

**NEW OECD
GUIDANCE ON
PERMANENT
ESTABLISHMENTS**

**– PRACTICAL
CONSIDERATIONS &
RECENT TAX DISPUTES**

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INTRODUCTION



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BRIEF HISTORY OF BEPS ACTION 7



- ❖ Three changes to PE rules of Art. 5 OECD to counter strategies to avoid PE in source state:
 - Agency PE (*para.s 5-6*)
 - PE exception for listed activities (*para 4*)
 - PE exception for short-term projects (*para 3*)
- ❖ No action against fundamental change in balance between source and residence states in taxing rights re cross-border business income (Action 1)

BRIEF HISTORY OF BEPS ACTION 7

Issue 1: Agency PE

Action 7 targets certain structures and arrangements aimed at avoiding para.s 5-6 thresholds in particular:

- Commissionaire arrangements;
- Sales contracts are substantially negotiated in State S but are concluded in the principal's residence state;
- The intermediary acts in a way meeting the conditions of the exceptions for "independent agent".

Issue 2: PE exception for listed activities

Action 7 targets the fragmentation of a cohesive business operation into several small operations in order to (i) claim that each of them is merely engaged in a preparatory and auxiliary activity and (ii) benefit of the Art. 5(4) exemption.

Issue 3: PE exception for short-term projects

Action 7 – in combination with Action 6 – targets the abusive splitting-up of contracts into several parts, each of them covering a period less than twelve months and attributed to a different company of the same group in order to fall outside the construction PE definition - Art. 5(3).

BRIEF HISTORY OF BEPS ACTION 7

Solution 1: Agency PE

1. New Agency PE requirements (Art. 5.5).
2. New Independent Agent exception (Art. 5.6).

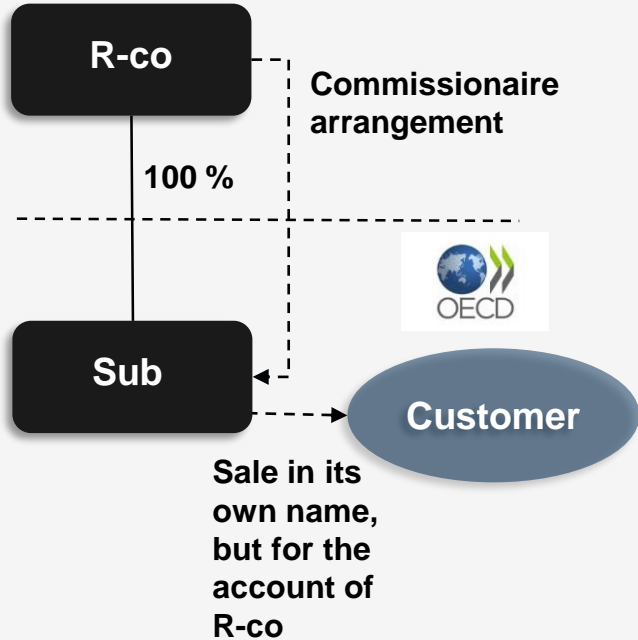
Solution 2: PE exception for listed activities

1. The proposed new wording of Art. 5.4 adds a catch-all requirement that each specific activity (or combination of activities) must be of a “preparatory or auxiliary character”.
2. Anti-fragmentation rule: if a second activity is carried on in the same state by the same enterprise or by a “closely” related enterprise, the exception of para. 4 is not applicable when the business activities constitute complementary functions that are part of a cohesive business).

Solution 3: PE exception for short-term projects

1. Principal Purpose Test introduced by Action 6 is aimed to prevent granting treaty benefit in inappropriate circumstances (Specific example in Action 6: Example J).
2. New Commentary on Art. 5.3: introduction of an optional insertion of a deeming rule to Art. 5.3 -> automatic addition of periods of “connected” activities by “closely related” enterprises.

AGENCY PE PRE BEPS



- ❖ Pursuant to Art. 5(5) OECD-MTC 2010 an **Agency PE** is created
 - if a person is **acting on behalf of the enterprise**,
 - **concludes contracts** in the **name of the enterprise**, and
 - performs these activities **habitually**.
- ❖ Pursuant to Art. 5(6) OECD-MTC 2010 an enterprise shall **not** be deemed to have a PE if it carries on business
 - through a broker, general **commission agent** or any other agent of independent status,
 - provided that such persons are acting in the **ordinary course of their business**.

AGENCY PE PRE BEPS



❖ Based on the current definition of Agency PE, 4 conditions have to be fulfilled:

- the existence of a person (the agent) that is not an independent agent from the enterprise (the principal);
- the agent acts on behalf of the principal;
- the agent has and habitually exercise an authority to conclude contracts in the name of the principal

The dependency of the agent is assessed by verifying the legal and economic independence (inter alia “extent of obligation” of the agent towards the principal, “detailed instruction “or “comprehensive control” exercised by the principal, the allocation of the “entrepreneurial risk” borne by the agent and by the principal, “number of principal” represented by the agent)

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AGENCY PE PRE BEPS



- ❖ The Agent by “Acting on behalf of the principal” and “habitually exercising an authority to conclude contract” involves the principal to a particular extent in the business activity of the state in which the agent is acting (i.e. the agent should have sufficient “authority” to bind the principal’s participation in the business activity of the state).
- ❖ “Habitually exercising” implies that the economic nexus with the source state must not to be an isolated case (*longa manus*)
- ❖ the “authority to conclude contracts” must be “in the name of” the principal. In principle it has to be verified whether the contracts conclude by the agent are “binding” on the principal.

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CURRENT PROBLEM WITH THE AGENCY PE PROVISION



- ❖ The nature of the agent in the different legal system
- ❖ Civil law countries: it can be identified two kind of representation direct and indirect representation. Direct representation implies that the agent acts in the name of the principal and legally binds the latter in relation to third party customer. Indirect representation implies that the agent is acting in its own name and binds itself in relation to third party customer (i.e. the concluded contract is not enforceable against the principal).
- ❖ Common law countries: Two kind of agents namely disclosed and undisclosed agent. Disclosed agent legally binds the principal in relation to third party customer whereas the undisclosed agent binds himself in relation to third party customer (although the principal can also be held liable by the third party customer)

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CURRENT PROBLEM WITH THE AGENCY PE PROVISION



- ❖ The independent agent concept

		Acting in the ordinary course of the business	
		YES	NO
Legal and economic independence	YES	NO PE	PE if art. 5(5)?
	NO	PE if art. 5(5)	PE if art. 5(5)

CURRENT PROBLEM WITH THE AGENCY PE PROVISION



- ❖ The interpretation of the requirement “authority to conclude contract” – legalistic vs economic approach

Economic approach	Legalistic approach
Legal binding of the contract is not decisive. An active participation in the legal arrangement can create the necessary “economic link” in the source state	The wording “in the name of” requires a contracts that legally binds the principal towards the third party client
Agency relationship (direct and indirect) binds the principal towards the third party client	Not every dependent agent will lead to an agency PE (distinction among direct and indirect representation)
Supported by Italian Philippe Morris case	Supported by the French Zimmer case, Norwegian Dell case

THE SOLUTION PROPOSED BY THE OECD WORKING PARTY



- ❖ Economic vs legal approach in the commissionaire arrangement new par. 32.1 on article 5
“ For example, in some countries an enterprise would be bound, in certain cases, by a contract concluded with a third party by a person acting on behalf of the enterprise even if the person did not formally disclose that it was acting for the enterprise and the name of the enterprise was not referred to the contract”
- ❖ Par. 5 is not restricted to the sale of goods “the paragraph would cover, for example, a situation where a person has and habitually exercise an authority to conclude leasing contracts or contracts for services.
- ❖ Does par. 6 apply only to the agents who do not conclude contracts in the name of the principal ?
- ❖ Assumption of entrepreneurial risk as a factor indicating independence
“the working party concluded that whilst there was no doubt that bearing the entrepreneurial risk was an important criterion to identify an independent agent the clarification proposed in par. 38,7 raised a number of questions that should be more fully examined in particular in light of the OECD TPG”.

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BEPS ACTION 7



- ❖ The action n. 7 of the BEPS Project is specifically aimed at preventing the “artificial avoidance of the PE status” and at updating the definition of PE “to prevent abuses” More specifically the aim of the action 7 is:

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

“in many countries, the interpretation of the treaty rules on agency PE allows contracts for the sale of goods belonging to foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profit from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as distributor by “commissionaire arrangements” with a resulting in shift of profit out of the country where the sale take place without a substantive change in the functions performed in that country”

BEPS ACTION 7 – PROPOSED SOLUTIONS



❖ The first discussion draft

	Options			
	A	B	C	D
"conclude contracts"				
replace "conclude contracts" by "engages with specific persons in a way that results in the conclusions of contracts"	X		X	
replace "conclude contracts" by "concludes contracts or, or negotiates material elements of contracts"		X		X
"contracts in the name of"				
add reference to contracts for the provision of property or services by the enterprise	X	X		
replace "contracts in the name of the enterprise" by "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise"			X	X
"non independency"				
strengthen the requirements of "independence"	X	X	X	X

BEPS ACTION 7 – NEW ART. 5(5)



❖ Option B, so called “material negotiation standard”, was chosen as preferred option:

“Notwithstanding the provision of paragraph 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a contracting State on behalf of an enterprise and , in doing so, habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise and these contracts are:

- a) In the name of the enterprise, or*
- b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that enterprise has the right to use, or*
- c) For the provision of services by that enterprise,*

That enterprise shall be deemed to have a permanent establishment in that state in respect of any activities which that person undertakes for the enterprise, unless, the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this place of business a permanent establishment under the provision of that paragraph”

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BEPS ACTION 7 – NEW ART. 5(6)



❖ *“a) Paragraph 5 shall not apply where person acting in a contracting state on behalf of an enterprise of the other contracting state carries on business in the first mentioned state as an independent agent and acts for the enterprise in the ordinary course of business. Where however a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.*

b) for the purpose of this article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial ownership interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s share or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s share or of the beneficial equity interest in the company) in the person and the enterprise”

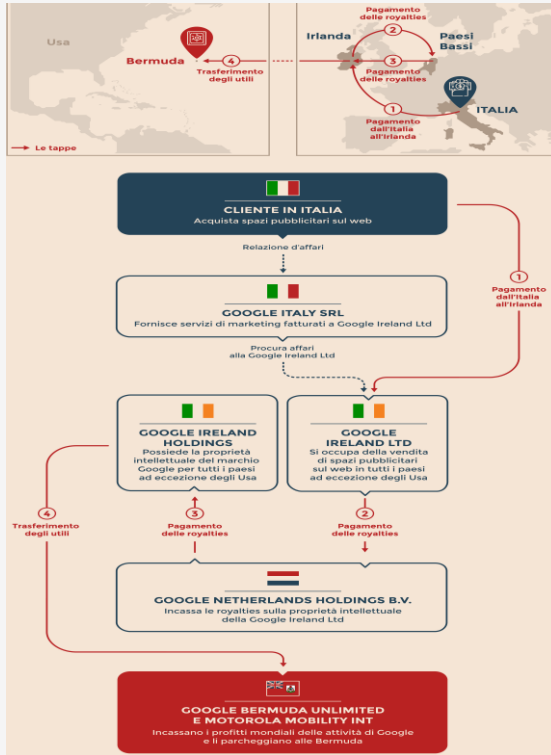
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SMALL REMARKS ON THE NEW DEFINITION



- ❖ the amendments to the commentary should not have any impact on existing tax treaties
- ❖ The Agency PE threshold is “lowered” thus generating more source based taxation but also more uncertainty surrounding the definition of Agency PE with probably a stronger need for an improvement of dispute avoidance mechanism (Rulings APA) and dispute resolution mechanism (MAP arbitrations)
- ❖ it is necessary to have a better clarification on whether the wider scope of the Agency PE provision would include only commissionaire arrangements or also other distribution model
- ❖ The economic approach is prevailing over the legalistic one. It would be sufficient that the agent acts on behalf of the principal and sells good or services belonging to the principal in order for the agent to constitute an agency PE of the Principal.

ITALIAN RECENT CASE: GOOGLE



Case

- ❖ Google Italy is 100% owned by Google Int. LLS (USA company)
- ❖ Google Italy provides supporting selling activity for the benefit of Google Ireland and was remunerated with a cost plus
- ❖ Google Ireland is in charge for online advertising sale for the world (except USA)
- ❖ Italian client were invoiced by Google Ireland
- ❖ Google Ireland paid royalties to Google Netherlands Holding BV
- ❖ The total Italian revenues were 637 million euro but only 67 million euro have been declared to be attributable to the Italian territory while the remaining 570 million were attributed to the Irish company
- ❖ The total amount of taxes declared and paid in Italy were 3,4 million equal to 0,5% on the Italian total revenues compared to a 24% statutory corporate income tax rate

ITALIAN RECENT CASE: GOOGLE



The Italian tax authority position

- ❖ Google Italy has to be considered as an Agency PE of Google Ireland (principal) mainly because the Italian client had a direct contact with the Italian company thus participating in the negotiation of the contracts (economic approach)
- ❖ Google Italy has to be considered not having an independent status (being the agent of only one principle) and not acting in the “ordinary course of its business”.

Google position

- ❖ Google Italy was not performing any sales activities toward the Italian client.
- ❖ Google Italy was not actively participating in the negotiation of the contracts because the contracts details (included pricing) were mainly established using algorithms provided by the same google search engine. The functions performed by the Google Italian employees were supposed to be minimal.

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ITALIAN RECENT CASE: GOOGLE



The settlement

- ❖ According to the press release issued by the Italian tax authorities the main tax impact was referred to Google Italy (303 Million)
- ❖ The profit attributable to the deemed Agency PE were only minimal (3 Million)
- ❖ It can be inferred that during the negotiations the parties agreed to move the case from an Agency PE issue to a pure TP issue most likely by applying new benchmark analysis or a new remuneration method to settle the arm's length fees to be paid by Google Ireland to Google Italy.
- ❖ The claim concerning withholding tax not applied by the Italian agency PE on the royalties paid to Google Netherlands Holding BV seems to be dismissed.

TP VS AGENCY PE



- ❖ Do we really need to lower the PE threshold in order to increase the source state taxation?
- ❖ A proper TP analysis on the “Source State” controlled entity can be the most effective and simple way to increase the source state taxation (see Italian Google case)?
- ❖ A proper TP documentation can eliminate or at least mitigate the risk of having an hidden agency PE in the Source State?
- ❖ It is possible to apply the same economic TP approach to tackle the “artificial avoidance of permanent establishment status” not only in the Agency PE case but every time there is an existing economic nexus in the source state represented by a “controlled entity” therein established?

SPEAKER PROFILE



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