Private & Confidential
Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

By email to: taxtreaties@oecd.org

8 January 2015

Dear Marlies,

BEPS Discussion Draft: Preventing the Artificial Avoidance of PE Status

1. General comments on the Discussion Draft

The response in the pages that follow reflects the views of the PwC network of firms, and we offer our observations on several key aspects of the Discussion Draft.

Our general response to the Discussion Draft is based on the observations that (1) the OECD has stated in the BEPS Action Plan that BEPS is not about changing the balance between source- and residence-based taxation and (2) Action 7 is concerned with artificial avoidance of the PE rules. However, the proposals contained in the Discussion Draft do not seem primarily focused on addressing questions of artificial avoidance of PEs. Rather, they suggest a conscious attempt to lower the PE threshold. The result is that, while some of the proposals will counter artificial avoidance of PEs, most of them will also apply to situations where there has been no such attempt at artificial avoidance.

We assume this approach has been taken because the Working Group has worked on the assumption that artificial avoidance of PEs comes from the threshold being too high. In our view, a better approach to deliver the objectives of Action Point 7 would have been to:

- assume (in the absence of evidence to the contrary) that the decades-old threshold is right
- identify how certain structures artificially sidestep the threshold; and
- devise ways of preventing them from doing so.

Simply lowering the threshold is in our view an arbitrary (and inefficient) way of addressing the identified problem which will result in many more inter-fisc disputes (for no great gain to any of them) and also in an arbitrary shift in the current residence/source balance.

It follows from the comments made above that some of the more important proposals included in the Discussion Draft are not supported by any meaningful explanation of the rationale behind the specific proposal made. Given the inevitable change in long-standing standards that is proposed (and the likelihood of unintended consequences that will arise) we consider it essential for the proposals to be

PricewaterhouseCoopers LLP, 7 More London Riverside, London SE1 2RT
T: +44 (0) 7583 5000 F: +44 (0) 7212 7500

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considered from the perspective of whether and how they further the BEPS agenda, thereby giving stakeholders a basis for commentary on the merits of the proposals made.

In our view, a major omission from the Discussion Draft is any significant discussion about the related PE profit attribution issues. The issue is of critical importance because in many cases the measure of profit attributable to a PE (under Article 7 of the OECD Model) will (due to the absence of "significant people functions" – "SPFs" – or "key entrepreneurial risk taking functions – "KERTs") be the same as what may be referred to as the corresponding transfer pricing analysis under Article 9 of the OECD Model (i.e. where an agent is taxed in its right on the income it receives for the services it provides). To avoid the proliferation of a multitude of PEs where there is no gain to any tax authority, we would recommend consideration be given to a rule which would avoid the need to recognise a PE in such a situation.

The Discussion Draft notes that the proposals it contains are not based on any consensus of the CFA or its subsidiary bodies. In relation to the PE rules in particular (because of their significance and the link to the PE attribution rules which we discuss below), we believe it important that a consensus position is developed. In our view failure to achieve a consensus position will be counterproductive, leading to very significant increases in dispute levels and double taxation.

Given the points made above, we consider it of the utmost importance for the OECD to deliver materially improved dispute resolution mechanisms if it proceeds with the measures contained in the Discussion Draft.

2. Commissionaire arrangements and similar strategies

Of the four options suggested for the amendment of the Art 5(5) rule, we consider option B to be the least problematic. This is on the basis it is closest to the current rule (given the existence of the reference in paragraph 33 of the Commentary to negotiating "all elements and details of a contract") and therefore it is likely to be the option which will be best understood (and therefore best applied) in practice. In this case, however, it would obviously be essential to develop clear and workable guidance on what is meant by "material elements" of a contract.

Notwithstanding the comments above, we consider that all of the four options proposed will pose real difficulties as regards the clarity of the standard intended and the uniformity of application in practice. As indicated earlier in this letter, we consider that a more targeted approach would have been preferable as the proposals in the Discussion Draft introduce a broad and subjective standard that could potentially apply in a very wide range of instances. The original focus was on commissionaire arrangements but the proposals are not restricted to commissionaires putting all distributor arrangements at risk and significantly raising the potential for unintended consequences and greater controversy. We suggest that the proposals be limited to commissionaire arrangements and arbitrage arrangements akin to commissionaire arrangements.

With regard to the proposal for strengthening the independent agent test, we are concerned that a consequence of the proposals will almost certainly be that more SPV agents (both affiliated and unaffiliated) 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. In our view, the rule is intended to identify agents whose business is independent of the principal's business such that:

- the source state may tax a foreign principal in the name of a domestic agent where the agent is, in essence, carrying on the principal's business; but

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- can only tax the domestic agent in its own name where the agent is, in essence, carrying on their own business.

This means that while the number of principals an agent represents might be a factor in determining whether its business is independent of the principal's business, it is not, nor should be regarded as, a determinative one. For similar reasons, we do not support the proposed exclusion of "related party" independence. Excluding related party agencies has the disruptive effect of protecting a principal from PE status if the principal uses an unrelated party but creating a PE if the agent performing the identical functions is related. In our view, that makes no sense and disregards the time-honoured principle of respecting transactions between related parties as long as they transact business at arm's length and respecting the separateness of corporations, as reflected in paragraph 7 of the PE article.

We believe it would greatly assist the interpretation of the rules discussed above if certain existing difficulties in the Commentary were also addressed – e.g. by an improved explanation of what is required to be regarded as economically independent. It would also be helpful if it could be clarified that references to concluding contracts, etc. is intended to refer to substantive functions and acts, not merely formal ones (e.g. as in power of attorney arrangements or an agent communicating and explaining terms and conditions set by the principal).

In the absence of material amendment to the proposals, we envisage widespread collateral damage will result from the proposals. For example, it may be expected that a potentially very wide range of agents (such as agents conveying standard "list prices", whether with discretion to vary the terms within limited ranges or not, agents providing client relationship services, marketing agents, etc.) will all fall within the scope of the amended rules proposed. Further, in the banking sector affiliates are used widely to perform origination and brokerage functions in the case of suitably-capitalised regional risk trading vehicles. A wide spectrum of agency roles will similarly be impacted. In the funds sector also, local country fund managers/advisers are used extensively by regional or global fund vehicles and this sector is also likely to be materially impacted the PE proposals.

The changes proposed for Art 5(5) and (6) are directed at "commissionaire arrangements and similar strategies". Whilst the scope of commissionaire arrangements is clear, the scope of "similar strategies" is not. If the suggestion we make above on limiting the proposals is not accepted, it would be helpful to understand more clearly the scope of the arrangements which the OECD wishes to target. For example, we assume it is not the intention of the proposals to impact buy-sell or back to back contracting arrangements, though the drafting of the proposals does not deal clearly with this point. We would recommend that the matter is clarified.

3. Specific activity exemptions and fragmentation

(1) Specific activity exemptions

We are sympathetic with the OECD Proposal, reflected in option E, to constrain the application of Art 5 (4) to broadly non-core activities, though this proposal will clearly require improved guidance on the meaning of the phrase "preparatory or auxiliary" and its application as the existing guidance (see paragraph 24 of the Commentary) is brief. We would recommend an expanded explanation and the use of examples in the Commentary in the event option E is followed.

We see no basis in policy terms for the exclusion of the specific activity exemptions as in option F, G and H and consider that the justification given for option H is in any event very weak, providing no substantive explanation for its inclusion.

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(2) Fragmentation

We have strong doubts as to the wisdom of extending the anti-fragmentation rule across entities as is proposed at option I. At a policy level, deeming the services of an affiliate as creating a PE may inappropriately penalise enterprises for offering services via affiliates (as opposed to the business going to a competitor). Further, we consider any possible improvements that might be claimed from such a change to the rule (though we are sceptical of the materiality of any such improvements) would clearly be more than offset by the deep difficulties in practice of identifying "complementary functions" and a "cohesive business operation". Further, and again as a practical matter, we consider that the vagaries of the terms of this proposal would in practice mean that tax authorities would seek to apply the rule far beyond the circumstances for which it is presumably intended.

Option J avoids using the problematic words referred to in the paragraph above but in our view does not sidestep the practical difficulties of identifying the circumstances in which the proposed rule is intended to operate.

For the above reasons we think the anti-fragmentation proposals should be dropped from the package.

4. Splitting up of contracts

At a policy level, we recognise the objectives of seeking to prevent abuse of the Art 5 (3) rule which are reflected in option K. However, we are concerned about the imprecision of the rule which is proposed, especially in relation to its potential for unintended collateral damage without further amendment. To avoid this result we would suggest tightening up the reference to "activities" in the proposed paragraph (b) in option K so that the requirement is for the same type of activities as are referred to in paragraph (a) of option K. The explanation of the provision would also be assisted by the inclusion of examples. We also favour the proposal in the Discussion Draft for the addition of an exception "unless it is established that obtaining the benefit of paragraph 3 is not one of the principal purposes for carrying on these activities through different enterprises".

We believe it preferable to deal with all of the PE provisions in Art 5 itself and accordingly we do not support option L.

5. Insurance

We see no basis for singling out the insurance sector for special treatment (nor is any rationale for the singular treatment proposed contained in the Discussion Draft). We therefore do not support option M. Option N would avoid this discriminatory treatment and put insurance business on the same footing as other businesses and in our view is therefore clearly preferable.

6. Profit attribution to PEs and interaction with action points on transfer pricing

The Discussion Draft itself recognises the importance of profit attribution issues to any decisions to be made on rule changes in Art 5; yet there is no significant discussion of profit attribution issues in the Discussion Draft. Rather, the Discussion Draft seems to proceed on the basis of an assumption that there are greater profits to be attributed to PEs than would be the case with a corresponding transfer pricing result (for instance, this assumption seems to be reflected in the example in paragraph 7 of the Discussion Draft). However, very often this will not be the case (due to the absence of SPFs or

KERTs). Our concern is that, without a great deal more clarification, needless PE attacks by the tax authorities will be encouraged in practice by the proposals in the Discussion Draft on the basis that tax inspectors will automatically assume that the PE changes must lead to greater profits attributable to a PE since why else would the OECD wish to sponsor the change?

We also have more fundamental concerns with the consequence of a sharply increased use of the profit attribution rules. Based on our experience of dealing with these rules around the world (and including especially in the financial sector for which these rules were initially developed) we consider that the highly complex rules simply cannot bear the materially increased weight which would follow from a lowered PE threshold in a multitude of specific cases. The attribution rules are too vague and subjective to support their application in the very large number of cases which would arise in practice as a consequence of the proposals in the Discussion Draft. We consider this is a further compelling reason to limit the proliferation of PEs to instances where there are sound policy reasons to require the recognition of a PE.

Yours sincerely

Richard Collier
Partner
PricewaterhouseCoopers LLP, London

cc Stef van Weeghel, Global Tax Policy Leader

PwC Contact	Email
Richard Collier	Richard.collier@uk.pwc.com
Steve Nauheim	Stephen.a.nauheim@uk.pwc.com
David Swenson	David.swenson@us.pwc.com
Mike Gaffney	Mike.gaffney@us.pwc.com
Ulf Andresen	Ulf.andresen@de.pwc.com
Jerome Monsenego	Jerome.monsenego@se.pwc.com
Alenka Turnsek	Alenka.turnsek@uk.pwc.com