

HOW FIXED IS

The OECD's review of permanent establishment could result in long-standing tax norms being overturned, writes **Jonathan Schwarz**

Political pressure for change – which has manifested itself in the Organisation for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project – is addressing the tax challenges of the digital economy.

The political debate has shaken the complacency that changes can simply be made by amending the commentary to the OECD model. In recent years amending the commentary without changing the text of treaties had become something of a tradition. This was certainly the case with the OECD's review of The Interpretation and Application of Article 5 (permanent establishment (PE)) of The OECD Model Tax Convention, began in October 2011, but has now been overtaken by political developments. Several elements of the meaning of permanent establishment are now under the microscope and amendments to the definition in the Model Convention itself are proposed in the OECD Action Plan on BEPS announced in July 2013.

FIXED PLACE OF BUSINESS

The fundamental requirement that there be a 'fixed place of business' as required by article 5(1) for a physical permanent establishment is the first priority. One of the main difficulties that the digital economy poses for existing international tax rules, says the OECD, is a company's ability to have a significant 'digital presence' in the economy of another country without being liable to taxation due to the lack of nexus. The

presence of a company in a country only on a computer or smartphone screen was previously rejected by the OECD as sufficient for that country to tax the company's operations. This rejection was predicated on the fact that viewing a web page on a computer screen did not itself constitute a fixed place of business at the place where it was viewed even if the non-resident enterprise conducted its business entirely through the website.

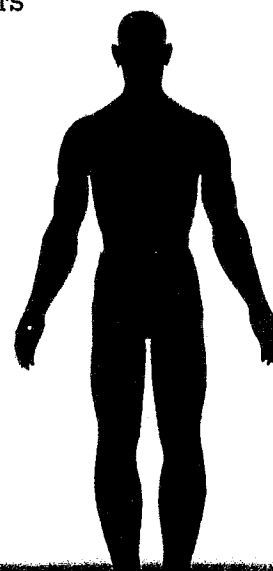
The OECD has considered that a fixed place of business can only exist where the server is located on which the website is housed. If no server is located in the country where the customer views the website, there is no permanent establishment there. The question is, however, once more on the agenda for tax reform.

COMMISSIONAIRE ARRANGEMENTS

Using 'commissionaire arrangements' – which do not give rise to permanent establishment under article 5(5) – as a substitute for local fully-fledged distributors will need a change in the wording of tax treaties.

The replacement of such distributors by commissionaires has been a common feature of business restructurings.

Successive supreme courts in civil law countries including the influential French Conseil d'Etat (Supreme Administrative



PERMANENT?

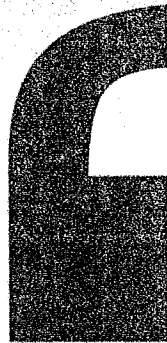
Court) in *Société Zimmer Ltd v Ministre de l'Économie, des Finances et de l'Industrie* and the Norwegian Supreme Administrative Court in *Dell Products (Europe) BV v Skatt Øst* have held that commissionaires cannot be agency permanent establishments as they do not conclude contracts on behalf of a principal. The courts have emphasised that agency permanent establishment exists only by operation of the legal relationship between the parties and that this relationship must be correctly classified in order to determine the existence or otherwise of a permanent establishment.

These decisions have given rise to some unhappiness among tax administrations as reflected in the OECD consultation on the meaning of permanent establishment. It has become apparent that changes by stretching the interpretation in the OECD Commentary on the Model Tax Convention will not produce the result that some tax administrations desire.

AUXILIARY ACTIVITY EXCEPTIONS

Thirdly, the application of the preparatory or auxiliary activity exceptions to the existence of a permanent establishment in article 5(4) is being challenged. The OECD says that multinational enterprises may artificially fragment their operations among multiple group entities to qualify for the exceptions from PE status for preparatory and ancillary activities. Where only preparatory or auxiliary activity is undertaken at a fixed place of business or by a local agent, there is no permanent establishment. This cliff-edge approach results in activity which may be productive to the non-resident enterprise being undertaken in a country without local exposure to profits taxation. Careful siting of parts of operations may therefore give multinational groups some measure of flexibility in determining the country in which its profits are taxed.

Often all three elements of the definition of permanent establishment combine in group



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structures which, in conjunction with the conventional application of existing transfer pricing or profit allocation principles, produce modest tax liabilities in the countries where activities or customers are located. Related profit attribution issues will therefore be examined by the OECD at the same time.

This re-evaluation of the meaning of permanent establishment is expressed by the OECD in its action plan on BEPS in terms of preventing treaty abuse and the granting of treaty benefits in circumstances that are regarded as inappropriate. Viewing these as issues of abuse risks the emergence of yet another layer of anti-avoidance rules instead of developing sound tax policy to address international aspects of the digital economy. The fact that tax administrations view orthodox applications of traditional concepts of permanent establishment as abusive, suggests that they may also seek to challenge existing arrangements using existing anti-avoidance tools.

The final report of the OECD Technical Advisory Group (TAG) on electronic commerce in June 2004 posed the question: are the current treaty rules for taxing business profits appropriate for e-commerce? No attempt was made to answer the question at the time. The question is now being answered, but in the context of cash-hungry governments who see themselves as source countries deprived of revenue by multinational businesses. Long-standing international tax norms and what have become conventional business structures are likely to face revolutionary change.



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