

## Base Erosion Profit Shifting and its Impact on PE



*The integration of national economies and markets has increased manifold in recent years. This has caused strain on the international tax framework, which was designed more than a century ago. Gaps and mismatches in the current international tax rules may at times result in either vanishing of profits for tax purposes or shifting of profits to no or low-tax locations where the business has little or no economic activity. The shifting of profits to no or low tax location is referred to as Base Erosion and Profit Shifting (BEPS). Apart from some cases of blatant abuses, the issues lie with the tax rules themselves. For years, the OECD promoted dialogue and co-operation between governments on tax matters. Indicators revealed that tax practices of some multinational companies had become aggressive over time, raising serious compliance and fairness issues. These issues were flagged by tax commissioners at the 2006 meeting of the Forum on Tax Administration in Seoul and different instruments have since been developed to better analyse and react to aggressive tax planning schemes which result in massive revenue losses. However, this in no way was able to provide a respite to tackle the aggressive tax planning schemes resorted to by multinationals. Read on to know more...*

BEPS resulted in a loss of revenue for governments that could otherwise be used for better governance and public spending to foster growth. Research undertaken since 2013 confirms the potential

magnitude of the BEPS problem, with estimates indicating annual losses of anywhere from 4 to 10% of global corporate income tax (CIT) revenues, i.e. USD 100 to 240 billion annually. In developing countries, where reliance on corporate tax as a source of revenue is generally higher than in developed countries, the potential impacts are particularly stark.

The level of interest and participation in the work has been unparalleled with over 60 countries<sup>1</sup> directly involved in the technical groups and others participating in shaping the outcomes through regional structured dialogues.



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Since then, all G20 and OECD countries have worked on an equal footing and the European Commission also provided its views throughout the BEPS project. Developing countries have been engaged extensively via a number of different mechanisms, including direct participation in the Committee on Fiscal Affairs. Stakeholders were consulted at length and in total, the BEPS project received more than fourteen hundred submissions from all that were impacted by BEPS issues. Fourteen public consultations were held, streamed live on line, as were webcasts where the OECD Secretariat periodically updated the public and answered questions.

Along with contribution from OECD and G20 countries to design common responses to international tax challenges, there has been unprecedented participation by developing countries in the development of commonly-agreed international tax standards. The fact that so many countries have participated in the work and cooperated in the development of changes to the international tax environment is in itself a significant achievement of the Project.

The Action Plan on BEPS (OECD, 2013) identified 15 actions, along three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency, as well as certainty for businesses that do not take aggressive positions.

Out of a collective need to address BEPS concerns, there is agreement on a comprehensive package of measures which are designed to be implemented through the domestic law and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The goal is to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms.

## Impact of BEPS Action Plan on the Scope of PE

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a Permanent Establishment (PE) to which the

profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State.

In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere. It had already been recognised in the past that the concept of PE referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention).

Nowadays it is possible to be heavily involved in the economic life of another country, *e.g.* by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). While addressing the issues with regards to the prevention of artificial avoidance of PE status (Action Plan-7), the work done with respect to the said Action Plan was identified by the TFDE<sup>2</sup> in Action Plan-1 as a key area of focus in order to ensure that BEPS risks in the digital economy could be addressed as well.

The OECD released an initial discussion draft on 31 October 2014 and a revised discussion draft on 15 May 2015. The revised discussion draft built on the 14 options presented in the first discussion draft and set out specific proposed changes to the PE definition in the OECD model treaty, accompanied by corresponding changes to the Commentary. In its final report, the OECD has recommended the proposed changes to the PE definition and related Commentary contained in the revised discussion draft to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition. The Action Plan 7 is based on the fundamental pillar of substance out of the three pillars outlined above.

<sup>2</sup> The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) in which non-OECD G20 countries participate as Associates on an equal footing with OECD countries, was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address them in context of Action Plan 1- Addressing the tax challenges of the digital economy

# International Taxation

The issues that are dealt in the Action Plan 7 are discussed in the ensuing paragraphs below

## Artificial avoidance of a PE Status through Commissionnaire Arrangements and Similar Strategies

A '*commissionnaire arrangement*' may be loosely defined as an arrangement through which a person sells products in a state in its own name but on behalf of a foreign enterprise that is the owner of these products. Since the person that concludes the sales does not own the products that it sells, that person 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).

Under the current Article 5(5) of the Convention, a person other than an agent of independent status, acting on behalf of a foreign enterprise having 'authority to conclude contract in the name of the enterprise' forms a PE of the foreign enterprise. The PE shall be determined in respect of activities undertaken by the enterprise, unless the activities can be limited to activities mentioned in paragraph 4<sup>3</sup> of the Article.

A foreign enterprise that uses a *commissionnaire* arrangement does not have a PE because it is able to avoid the application of Article 5(5) (i.e. creation of a PE) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a *commissionnaire* are not binding on the foreign enterprise. Since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State. *Commissionnaire* arrangements have been a major preoccupation of tax administrations in many countries, as shown by a number of cases dealing with such arrangements that were litigated in OECD countries. In most of the cases that went to court, the tax administration's arguments were rejected.

Similar strategies that seek to avoid the application of Article 5(5) of the OECD Model Tax Convention involve situations where contracts which are substantially negotiated in a State are not formally concluded in that State because they are finalised or authorised abroad.

OECD, in its Report, proposes to change Paragraph 5 of Article 5. It states that Dependent Agent PE shall exist where a person on behalf of an enterprise habitually concludes a contract or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. The report also states that the contracts mentioned in Article 5(5) are the contracts (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, etc. or (c) for the provision of services by that enterprise.

Co-incidentally India's observations on this issue, similar to the OECD amendments, state that a person, who is authorised to negotiate the essential elements of a contract and not necessary all the elements and details of the contract, on behalf of foreign resident, can be said to exercise authority to conclude contracts. In the Indian context, which is governed by the common law where the agent binds the principal, and since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, with the BEPS recommendations made vis-a-vis the *commissionnaire* arrangements structures that kind of blurs the existing contractual obligations with respect to conclusion of contracts, it would be interesting to see how the change would impact India.

It would also be interesting to see how this amendment would impact a scenario where an agent also has substantial non-agency businesses as in the case of Western Union Financial Services<sup>4</sup> where it was held that the agents do not constitute a dependant agent PE of the assessee in India.

It is also noteworthy to mention that the concept of conclusion of contracts is in fact a matter of domestic law, which is proposed to be amended by Action Plan 7 through execution of bilateral tax treaties.

The existing Article 5(6) of the Model Convention specifies that an enterprise shall not be deemed to have a PE merely because it carries business in the Contracting State through a broker, general commission agent or any other agent of an independent status, provided such persons act in the ordinary course of their business.

The amendments to Paragraph 6 of Article 5 now state that, where a person acts exclusively or almost

<sup>3</sup> Para 4 of Article 5 defines the specific activities which shall be deemed not to include in the definition of the term 'PE'

<sup>4</sup> Western Union Financial Services Inc v. ADIT [2007] 104 ITD 34 (Delhi)

exclusively on behalf of one or more enterprise to which it is closely related, the person shall not be deemed to be an independent agent.

The revised discussion draft proposed that the concept of 'associated enterprises' should be replaced by a narrower concept by replacing the wording 'one or more enterprises to which it is connected' in place of 'one enterprise or associated enterprises'.

As per the final report, a person shall not be considered as an independent agent if such a person acts almost exclusively on behalf of one or more enterprises to which it is closely related. Further, a person is closely related to an enterprise if, one has control of the other or both are under the control of the same enterprise. The final report includes for this purpose cases where a person possesses directly or indirectly more than 50 per cent of the beneficial 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 shares or the beneficial equity interests.

## Artificial Avoidance of PE Status through Specific Activity Exemptions

The current OECD Model Tax Convention includes specific activity carved out as exemptions under Article 5(4) from the PE definition. The activities listed in subparagraphs a) to d) therein, were exempted from being classified as PE even if the activities were carried on at a fixed place and the same extended beyond the preparatory or auxiliary condition as well. Since the introduction of these exceptions, however, there have been dramatic changes in the way that business is conducted. Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities.

The work on Action Plan 7 concluded that activities previously considered to be merely preparatory or auxiliary in nature for the purposes of the exceptions usually found in the definition of PE may nowadays correspond to core business activities of an enterprise, particularly in the digital economy.

In order to ensure that profits derived from core activities performed in a country can be taxed in that country, with regards to the specific activity exemptions under Article 5(4) of the

OECD Model Tax Convention, the Action Plan recommends modification to Article 5(4) of the Convention so that each of the exceptions included in that provision is restricted to activities that are otherwise of a preparatory or auxiliary character. It is also recommended to provide the additional Commentary guidance which clarifies the meaning of the phrase "preparatory or auxiliary" using a number of examples.

The implication of this amendment proposed in the OECD Model Convention may require further evaluation in light of the view taken by the judiciary in India in a decision pronounced by the Karnataka High Court in the case of Columbia Sportswear Company<sup>5</sup> where by virtue of the activities<sup>6</sup> undertaken by the Indian entity, for the purchase of goods exported on behalf of the foreign enterprise, did not result into a PE of the said foreign entity in India.

A new anti-fragmentation rule is introduced to ensure that it is not possible to benefit from the specific activity exceptions through the fragmentation of business activities among closely related enterprises. This rule seeks to deny the preparatory and auxiliary exception if the foreign enterprise or a related enterprise carries on related activities in the same jurisdiction and those activities, taken as a whole, go beyond preparatory and auxiliary. Noteworthy here is that the OECD prescribes that a resident entity can be seen as a PE in the same state.

An instance where a PE could be created would be the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller.

This issue also extends to ecommerce/online activities. For example, development and increasing use of 3D printing may also be subject to issues like whether and under what circumstances payments by purchasers may be classified as royalties rather than as business profits, or may be treated as fees for technical services. Whether a transaction is characterised as business profits or as another type of income, therefore, can result in a different

<sup>5</sup> Columbia Sportswear Company v. DIT [2015] 62 taxmann.com 240 (Kar)

<sup>6</sup> The liaison office of the taxpayer identified a competent manufacturer, negotiated a competitive price, helped in choosing the material to be used, ensured compliance with the quality of the material, acted as go-between, between the taxpayer and the seller or the manufacturer, seller of the goods and even got the material tested to ensure quality in addition to ensuring compliance with its policies and the relevant laws of India by the suppliers



# International Taxation

treatment for tax treaty purposes. This calls for a need to clarify the application of existing rules to the emerging business models.

## Splitting up of Contracts

The exception in Article 5(3), which applies to construction sites, has given rise to abuses through the practice of splitting-up contracts between closely related enterprises. In certain cases, enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group.

It would be interesting to note that the Indian judiciary has taken a contrary stand in the case of *J.Ray McDermott Eastern Hemisphere Limited*<sup>7</sup> where it was held that the Mauritian company (engaged in providing services in the Indian continental shelf) would not constitute a construction PE since duration of each contract is less than the prescribed limit of nine months. The splitting-up of contracts may depend of the factual matrix of each case and treating all separate and distinct contracts as one for the purpose of duration test would require further detailed analysis.

As a matter of fact, the BEPS Action Plan 7 does not suggest any change in the existing article 5(3). The BEPS Action Plan proposes to address the issue arising on account of the splitting up of contracts through the Principal Purpose Test (PPT) rule under Action Plan 6- Preventing the Granting of Treaty Benefits in

Inappropriate Circumstances, with associated changes to the OECD Commentary to Article 5 of the Model treaty. It would be important to note that the Delhi Income-tax Appellate Tribunal in the case of *Sumitomo Corporation*<sup>8</sup> held that where there are several sites where supervision is going on in a country, the rule is that the test of minimum period should be determined for each individual site or installation project. The proposed amendment could also have an impact on the dredging operations of MNC's having a presence in India.

## Some Developments in the European Region in Line with the Action Plan 7

As far as the developments in the European region are concerned that would take ahead the actions deliberated by the Action Plan 7, the UK claims to have addressed the concerns around perceived avoidance of triggering UK PEs by foreign enterprises by introducing the Diverted Profits Tax (DPT) legislation (effective 1 April 2015). Further, few other European countries<sup>9</sup> also have taken action in response to the BEPS Action Plan 7.

## The Way Ahead

These proposed changes to the PE definition will be implemented as part of the multilateral instrument adopted under the work on Action 15. However, follow-up work on profit attribution rules in relation to PEs still has to be concluded before the end of 2016, which is the deadline for negotiation of the multilateral instrument.

The BEPS Action Plan 7 does not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a permanent establishment under Article 7 but there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this report, in particular for PEs outside the financial sector. There is also a need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital.

OECD has released the reports within a period of little over two years from coining of the BEPS concept in 2013. Basis the reports released, there appears to be much work yet to be done in this regards to provide a precise direction to address the PE circumvention achieved by Multinational Enterprises as alleged by the tax authorities.

If the manner in which OECD has executed the BEPS initiatives is anything to go by, it would be interesting to see how the need for additional guidance on the issue of attribution of profits to PEs, and the follow-up work on attribution of profits issues related to Action 7 would be reconciled with Action 7 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument. ■

<sup>7</sup> DCIT v. *J.Ray McDermott Eastern Hemisphere Limited* [2012] 54 SOT 363 (Mum)

<sup>8</sup> *Sumitomo Corporation v. DCIT* [2014] 162 TTJ 46 (Delhi)

<sup>9</sup> Italy, Poland, Portugal, Spain, Sweden and Turkey