to a substantial number of PEs. Based on the above example, assuming that the UK headquartered customer uses all of the Group X's 50 refueling locations, 49 PEs would be created in the UK. This situation would be multiplied to the extent that other Group X entities negotiated similar umbrella contracts with other airline groups (e.g. the French entity negotiating with a French airline etc.). Each other entity negotiating each umbrella contract could create 49 additional PEs.

We have estimated that the initial set up costs for each new PE would be \$350k – this includes systems and legal fees and, although there will be systems savings for each new PE, a complete redesign could still run into tens of millions of dollars, plus there are ongoing annual compliance costs in the region of \$30k - \$60k per PE, covering the costs of retaining a third party to file returns, creating the necessary TP documentation and employing control function staff. In aggregate these costs would be unsustainable and therefore, a fundamental re-work of the model would be required, possibly towards more of a central trading model

The above example is a common way in which such contracts are structured, and is not limited to and particular sector or even airline contracts. The new PEs will not be as a result of people

activities of overseas companies. For example, Chinese employees involved in marketing to Chinese airlines and delivering fuel at Chinese airports are not working in the UK, yet the Chinese company would have a UK PE.

Removal of “delivery” from subparagraphs a) and b) of paragraph 4 of Article 5

Oil and oil products are sold through an international trading business. A typical trading operation will have a small number of companies that enter into trades of oil, oil products or gas with third parties around the world. Negotiations are carried out by employees of these companies in the jurisdiction in which they are resident and contracts are concluded either by telephone or followed up by written confirmation or online. The trading company has no economic substance (people activity) in the vast majority of countries with which it trades oil and gas. For an integrated oil company, any physical substance will be in an unrelated business such as oil and gas exploration.

In order to satisfy the delivery of a product to a customer, the trading company may rent tanks to store oil products which are then used to deliver to local markets. The tanks are operated and maintained by third parties. The oil/gas that is stored in the tanks is “maintenance of stock”. The cost to rent the storage is taxed locally. The margin earned on selling to customers is taxed in the country of residence of the trading company where all the economic activity takes place – negotiations and conclusion of contracts.

The trading company has to be able to provide the oil or gas to meet its contractual obligations and shipping and transportation of such commodities is not always as straightforward as it is in some other sectors that may utilize the exemptions under paragraph (5). The oil, gas or product cannot be guaranteed to arrive in a given port at a specified date and time to suit the customer needs. The creation of a PE through the mere holding of hydrocarbons in storage will increase compliance burdens, adding much complexity. It is also unclear what income would be attributable to a PE created in these circumstances, given all the economic activity is carried out in the location of the trading company. This will increase the risk of cross border tax disputes between tax administrations.

For one BIAC member, it has been estimated that additional direct tax registrations will be required in up to approximately 40 jurisdictions, with knock-on effects for indirect taxes. The resulting compliance burden would add to costs of such transactions that could make them uneconomic. It is estimated that this would result in an additional up front compliance cost of \$14 million, with annual additional compliance costs of \$2.4 million.

The nature of this industry often means that the supply of oil and gas results in slim margins. Opening up new markets, often in developing economies are challenging projects. The proposed changes to the definition of a PE will create further uncertainty and risk. In the competition for capital, these projects will compare less favorably than other ventures if these changes are made, with the potential knock on effect that the lack of energy will have on developing countries own economies.