Irish Tax Institute

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Response to OECD Discussion Draft:

Artificial Avoidance of PE Status

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About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Introduction

Action 7 of the OECD's Base Erosion and Profit Shifting (BEPS) project is entitled "Preventing the Artificial Avoidance of PE Status".

While the Discussion Draft contains a number of options for changes to the definition of Permanent Establishment ("PE"), all the proposals, if implemented, would result in a dilution of the existing PE threshold which will arguably result in an increase in inter-fiscal disputes and potentially and uncertain change in the balance between source and residence-based taxation.

A. Impact of the options proposed – four key repercussions for businesses and countries

1. Significant and disproportionate business cost and risk

The changes proposed to the PE definition would almost certainly result in additional PEs being created for corporate tax purposes which would significantly increase the administrative and compliance burden for businesses. This cost would be amplified by increased levels of risk for businesses operating internationally:

- Risk - arising from uncertainty over the changed definitions and whether a corporate tax PE actually exists under the new rules. There is very little guidance in the proposals as to how new terminology in any amended PE definition would be interpreted and countries are likely to adopt a wide range of differing interpretations thus increasing the level of uncertainty and the risk of double taxation.
- Risk - resulting from increased uncertainty and compliance cost for indirect taxes as a result of an evolving direct tax regime.
- Risk - of interest and penalties for non-compliance if a PE is ultimately found to exist under the new rules, which had not been recognised by the company. This is particularly important as tax compliance penalties are on the increase worldwide.

Despite this level of cost and risk that will be borne by businesses, many of the additional PEs created may be attributed little (if any) profit, based on the substance of the activity carried out through them. The result would then be little, if any, extra tax revenue for the source country and, in some cases, any new tax liability generated may simply replace the existing tax being paid by a related party in the same country.

Increasing the number of PEs would also have other knock-on implications for businesses and tax administrations. Other compliance obligations will arise for business, such as the completion and filing of additional Country by Country Reporting templates and potential need to revisit transfer pricing analyses. The resources of tax administrations may also become tied up in additional audits, enquiries and MAP/Competent Authority claims for administrative PEs that have little attributable profit.

2. Less efficient Business and Global Trade Models could end up being adopted by multi-national companies

The lowering of the PE threshold could also result in businesses adopting alternative and potentially less efficient business models, simply to minimise the additional administrative costs of creating multiple PEs worldwide. For example, businesses could take the costly decision of outsourcing activities currently carried out more efficiently in-house, to avoid the punitive administrative costs of creating a PE.

Widely worded definitions would result in significant uncertainty which could negatively impact international trade flows. In small open economies such as Ireland, a significant proportion of businesses, including SMEs, are heavily reliant on exports and trade in foreign jurisdictions. Therefore, the unintended effect of increased risk surrounding PEs and the increased compliance burdens could prove a barrier to the continued growth and expansion of businesses and restrict the ability of such businesses to trade internationally.

Increasing barriers to entering new markets (by making the PE threshold lower and more uncertain) could also impact negatively on those markets. A business may be less likely to enter a new market if minimal activity in the country can create a PE and result in significant compliance obligations.

3. Greater uncertainty and disputes for both businesses and tax authorities

As noted above, there is significant potential for uncertainty if the proposed changes are adopted as currently worded. There is little guidance in the Discussion Draft on interpretation for any of the proposed options and detailed examples and guidance are essential before any changes are decided upon. In fact, the lack of guidance currently makes it is difficult to provide detailed comments on the exact impact of the changes on existing business models. There is also uncertainty around implementation of the changes.

This increased uncertainty will create more disputes between (and more MAP challenges by) tax authorities. This will undoubtedly put further pressure on the resources of tax authorities which are already struggling to deal with the huge increase in MAP cases in recent years[1]. This uncertainty could cause significant damage to international trade.

4. The current proposals go far beyond targeting artificial avoidance

The Irish Tax Institute fully endorses the OECD's overall objective of preventing the artificial avoidance of PE status. However, the proposed options appear much wider than this stated aim. The Discussion Draft clearly states that the OECD's work on this action is not directly aimed at changing the existing international standards on the allocation of taxing rights on cross border income. However, with its lowering of the PE threshold and narrowing of available exemptions, it is inevitable that the changes proposed in the Discussion Draft would create a clear shift towards increased taxing rights for source countries generally.

There appears to be a tacit implication from the wide wording of the options, that simply operating in a lower tax country is in itself a "BEPS" motivated activity, rather than a legitimate commercial choice. It would be preferable if any changes to the PE definition were targeted at situations which have the hallmarks of "BEPS" actions – such as situations where there is double non-taxation or clear artificial avoidance of PE status.

B. Detailed Comments on Commissionaire Arrangements (Options A to D)

The intention of the proposed options appears to go beyond simply targeting Commissionaire structures which more typically arise in civil law jurisdictions - the measures could potentially impact a wide range of businesses with global sales operations. The overall approach of lowering the dependent agent test from the current "concluding contracts" test would widen the scope of the rule and introduce greater uncertainty and subjectivity as to whether a PE exists in many cases.

Of the four options A-D, Option B would appear be less problematic than options A, C or D. However detailed guidance and clarification would be necessary to fully examine the potential impact of this option. In particular, it is important that any guidance issued addresses the following issues:

[1] The most recent OECD statistics show the rising number of outstanding MAP cases in most OECD countries - http://www.oecd.org/ctp/dispute/mapstatistics2012.htm

- Detailed guidance and examples are needed to demonstrate the meaning of the phrase "negotiates the material elements of contracts".
- It should be clarified that a local entity must have power to bind the company in order for a PE to be created.
- It should be clarified that the use of the wording is not intended to create a PE in situations which can commonly occur in business to business transactions where preliminary or interim discussions of terms of a contract occur in a State which do not reflect the final agreement of terms.
- Guidance should also make clear that a PE would not be created in a situation where local staff are given strict negotiation parameters and do not have authority to derogate from these parameters.

It is inevitable that a consequence of the proposals to strengthen the independent agent test (in the proposed paragraph 6 in options A to D) will be that more agents, both related and unrelated, are treated as dependent agents, and therefore as PEs of their principals, leading to a material shift in taxing rights from residence to source states.

While the number of principals an agent represents may be relevant in determining the dependent or independent status of that agent, it should not be the determinative of the status. Similarly, the wording of the proposed paragraph 6 could result in a related party agent and unrelated party agent being treated differently as to whether a PE is created for the principal even though identical activities may be carried on by the agent. This appears to be at odds with respecting arm's length related party transactions, and appears to disregard separate legal corporation status.

C. Detailed Comments on Specific Activity Exemptions (Options E-J)

Options E to J in the Discussion Draft propose changes to the Specific Activity exemptions in Article 5(4) of the OECD Model Treaty.

Option E - preparatory and auxiliary exemption

Option E proposes to restrict all of the exemptions to activities which are "preparatory and auxiliary". The phrase is currently used in a number of the exemptions and the experience of our members is that it can be interpreted differently across countries and can create significant uncertainty. Extending the requirement to all of the exemptions will likely increase this uncertainty and result in an increase in the number of PE challenges made by tax authorities.

We suggest that the concerns above might be addressed by adopting a variation to General Option E which would be to have a presumption inserted into the lead in statement in paragraph 4 of Article 5 that the specific activities in subparagraphs (a) to (d) in article 5(4) could continue to be eligible for exemption unless those activities are core to the business activities of the enterprise - perhaps using wording such as 'form a significant and essential part of the enterprise as a whole.

To supplement this, detailed guidance on the meaning of 'core' activities and the meaning of 'preparatory and auxiliary' would be needed.

The Discussion Draft proposes Options F, G and H be implemented if Option E is ultimately not adopted.

Option F – delivery exemption

Option F proposes that the exemption for 'delivery' is removed. This is likely to create a significant number of permanent establishments where warehouses are located in larger consumer markets. It could lead to the outsourcing of delivery functions to avoid incurring the prohibitive administration costs of a PE, even where delivery is currently carried out more efficiently by other group entities. It could also lead to warehouses being established in less commercially efficient locations (e.g. by locating a warehouse on a border to serve multiple countries, thus ensuring that only one PE is created, rather than locating separate warehouses in more efficient locations in each country).

As noted above, there may be relatively little profit actually attributable to the delivery function carried out by these ‘delivery’ permanent establishments, resulting in little tax being generated but significant administrative and compliance costs incurred by the business.

Options G and H – purchasing and collecting information exemptions

Options G and H propose deleting the exemptions for purchasing and for the collecting of information.

It is not apparent what the rationale is for removing these exemptions as part of the BEPS process - these activities would not seem to create BEPS concerns. Again, these options could result in significant administrative PEs with very little profit attributable to them. Many businesses with global procurement models would be significantly affected and may ultimately need to adopt less efficient business models to avoid the administrative consequences of creating multiple PEs.

Option I - fragmentation

We have reservations about the proposals to extend the anti-fragmentation rules as provided for under Option I. Deeming the services of an affiliate entity as creating a PE may disproportionately penalise enterprises for using affiliates to provide appropriate services. Furthermore, the potential uncertainty and subjectivity surrounding the proposed terms “complimentary functions” and “cohesive business operations” may lead tax authorities to seek to ignore the separate legal personality of substantive legal entities.

D. Splitting up of contracts

Careful consideration of the proposals in Option K are needed as, in the absence of further qualification or amendment, a range of different activities within a single MNC group could be aggregated where there is arguably no abuse of the sort that is envisaged. To prevent this, we would suggest the activities referred to in paragraph (b) be linked so as to refer to the actual activities to be undertaken in paragraph (a).

E. Insurance

Option M proposes a specific change which would deem a PE to exist in respect of certain insurance activities. There is no explanation given in the Discussion Draft as to why the insurance industry has been identified as requiring specific treatment. As paragraph 39 of the Commentary to Article 5 notes, the creation of a PE by virtue of premium collection or locally sited risks would be contrary to the factual and legal situations in many countries, and therefore it will not be appropriate in many circumstances. We believe that this comment continues to be valid. There is a risk that implementing this proposal would impose a disproportionate compliance burden on insurers by creating a significant number of tax PEs where there would be no regulatory PE and with no or minimal profit being attributed to the tax PE.

Except in cases where an insurance or reinsurance company has a physical presence in the country, we recommend that the guidance should make it clear that a taxable presence should only arise in the country if the insurance company would be carrying on a KERT (key entrepreneurial risk taking) function in that country (as defined in the 2010 Report on the Attributions of Profits to Permanent Establishments). Alternatively the tax approach to PE could be aligned with the regulatory approach to establishment for insurance/reinsurance, so that in the absence of a company having a regulatory establishment in a country it would not have a taxable presence, but that if it had a regulatory presence in the country the normal tax rules would apply to determine its taxable status.

F. Profit Attribution

There is limited analysis in the Discussion Draft on the key question of profit attribution to the new PEs that could result from the proposed changes. The Discussion Draft appears to make the assumption that moving towards an increasing number of PEs will result in an increased tax take. However, this may not be the case in practice.

If the PE threshold is lowered as proposed in the Discussion Draft it is increasingly important that consistent approach is adopted as to how profits should be attributed to these new PEs.

It is very important to preserve the principles on profit attribution established in the OECD's 'Report on the Attribution of Profits to Permanent Establishment" of 2010. An enhancement in the legal standing of this report (similar to the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in many countries), would ensure that a formulary apportionment approach is not adopted by any country seeking to attribute profits to a PE. Our concern here is that, in the absence of clarification, the practical effect will be increased PE attacks by Revenue authorities on the assumption that the PE changes must lead to greater profits attributable to a PE.