Unexpected taxing rights may result from changes to PE threshold aimed at artificial fragmentation

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In brief

The OECD BEPS project recommended that the presence of a permanent establishment (PE) required under most double tax treaties to give taxing rights to a host country should be determined by taking into account certain activities in that country of related businesses. These changes to the PE threshold could apply in situations that multinationals may not expect.

The proposed changes to the PE definition can be applied under a new treaty or through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), potentially under an existing treaty.

International groups should review their existing supply chains and operating models and determine whether the new anti-fragmentation rules might apply and result in unexpected PEs.

In detail

Background

The OECD BEPS project included Action 7 which recommended the development of changes to the PE definition in Article 5 of the OECD Model Tax Convention (MTC). The changes aimed to prevent the artificial avoidance of PE status, including through the specific activity exemptions of Article 5(4) in certain circumstances. In particular, the OECD wanted to clarify that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part merely is engaged in preparatory or auxiliary activities. But these changes to the PE threshold could apply in situations that multinationals may not expect.

The proposed changes to the PE definition could potentially occur in existing double tax treaties through the MLI. The MLI also allows a country to 'reserve' against these optional changes and to declare which option they will apply where the OECD has provided implementation alternatives.

A few new treaties already have been negotiated to incorporate these changes. However, as of the last OECD update of 6 February 2020, there are 94 signatories to the MLI. Of these, 42 already have completed the ratification and deposit process, so we know what options these countries have chosen in relation to the anti-fragmentation changes. International groups should review existing supply chains and operating models to understand if the new anti-fragmentation rules might apply and result in unexpected PEs.

Meaning of 'anti-fragmentation'

The OECD's stated objective was, given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages, to clarify that MNEs may not avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities.

The 2017 OECD Model Tax Convention includes an updated Article 5 within which countries can opt to include additional paragraph 4.1 which would, if implemented, deny the specific activity exemptions. They would not be 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:

1. the same or the other place is a PE (including a local resident company) or
2. the overall activities from a combination of the activities is not of a preparatory or auxiliary character.

In either case, the activities carried on by the two (or more) enterprises must constitute complementary functions that are part of a cohesive business operation in order for paragraph 4.1 to apply.

This change potentially has significant implications for how MNEs typically set up their supply chains and operating models where they have historically relied on the specific activity exemption to ensure they do not create a PE. MNEs and others are concerned about the broad drafting of new paragraph 4.1, the potential for different tax authorities to take alternative approaches to its interpretation and the, as yet, untested nature of the new rule.

Specifically, it is unclear what 'cohesive business operations' and 'complementary functions' will mean and whether different tax authorities will adhere to a similar set of principles or whether the interpretation will vary depending on the tax authority. Also uncertain is how to determine which entity would be the relevant taxable person that is deemed to have the PE as a result of applying the anti-fragmentation rule.

Adoption of anti-fragmentation

As noted above, 94 territories have signed on to the MLI (on at least a provisional basis and awaiting ratification); this covers over 1500 double tax treaties globally. Of these 94 territories, only some have opted in to (i.e., not reserved against) the anti-fragmentation article. Therefore it potentially will be implemented for 525 treaties.

Note that some territories have PE definitions enshrined in domestic law, whilst others more generally rely on the treaty definitions. As a result, certain territories (such as the United Kingdom and Japan) adopting the MLI's anti-fragmentation article need to update their domestic legislation to ensure that adoption under the MLI has the desired effect. The United Kingdom has done this already.

This means that under domestic law a new lower PE threshold effectively may be in place before even beginning to consider the treaty position.

The table below shows the position taken by the 10 highest-ranking GDP countries in the world with respect to whether they have adopted, or are planning to adopt, the MLI and their position in respect of the anti-fragmentation rule.

Table 1 - PwC and OECD data as at 18 January 2020

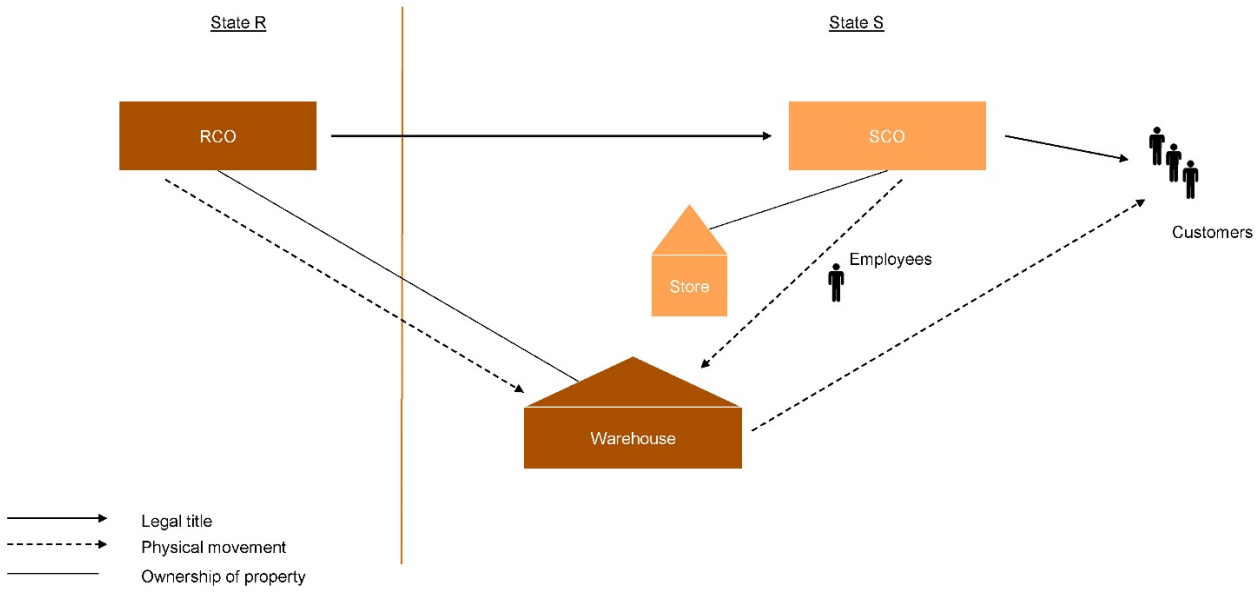
Country	Adopted/ planning to adopt the MLI?	Deposited instrument of ratification? (in force from)	Number of covered tax agreements	Adopted Article 13 (paragraph 4) of the MLI?	Domestic legislation changes required/introduced?	Specific comments from local tax authorities
United States	N	-	-	-	-	-
China	Y	N	102/110	(Provisional)N	-	-
Japan	Y	Y(1/1/19)	39/74	Y	Y	No guidance has been released
Germany	Y	N	35/96	(Provisional)N	-	-
United Kingdom	Y	Y(1/10/18)	121/130	Y	Y	No guidance has been released
India	Y	Y(1/10/19)	93/94	Y	-	-
France	Y	Y(1/1/19)	91/108	Y	N	*see below
Brazil	N	-	-	Y	-	-
Italy	Y	N	84/97	(Provisional)Y	-	-
Canada	Y	&(1/12/19)	75/93	Y	-	-

*The French domestic PE threshold already is interpreted very widely and includes an 'economic commercial cycle' PE definition which refers to "a series of economic operations sharing the same goal, and which taken together, constitute a cohesive whole". No guidance has been issued by the French tax authorities at this point in relation to how they will interpret the new OECD rules in light of their existing rules.

OECD example

The table above shows that individual territories have not provided significant guidance. However, the MLI commentary provides the following example of particular relevance to supply chains.

Diagram 1



RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO.

When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer. The ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse.

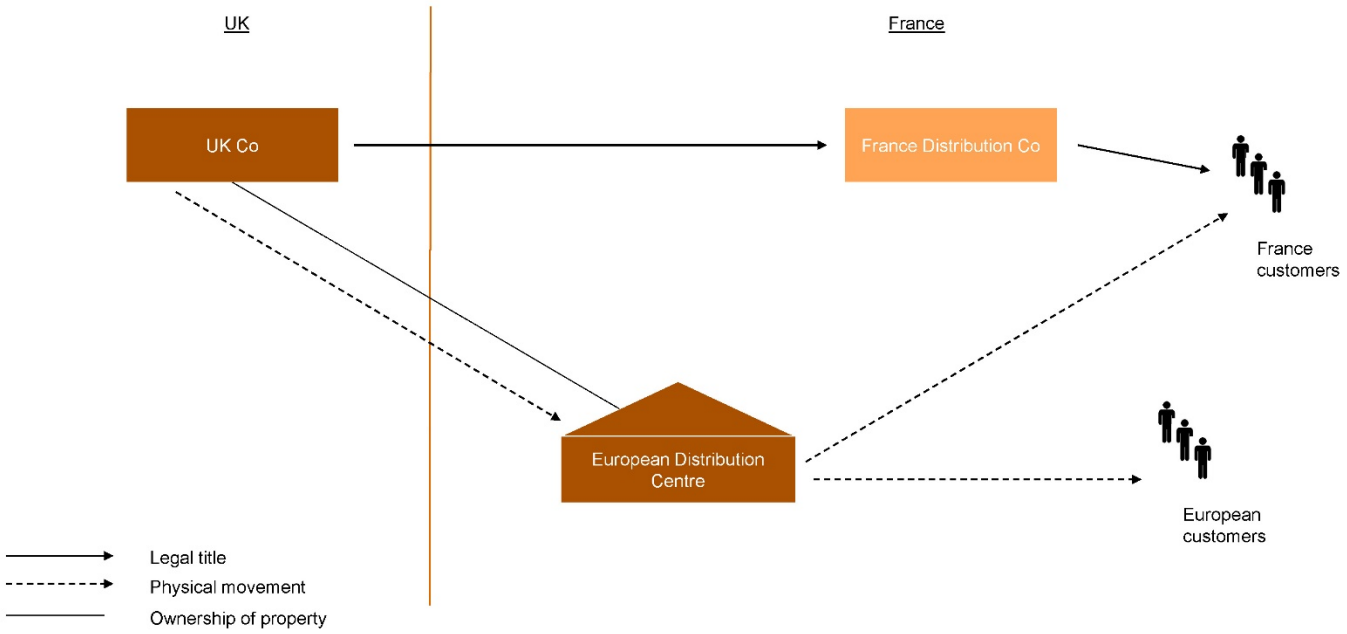
In this case, the specific activity exemptions would not be available, as RCO is considered as meeting the provisions of paragraph 4.1:

- SCO and RCO are closely related enterprises.
- SCO's store constitutes a PE of SCO (We assume that the warehouse meets the definition of a fixed place in this example, whereas if the warehouse was operated by a third party the analysis might need to start with whether it is in fact a fixed place before moving on to consider the anti-fragmentation rule).
- The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions as part of a cohesive business operation - i.e., storing goods in one place for the purpose of delivering these goods as part of obligations resulting from the sale of these goods through another place in the same State).

What we are seeing in practice

Our experience indicates that the new rules can create ambiguity, even in relatively simple scenarios. We have outlined an example below.

Diagram 2



In this example UK Co has separate distribution subsidiaries in each European country, each with a local office, including France. In addition, its main European Distribution Centre (EDC) is in France, operated by a third party, where it maintains significant amounts of inventory. UK Co previously has been comfortable that it did not have a PE in France as a result of

the specific activity exemptions. We assume for this example the warehouse constitutes a fixed place for UK Co, but further analysis on this point is often needed on a case-by-case basis, especially where the warehouse is not operated directly by UK Co (see later). As a result, UK Co now needs to consider the potential application of paragraph 4.1 to confirm that UK Co does not have a PE in France, especially given the presence and activities of French Distribution Co.

This means that the first two conditions are met as:

- UK Co and French Distribution Co are closely related enterprises and
- French Distribution Co's office constitutes a PE of French Distribution Co.

However, do the business activities carried on by UK Co at its EDC and by French Distribution Co at its office constitute complementary functions as part of a cohesive business operation, i.e., storing goods in one place for the purpose of distributing these goods as part of obligations resulting from the sale of these goods through another place in the same State?

A key difference between this and the OECD example is that the EDC serves other customers within Europe and French Distribution Co's customers may make up a relatively small proportion of the total.

As noted above, there potentially is a question over whether the EDC would in fact form a fixed place of business of the UK Co given that EDC is managed or operated by a third party. This may be a question that groups previously have not had to consider given the availability of the specific activity exemption before the implementation of anti-fragmentation. A key question is whether the EDC is considered 'at the disposal of' UK Co and requires considering aspects such as access rights under the contract with the EDC, regularity of UK Co employee visits to the EDC, what activities they undertake when on-site, and what the sign-in process is for them.

Areas of uncertainty

This (relatively) simple example above shows the open questions that MNEs face as they grapple with the new rule in an environment where there is virtually no guidance as to how different tax authorities, who might have competing views, will interpret the rule. Therefore, taxpayers may wish to assess their supply chains in light of the new rule and, where the position is uncertain, could consider approaching the relevant tax authorities in the territories of their activities to obtain certainty over the treatment of their current (and potentially future) arrangements.

Note that toll manufacturing is among other potential arrangements that could raise similar questions to the EDC example above. Thus it should also be considered in order to understand how the anti-fragmentation rules might impact these models.

Overall, two relatively simple examples of cross-border supply chains/ operating models have been shown above. Each highlights the uncertainty resulting from certain territories' adoption of the new anti-fragmentation rule put forward by the OECD as part of its BEPS initiative.

Note that this bulletin covers the threshold of the new anti-fragmentation rules but not the attribution of profits to the PE. To this end, the OECD has released an additional report titled Additional Guidance on Attribution of Profits to Permanent Establishments to aid multinationals with developing a profit split between the PE and the enterprise where the new anti-fragmentation PE definition might apply. The general view seems to be that the potential for attributing significant profits to the anti-fragmentation PE is limited.

The takeaway

As a result of the OECD BEPS initiative, the PE definition has become wider where territories have adopted the proposed changes that include paragraph 4.1. International groups should review existing supply chains and operating models to understand if the new anti-fragmentation rules might apply and result in unexpected PEs.

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 people whose details are set out below:

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