

Implications of the new permanent establishment definition on retail and consumer multinationals



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One of the most far-reaching outcomes of the Organisation of Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project is the modification of the definition of a PE.

In Action 7 of the BEPS project, the OECD tries to tackle common tax avoidance strategies used to prevent the existence of a PE, including through agency or commissionaire arrangements instead of establishing related distributors. Action 7 also aims to prevent the misuse of specific exceptions to the PE definition, which relate to activities of a preparatory and auxiliary character. The changes in the PE definition have significant consequences for international groups. Some sectors, especially the retail and consumer (R&C) industry, seem to be even more exposed than others to the changes.

Effecting the changes to the PE definition will require amendments to bilateral tax treaties. To facilitate this process, the OECD is working on a multilateral instrument that will implement the results of tax treaty-related BEPS measures in existing bilateral tax treaties. The instrument should be ready for signature by the end of 2016. It is expected that the changes proposed by the OECD may be effective from 2017.

The key changes to the definition of a PE can be summarised as follows:

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- *Dependent agent PE.* Currently a PE arises when an agent acting on behalf of a foreign enterprise habitually exercises authority to conclude contracts in the name of the enterprise, unless the agent is an independent agent (legally and economically independent from its principal) acting in the ordinary course of its business. Since the current definition is limited to the formal conclusion of contracts, the OECD widened it to also include situations in which an agent habitually plays the principal role leading to the conclusion of contracts that are then routinely concluded without material modification by the enterprise.
- *Specific activity exemptions and anti-fragmentation rules.* Under the current regulations, a PE is deemed not to exist when a place of business is engaged solely in certain activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing of goods or merchandise, collection of information). With the revised regulations, the exclusion will apply only when these activities are preparatory or auxiliary in relation to the business as a whole. Anti-fragmentation



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rules have also been introduced to prevent the breakup of an operating business into several small business units in order to benefit from the preparatory or auxiliary exemption. As a result of the new provisions, the activities performed by different related parties are to be combined (analysed on an aggregated basis) when assessing whether they can be regarded as of a preparatory or auxiliary nature.

- *Splitting up of contracts.* According to the existing provisions, a PE arises when work on a construction site lasts at least 12 months. In order to prevent splitting up contracts artificially into shorter periods, the OECD advocates for a principal purposes test,¹ or a specific provision that allows for combining the activities of the related enterprises carried out at one construction site during different periods of time, each exceeding 30 days, when determining the duration of work.

What are the main concerns of these changes for R&C multinationals?

The most significant impact on R&C multinationals will likely result from the changes to the specific activity exemptions.

According to the OECD, the decisive factor used to assess whether a given activity can be regarded as preparatory or auxiliary involves determining whether the activity carried out by the place of business in itself

forms an essential and significant part of the overall activity of the enterprise. In particular, the activity cannot be regarded as of a preparatory or auxiliary nature when the general purpose of the activity performed by the place of business is the same as the general purpose of the whole enterprise. For companies operating in the R&C industry, activities such as purchasing or warehousing typically correspond to a company's core business activities and thus these companies may no longer benefit from the existing activity exemptions. Further considerations on the potential influence of the new PE regulations on purchasing and warehousing functions are presented below.

Purchasing

R&C multinationals often use central buying entities to streamline purchases. These entities are typically represented in local markets by related party service providers or purchasing offices. In principle, responsibilities of such local units include searching, auditing, and selecting suppliers as well as negotiating with suppliers with regard to products and the commercial terms of cooperation. Under the new PE definition, such local places of business will constitute a PE, as the purchasing function is an essential and significant part of the enterprise's overall activity (consisting of selling these goods).

The other model used by multinationals involves a central purchasing department that provides support services for the operating companies that purchase goods directly from suppliers. Such support usually includes selecting and recommending suppliers, negotiating global purchase agreements with suppliers, and supporting negotiations with local suppliers. So far, such activity has not been sufficient to create a PE.

Under the new regulations, one may argue on the one hand that in this scenario the dependency condition is not met, as the central department does not follow the instructions of the operating companies but rather instructs them on how to execute the purchasing process. Thus, the central purchasing department should be perceived as an independent agent. However, because in principle such services are provided for the benefit of group entities only, tax authorities might claim that the central purchasing department does not in fact meet the independent agent condition, which would result in the creation of a PE (provided that all other conditions are met). This example shows that the inherent subjectivity of the new provisions triggers a risk of creating a PE even when tax is not the key driver behind the arrangement.



¹ This rule is one of the outcomes of Action 6 of the BEPS project on the prevention of treaty abuse. According to this rule, if one of the principal purposes of a transaction or arrangements is to obtain treaty benefits, these benefits will be denied unless granting them would be in line with the object and purpose of the provisions of the treaty.

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Warehousing

Currently, most R&C multinationals are involved in online sales, with some international sellers engaged solely in digital sales. Online sales usually require that an enterprise maintain a warehouse abroad (with an adequate number of employees) where goods owned by the enterprise are stored and delivered to local customers (once sold by the enterprise). It seems indisputable that storage and delivery activities to fulfil online sales constitute an essential part

of an enterprise's distribution business and therefore do not have a preparatory or auxiliary character. As a result, under the new PE definition, these local places of business are likely to constitute a PE of the enterprise.

Overall impact of the changes

The existence of a PE does not automatically mean a material increase in tax exposure (although it is likely to trigger additional compliance costs and administrative burden for businesses), especially where the local place of business already receives arm's length remuneration. In most cases, remuneration based on costs incurred by the PE should be appropriate, though there may be situations in which remuneration based on commission would be more suitable. This might apply in particular when a local unit either concludes contracts with suppliers or plays the principal role leading to the conclusion of contracts that are then routinely concluded without material modification by the enterprise. Selection of the appropriate method of profit attribution to the PE, as well as determining whether or not a given place of business constitutes a PE, are the areas where there is heightened risk of a dispute with tax authorities. This translates into uncertainty and increased compliance costs, and may also result in double taxation.

In order to prepare for the new regulations, multinationals should review their existing structures or planned arrangements. In particular, they should analyse the activities performed by their entities/ places of business from the perspective of the value chain of the whole enterprise in order to identify activities that could give rise to a PE, and measure the impact of any potential PE on the business. Depending on the outcomes of this analysis, taxpayers might need to revise their business models or gather and document arguments supporting their position.

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