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# Grant Thornton discussion draft response

## BEPS Action 7: Preventing the artificial avoidance of PE status

Grant Thornton International Ltd, with input from certain of its member firms, welcomes the opportunity to comment on the OECD Revised Discussion Draft entitled BEPS Action 7: Preventing the artificial avoidance of PE status, issued on 15 May 2015.

Our observations and detailed comments are set out within this document.

## Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

The revised discussion draft specifies that Article 5(5) and 5(6) should be modified on the basis of option B.

**Comment:** Grant Thornton International Ltd welcomes the working party's preference of option B over option A.

### Negotiation of material elements of contracts

As indicated in our previous comments dated 5 January 2015, the use of the concept of 'negotiates material elements of contracts' may lead to significant uncertainty in certain scenarios. For example, it is unclear whether a Permanent Establishment (PE) would be created where the board of directors of an enterprise in a contracting state has considered and authorised material elements of a contract and requests a local agent in the other contracting state merely to communicate on its behalf.

The plural form of the phrase 'the material elements' raises a number of issues. These issues are outlined below.

It is unclear whether all material elements need to be habitually negotiated by the agent in order for a PE to arise.

It is also uncertain whether the negotiation of a single material clause will result in the establishment of a PE. The phrase is ambiguous when read in light of paragraph 38.10 of the commentary. Paragraph 38.10 provides, by way of analogy, that 'where the plural form is used, the reference to the 'same persons or enterprises…covers cases where there is only one such person or enterprise'.

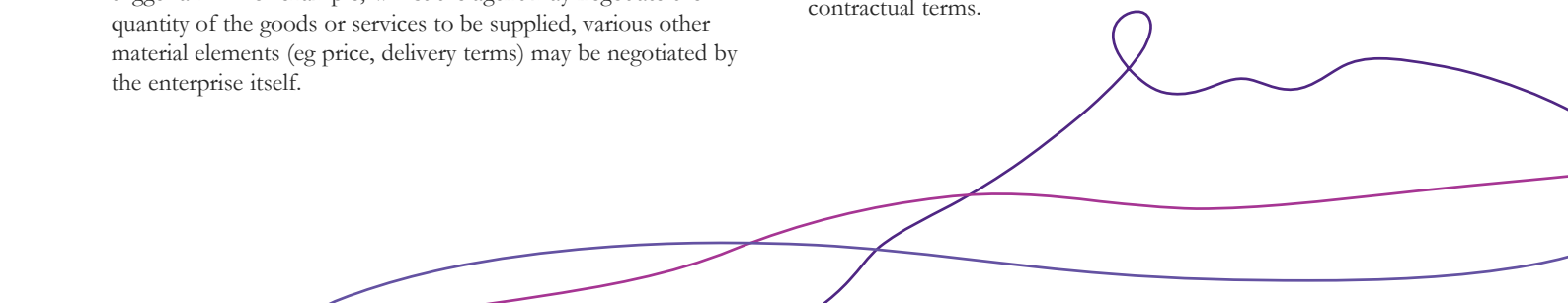
Notwithstanding the above, it is not clear how many material elements must be habitually negotiated by the agent in order to trigger a PE. For example, whilst the agent may negotiate the quantity of the goods or services to be supplied, various other material elements (eg price, delivery terms) may be negotiated by the enterprise itself.

Given the various issues that arise with respect to the interpretation of the phrase 'the material elements', we would recommend that the OECD provide further guidance to clarify the above issues.

We note that the proposed commentary appears to go further than the text of option B, and potentially to use elements of option A (see for example the wording in paragraph 32.6). Option A was opposed by many commentators and has been rejected by the working party, so we would recommend that the language and examples in the commentary be modified to avoid any confusion and potential disputes over the creation of numerous potential PEs.

We also note that the various examples in paragraph 32.6 appear to confuse different aspects of the Action 7 proposals. A key feature of one example given in this paragraph involves a local warehouse from which goods belonging to the enterprise are delivered. It would seem more appropriate to view the existence of the warehouse from which goods are delivered as giving rise to a PE than the activities of the local employees, particularly if locally they only accept offers rather than actually negotiate or make them. If there were no local warehouse, then the activities of the employees do not appear to be 'material' to customer contracts.

In addition, paragraph 32.6 indicates that a PE may be created where a person solicits and receives, but does not formally finalise, orders. Again, it is difficult to see how a PE could arise if the presence of an enterprise of a contracting state in the other contracting state was confined to an employee who simply solicits offers from potential clients (but where offers are then made directly to the head office) and is not involved in the negotiation or conclusion of any customer contracts. Whilst the 'soliciting' of offers does go beyond merely promoting and advertising goods or services, it may not involve the negotiation or conclusion of contractual terms.



Paragraph 32.6 also does not consider the common situation where the role of local employees is only to explain the material features or benefits of the product or services offered but not to explain the terms of the contract. We assume that such activity in isolation should not give rise to a PE by virtue of being of an auxiliary nature but would welcome confirmation of this point.

### Habitual conclusion of contracts

In relation to paragraph 33.1 of the commentary, and given the apparent greater emphasis now placed on this concept, we would appreciate further clarification of the meaning of 'habitually' (in the new context of the proposed revised article 5(5)). Specifically, dependent on the overall scale of the wider enterprise's activities, it remains unclear whether the negotiation of material elements of a single contract or a mere handful of contracts could give rise to a PE.

### Independent agents

The inclusion of the tests in subparagraph b) of paragraph 6 of article 5, helpfully provides a degree of clarity on the meaning of an 'independent agent'. The revised commentary suggests that an agent who is not 'connected' could still give rise to a PE, if that person acts on behalf of only one enterprise 'for a short period of time (eg at the beginning of that person's business operations). We think that this would impose an inappropriate burden on many businesses while they grow their customer base in a new territory. It may also have a detrimental effect where a business is being wound down. Neither of these circumstances appears deliberately focused on the artificial avoidance of a PE.

It is our understanding that the second part of subparagraph b) essentially complements the first part, such that independence should be tested with reference to all the relevant facts and circumstances. It is therefore inaccurate in paragraph 38.10 of the commentary to refer to the second part of subparagraph b) as an 'alternative rule'. Paragraph 38.10 should instead describe the second part of subparagraph b) as a 'complementary rule' or 'principle of control'.

## Artificial avoidance of PE status through the specific activity exemptions

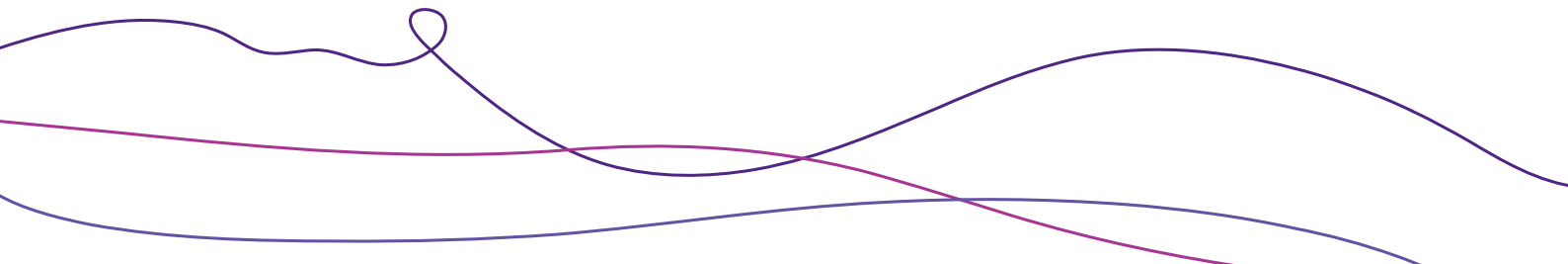
### List of activities included in Art. 5(4)

The revised discussion indicates that article 5(4) of the OECD model should be altered such that each of the exceptions specified therein would be limited to activities that are otherwise of a 'preparatory' or 'auxiliary' character.

**Comment:** Grant Thornton International Ltd welcomes the working party's preference of option E over option F.

While we acknowledge the OECD's guidance on the meaning of 'preparatory or auxiliary' as outlined in paragraph 21.2 of the revised discussion draft, more specific definitions and examples would be needed to achieve clarity and certainty. As outlined in our letter dated 5 January 2015, taxpayers would wish to understand, for example, under what circumstances would a warehouse be characterised as fundamental to a business, and importantly, when it would not.

In addition, we note that paragraph 21.2 suggests that for an activity to be preparatory, it should generally be 'carried on during a relatively short period'. For the sake of clarity, we would also welcome additional specific examples of this.



### Fragmentation of activities between related parties

The revised discussion draft incorporates an anti-fragmentation rule as originally proposed in the October 2014 public discussion draft.

**Comment:** We note that the proposed anti-fragmentation rule will deny the specific activity exemptions where complementary business activities are carried on by associated enterprises at the same location, or by the same enterprise or associated enterprises at different locations.

The approach of combining activity not just of a given legal entity but also of related parties to assert that a PE is created may lead to a material increase in uncertainty. Within the meaning of Action 7 it also leaves substantial room for conflicting interpretation by the tax authorities in individual jurisdictions of the meaning of 'cohesive operating business'.

In addition, we are concerned that the proposed anti-fragmentation rule would give source countries an ability to ignore or pierce the separate legal personality of substantive legal entities in a manner which was unwarranted by the fact pattern.

While we note that the commentary contains detailed examples of when the new rule would apply, we believe taxpayers would find it helpful also to have specific examples of situations that are not regarded as artificial fragmentation.

## Splitting up of contracts

**Comment:** We welcome the suggestion that the above matter should normally be dealt with through the addition of an example in the commentary on the principal purpose test provision proposed under BEPS Action 6: Prevent treaty abuse.

## Insurance

**Comment:** We welcome the suggestion that no specific rule for insurance enterprises should be added to article 5 and that concerns relating to cases where a large network of exclusive agents is used to sell insurance for a foreign insurer should be addressed through the more general changes proposed to article 5(5) and 5(6) discussed under section A above.

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

The revised discussion draft notes that follow-up work on attribution of profits issues will be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016.

**Comment:** We envisage an increase in the number of potential PEs as a result of Action 7 but in many of these cases it appears there should be little or no additional profit recognised in a territory. This uncertainty should be clarified as soon as possible. Additional guidance on the issue of attribution of profits to PEs is needed now, and we are concerned by the delay in updated guidance which suggests that the BEPS project will not be concluded by the end of 2015.

**If you would like to discuss any of these points in more detail then please contact:**

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