
Revamped dependent agent rule a marked change in the OECD's final BEPS permanent establishment report

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In brief

The final permanent establishment (PE) report of 5 October 2015 (Preventing the Artificial Avoidance of PE Status) is the third paper produced by the work on Action 7 under the OECD-led base erosion and profit shifting (BEPS) project.

The report follows the initial October 2014 paper which presented options to consider for some technical changes relating to the PE rules in Article 5 of the OECD Model Double Tax Treaty. These options were then narrowed down to finalised proposals in the May 2015 OECD PE Paper. The finalised (October 2015) paper mostly follows previous proposals in the May 2015 paper, but includes also some marked changes, chief of which is the wholly revamped dependent agent rule.

In detail

Dependent agent rule

It has been clear for some time (and since long before the BEPs project commenced) that the OECD wanted to change the terms of the dependent agent rule, primarily due to concerns about commissionaire and similar arrangements (which currently fall outside the scope of the rule).

The proposal in the earlier May 2015 PE report was to re-draw the terms of the test (which currently focuses on habitual contract conclusions by the agent concerned) and expand it

to include situations where an agent negotiates the 'material elements' of contracts. That approach has been dropped and instead the final PE report introduces a new additional test. The revised test is met where the agent "habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification" [by the principal].

The test improves on the previously proposed and more open-ended 'negotiates the material elements' test because it: restricts the test to the

conclusion of contacts; implicitly requires consideration of the role of both the agent and principal (whereas the previous test focused only on the agent's role); and sets a relatively high bar for the threshold ('the' principal role, not 'a' principal role). However, the test's framing leaves unresolved some questions about the test's scope (e.g., the criteria for assessing whether the 'principal role' test is met and the meaning of 'material modification'). The revised commentary is of limited assistance in renaming the uncertainties.

Concerns will likely arise where both principal and agent play a role in the process which leads to the conclusion of the contract, or where standard form contracts are involved. A particular concern will be whether, and in what circumstances, client relationship functions that involve introducing new business to a client (covering potentially a very broad spectrum of agency activity), are caught.

The final report has, however, clarified that the revised dependent agent rule will not apply where an intermediary acts in a principal, not agency, role (which might be true with certain low-risk distributor structures).

Independent agents

There are no fundamental changes to the proposals to revise the independent agent test that were proposed earlier in the BEPS process. Thus, the major change remains to prevent agents that act exclusively for 'closely related' (formerly 'connected' – see further below) parties from being able to qualify as independent agents. There are now also two additional changes. First, this rule has been revised so that it applies to 'closely related' rather than the previously proposed 'connected' parties. The definition of the test is similar and in both cases revolves around common control, except that the 'closely related' test may be met 'based on all the facts and circumstances'.

Second, there are further changes to the commentary explanation of what it means to be independent. More specifically, some of the references relevant to economic independence that were omitted by the previous proposals of May 2015 have now been re-instated. However, the commentary explanation remains unclear and needs further attention.

Specific activity exemptions

There are various 'specific activity' exemptions from PE status in Article 5(4) of the OECD Model Tax Treaty. These relate to maintaining facilities for the display or storage of goods, etc.

The May PE report proposed that all such specific activity exemptions should be made subject to an overall 'preparatory or auxiliary' requirement. Despite what seemed to be an earlier agreement to do just this, an alternative option is now incorporated into the final PE report which allows states to maintain the approach in the article's current version (i.e., with no requirement that each of the various specific activity exemptions is subject to this 'preparatory or auxiliary' test.)

An explanation of the terms 'preparatory' (emphasising the short-term duration of the relevant activity) and 'auxiliary' (being an activity "to support, without being part of, the essential and significant part of the activity of the enterprise as a whole") is also included in the commentary, supported by new examples designed to illustrate the intended operation of these terms.

Anti-fragmentation rule

Broadly in line with the earlier proposals, this proposal adds a new anti-fragmentation rule to Article 5(4) of the OECD Model (as above). As a result, the specific activity in the final PE report exemption is not available to a fixed place of business used or maintained by an enterprise if the same or a closely related enterprise carries on business activities at either the same place or at another place in the state if either:

- the same or the other place is a PE, or
- the overall activity from a combination of the activities is not

of a preparatory/auxiliary character,

and in either case the activities carried on (by the two enterprises at the same place, or by the same or closely related enterprise at the two places) constitute complementary functions that are part of a cohesive business operation.

Splitting-up of contracts

With the intention of countering the artificial splitting-up of longer-term contracts to fall within the 12 month construction /installation site PE rule of Article 5(3) of the OECD Model, there will be an additional example in the commentary on the principal purpose test and changes to the commentary on Article 5(3) itself.

In practice, the change may also affect the interpretation of services' PE provisions (which relate to the 'same or a connected project').

Insurance

One of the options initially aired was a separate PE rule for insurance business. In this proposal an insurance enterprise would be deemed (except with regard to re-insurance) to have a PE in a state if it collects premiums or insures risks situated in the state concerned through a person other than an agent of independent status.

In line with the earlier proposal from May 2015, the finalised paper now confirms there will be no separate rule for the insurance sector. However, it directs concerned tax authorities to the modified dependent agent PE rule (and modified independent agent PE rule). This means as a practical matter that some tax authorities may pursue the matter by applying the revised tests in Article 5(5) and 5(6) as discussed above. This is particularly relevant in cases where tax authorities consider that the Knights of Columbus

case (which upheld the independent agent status of a network of local agents acting for an insurance company) was wrongly decided.

PE attribution

The finalised PE paper also confirms the OECD's decision to defer consideration of the relevant profit attribution arrangements and interaction with transfer pricing. That work will therefore not be addressed until next year.

Significant changes to the principles of attribution to PEs (as dealt with in the 2008/2000 OECD Reports on the Attribution of Profits to Permanent Establishments) are not expected, though it is understood the work will clarify the approach to attribution to

PEs in cases of commissionaire arrangements, etc.

In our view, it is disappointing that the work on profit attribution has been deferred in this way.

The takeaway

Action 7 has been directed at correcting specific abuses arising from the existing terms of the threshold PE rule. The resulting lowering of the PE threshold may, in practice, lead to significant dispute.

Most significantly, the recommendations widen the dependent agent test and narrow the independent agent exemption. Other proposals would tighten the specific activity exemptions from PE status for

facilities used for storage, display or delivery of goods, etc. (these also include an anti-fragmentation test to prevent the artificial split of activities across separate legal entities in order to qualify for that exemption).

The deferral of the PE attribution work means these issues are not appropriately taken into account in framing the threshold PE test. Coupled with the very significant increased focus on PE issues, this likely means that tax authorities will often pursue PE attacks in circumstances when there is nothing to be gained, i.e., because there are no attributable profits beyond the measure of profit already taxed under the corresponding transfer pricing arrangements.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact one of the following:

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