

Revised discussion draft

# BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

15 May 2015 – 12 June 2015





**NEW DISCUSSION DRAFT ON ACTION 7  
(PREVENT THE ARTIFICIAL AVOIDANCE OF PE STATUS)**

15 May 2015

**NEW DISCUSSION DRAFT ON ACTION 7 OF THE BEPS ACTION PLAN  
(PREVENT THE ARTIFICIAL AVOIDANCE OF PE STATUS)**

*New discussion draft*

The OECD *Action Plan on Base Erosion and Profit Shifting*, published in July 2013, identifies 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions.

The Action Plan stresses the need to update the treaty definition of permanent establishment (PE) in order to prevent abuses of that threshold. It notes that the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor, which has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor with “*commissionnaire* arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. The Action Plan also notes that multinationals may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and auxiliary activities.

Action 7 of the Action Plan indicates the need to address these issues:

**ACTION 7 – *Prevent the Artificial Avoidance of PE Status***

*Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionnaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.*

Further, the Report *Addressing the Tax Challenges of the Digital Economy* has identified issues in the digital economy that need to be taken into account in the course of the work on Action 7, namely ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment (PE) status and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status.

In October 2013, the OECD invited all interested parties to contribute examples of strategies that allegedly result in the artificial avoidance of PE status and that could therefore be

addressed as part of the work on Action 7. After discussing such strategies and ways of addressing them, the OECD released, on 31 October 2014, a first discussion draft on Action 7 which described a number of PE avoidance strategies and included a number of alternative options on how to deal with these strategies.

Based on the comments that were received on that discussion draft and the interventions at a public consultation meeting held on 21 January 2015, Working Party 1 on Tax Conventions and Related Questions (the subsidiary body of the OECD Committee on Fiscal Affairs that deals with tax treaty issues) met in March 2015 to review the options included in the October 2014 discussion draft. The main objective of that meeting was to move from a series of alternative options to one specific preferred proposal with respect to each PE avoidance strategy previously identified.

This new discussion draft reflects the proposals that resulted from that meeting and on which the Committee on Fiscal Affairs is now inviting comments. The discussion draft and the comments received on it will be discussed at the Working Party 1 meeting of 22-26 June 2015, when the Working Party will be asked to finalise the changes to the OECD Model Tax Convention that will be proposed as the result of the work on Action 7.

As part of the transparent and inclusive consultation process mandated by the Action Plan, the Committee on Fiscal Affairs (CFA) invites interested parties to send comments on the specific proposals included in this new discussion draft.

Comments should be sent by **12 June 2015** at the latest (no extension will be granted) and should be sent by email to [taxtreaties@oecd.org](mailto:taxtreaties@oecd.org) in Word format (in order to facilitate their distribution to government officials). They should be addressed to Marlies de Ruyter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

**Comments should be kept as short as possible:** commentators should note that the proposals in this second discussion draft were all included among the options that appeared in the October 2014 discussion draft on which extensive comments were submitted and on which a public consultation meeting was held on 21 January 2015. For the same reason, no public consultation meeting will be held on the proposals included in this second discussion draft.

Please note that all comments received regarding this consultation draft will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

*Although this second discussion draft includes specific proposals rather than alternative options, these proposals do not, at this stage, represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.*

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## EXECUTIVE SUMMARY

Action 7 of the BEPS Action Plan calls for the development of “changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of *commissionnaire* arrangements and the specific activity exemptions”.

The preliminary results of the work on Action 7 were released on 31 October 2014 in a discussion draft that described a number of PE avoidance strategies and included a number of alternative options on how to deal with these strategies. More than 850 pages of comments were received on that discussion draft and a public consultation meeting was held on 21 January 2015. Working Party 1 on Tax Conventions and Related Questions subsequently reviewed the options included in the discussion draft in light of these written comments and the discussions at the public consultation meeting with a view to producing one specific proposal with respect to each PE avoidance strategy identified in the discussion draft.

This new discussion draft reflects the proposals that resulted from that work and on which the Committee on Fiscal Affairs is now inviting comments. The discussion draft and comments received on it will be discussed at the Working Party 1 meeting of 22-26 June 2015, when the Working Party will be asked to finalise the changes to the OECD Model Tax Convention that will be proposed as a result of the work on Action 7.

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

The October 2014 discussion draft indicated that changes were needed to the wording of Art. 5(5) and 5(6) of the OECD Model in order to address *commissionnaire* structures and similar arrangements. As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business.

The discussion draft put forward four alternative options (Options A, B, C and D) for changes to Art. 5(5) and 5(6) that were intended to reflect that policy without allowing the types of avoidance strategies that have taken place under the current wording of the Article.

The comments received on the discussion draft reflected a number of concerns with respect to each of these options. The vast majority of commentators who expressed a preference for one of the options, however, supported Option B. In many cases, however, support for any of the options was qualified by conditions as to changes that should be made or clarifications that should be provided. A frequent complaint was the uncertainty of many new concepts put forward in these options. The comments also included strong objections to the proposed restriction (common to the four options) of the “independent agent” exception in Art. 5(6).

When Working Party 1 discussed these comments, it concluded that Option B was preferable to Options A, C and D and there was general support for the changes proposed, under all options, to the independent agent exception of Art. 5(6). It was agreed, however, that the concept of “associated enterprises” used in

Art. 5(6) should be replaced by a narrower concept and that Art. 5(6) should not automatically exclude an unrelated agent acting exclusively for one enterprise.

The Working Party also decided that it was important to provide additional Commentary guidance on the changes to be made to Art. 5(5) and 5(6).

It also agreed that the changes to Art. 5(5) were not intended to address BEPS concerns related to the transfer of risks between related parties through low-risk distributor arrangements, acknowledging that these concerns were best addressed through the work on Action 9 (Risks and Capital) because they were different from the concerns that arise from situations where (unlike what happens in a distributor arrangement) sales generated by a local sales workforce are not attributed to a resident taxpayer.

These conclusions are reflected in Section A, which includes a proposal for replacing Art. 5(5) and Art. 5(6) of the OECD Model and the Commentary on these paragraphs.

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

Some aspects of Art. 5(4) of the OECD Model Tax Convention, according to which a permanent establishment is deemed not to exist where a place of business is used solely for certain activities, give rise to BEPS concerns.

The first approach that the October 2014 discussion draft identified in order to address these concerns was to amend Art. 5(4) of the OECD Model so that all its subparagraphs would be subject to a “preparatory or auxiliary” condition (Option E). The discussion draft also indicated, however, that if Option E was not adopted, it would be possible to address BEPS concerns specifically related to subparagraphs *a*), *b*) and *d*) of Art. 5(4) through the following three options:

- Option F: removing the reference to “delivery” from subparagraphs *a*) and *b*).
- Option G: amending subparagraph *d*) of Art. 5(4) so as to remove the exception for purchasing.
- Option H: deleting subparagraph *d*) of Art. 5(4) so as to remove both the exception for purchasing and the exception for collecting information.

Although the comments received on the discussion draft indicated that there were strong objections to Options E-F-G-H, Option E was generally considered to be preferable to the other options. A large number of commentators, however, complained about the uncertainty of the phrase “preparatory or auxiliary” and requested that more guidance and examples be provided as regards the meaning of that phrase.

Based on these comments, Working Party I concluded that Option E was preferable to Options F, G and H and, therefore, that Art. 5(4) of the OECD Model should be modified so that each of the exceptions included in that paragraph would be restricted to activities that are otherwise of a “preparatory or auxiliary” character. It was also agreed, however, that it was important to provide additional Commentary guidance concerning the meaning of the phrase “preparatory or auxiliary”.

These conclusions are reflected in the first part of Section B, which includes a proposal for replacing Art. 5(4) and its Commentary.

The second part of Section B deals with concerns related to the application of paragraph 4 where activities are fragmented between related parties. The October 2014 discussion draft indicated that, given the ease with which subsidiaries may be established, such concerns could be addressed by a rule that would take account not only of the activities carried on by the same enterprise at different places but also of the

activities carried on by associated enterprises at different places or at the same place. The discussion draft included two alternative versions of that rule: one that applied only to situations where one of the enterprises maintains a fixed place of business that constitutes a permanent establishment (Option I) and one that did not include that requirement and could therefore apply where none of the places to which it referred constituted a permanent establishment but the combination of the activities at the same place or at different places went beyond what is preparatory or auxiliary (Option J).

Whilst a few commentators supported the idea of an anti-fragmentation rule, the vast majority of commentators expressed strong objections to Options I and J. With a few exceptions, commentators who referred to Option J were of the view that Option I would be more practicable, even though it was argued that both options would be difficult to apply in practice.

Working Party 1 considered that, despite these comments, it was essential to have an anti-fragmentation rule in order to address BEPS concerns related to Art. 5(4) and that such a rule would be the logical consequence of the view that Art. 5(4) should only apply to activities of “preparatory and auxiliary” character because it was relatively easy to use related companies in order to segregate activities which, when taken together, went beyond that threshold. For similar reasons, delegates expressed a preference for Option J, which would apply whenever the relevant business activities exceeded the threshold of preparatory or auxiliary, regardless of whether any of the enterprises had a permanent establishment.

These conclusions are reflected in a proposal for a new paragraph 4.1 and related Commentary that is included at the end of Section B.

### **Splitting-up of contracts**

The October 2014 discussion draft concluded that BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by paragraph 3 of Article 5 could be addressed either through an “automatic” rule that would take account of any activities performed by associated enterprises (Option K) or through the “Principal Purposes Test” rule proposed as a result of the work on Action 6 (Option L).

The written comments received on the discussion draft included objections to both Options K and L. Among those who expressed a preference, however, a clear majority supported Option L. Based on these comments, Working Party 1 concluded that the addition of an example in the Commentary on the PPT rule (as proposed under Option L) would deal appropriately with the splitting-up of contracts issue. It was also agreed that a more automatic rule based on Option K should be included in the Commentary as a provision to be used where countries, unable to address that issue through domestic anti-abuse rules, would not include the PPT in a treaty or would want to address expressly concerns related to the splitting-up of contracts. At the same time, however, it was agreed to make a number of drafting changes to the rule as it appeared under Option K.

These conclusions are reflected in the proposal included in Section C of this discussion draft.

### **Insurance**

The October 2014 discussion draft included two options (Options M and N) aimed at situations where foreign insurance companies do large-scale business in a State without having a permanent establishment in that State. It noted, however, that insurance (including re-insurance) raised difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed and that a change to the PE threshold would not address cases where the remuneration of risk is shifted through the payment of insurance or re-insurance premiums to an associated enterprise that performs no functions in a State, suggesting that it might therefore be more appropriate to address the BEPS concerns related to such cases

through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted.

The vast majority of the written comments that were received on this issue and a large number of interventions during the public consultation meeting of 21 January 2015 put forward the view that there should be no special rules applicable to insurance, which should be treated like other businesses.

As indicated in Section D, Working Party 1 concluded, based on these comments, that no specific rule for insurance enterprises should be added to Article 5, which means that concerns related 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 Art. 5(5) and 5(6).

### **Issues related to attribution of profits to PEs and interaction with Action Points on Transfer Pricing**

The October 2014 discussion draft acknowledged that, although the existing rules of Article 7 would be appropriate for determining the profits of any additional PE arising under the options included in the discussion draft, there was a need for additional guidance on how these rules would apply to such PEs, in particular outside the financial sector. The discussion draft also stressed that there was a need to take account of the results of the work on other parts of the Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital.

Work on attribution of profit issues related to Action 7 cannot, therefore, realistically be undertaken before the work on Action 7 and Actions 8-10 has been completed. Section E indicates that, for these reasons and based on the many comments that have stressed the need for additional guidance on the issue of attribution of profits to PEs, it was decided that follow-up work on attribution of profits issues related to Action 7 would be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7.

## NEW DISCUSSION DRAFT ON ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

### Introduction

1. At the request of the G20, the OECD published the report *Addressing Base Erosion and Profit Shifting* (the “BEPS Report”) in February 2013. The BEPS Report identifies the root causes of BEPS and notes that tax planning leading to BEPS turns on a combination of coordinated strategies. The following paragraph from the BEPS Report relates to the current treaty definition of permanent establishment:

It had already been recognised way in the past that the concept of permanent establishment referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model). Nowadays it is possible to be heavily involved in the economic life of another country, *e.g.* by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere.

2. Following up on the BEPS Report, the OECD published its *Action Plan on Base Erosion and Profit Shifting*<sup>1</sup> (BEPS Action Plan) in July 2013. The BEPS Action Plan identifies 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions. It deals with avoidance strategies related to the permanent establishment concept as follows:

***(ii) Restoring the full effects and benefits of international standards***

[...]

***The definition of permanent establishment (PE) must be updated to prevent abuses.*** In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by “commissionnaire arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.

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1 Available at: <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

### *ACTION 7 – Prevent the Artificial Avoidance of PE Status*

*Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.*

3. The BEPS Report and the Action Plan recognise that the current definition of permanent establishment must be changed in order to address BEPS strategies. The Action Plan also recognises that in the changing international tax environment, a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States. The Action Plan indicates that whilst actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.

4. Work on Action 7 was initially carried out by the Focus Group on Artificial Avoidance of PE Status. That Group first met in September 2013, when it discussed various aspects of the permanent establishment definition that could give rise to BEPS concerns and identified a number of strategies that suggested the artificial avoidance of the PE threshold. That Group subsequently invited all interested parties to contribute examples of strategies that allegedly resulted in the artificial avoidance of PE status.<sup>2</sup>

5. The strategies that were identified were discussed at the second meeting of the Group in March 2014. At that meeting, the Group identified strategies that required further work as well as a number of options for changes to Article 5 of the OECD Model Tax Convention that would address these strategies. A number of alternative options for changes to Article 5 were subsequently drafted and were discussed at the third meeting of the Focus Group on 17-19 September 2014, when the Group decided to seek comments on these options. In doing so, the Group benefitted from the analysis contained in the report *Addressing the Tax Challenges of the Digital Economy*, which recommends that the work on Action 7 consider whether certain activities that were previously considered to be preparatory or auxiliary may be increasingly significant components of businesses in the digital economy, as well as whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.

6. The results of the work of the Focus Group were released on 31 October 2014 in a first discussion draft<sup>3</sup> on Action 7 which described the PE avoidance strategies identified by the Group and which included a number of alternative options on how to deal with these strategies. That discussion draft included:

- 4 options (Options A to D) for changes to Art. 5(5) and (6) of the OECD Model concerning the artificial avoidance of PEs through *commissionaire* arrangements and similar strategies;
- 4 options (Options E to G) for changes to Art. 5(4) of the OECD Model (which includes a list of specific PE exceptions);

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2 See <http://www.oecd.org/ctp/treaties/identifying-strategies-artificial-avoidance-permanent-establishment-status.htm>.

3 Available at: <http://www.oecd.org/ctp/treaties/discussion-draft-action-7-prevent-artificial-avoidance-pe-status.htm>.

- 2 options (Options I and J) for changes to Art. 5(4) that would address concerns with fragmentation of activities in order to benefit from the exceptions provided by that provision;
- 2 options (Options K and L) on how to deal with the splitting-up of contracts for the purposes of benefiting from Art. 5(3) of the OECD Model (the rule according to which a construction site is not a PE unless it lasts at least 12 months);
- 2 options (Option M and N) on how to deal with insurance companies that sell insurance in a local market without having a PE in that market.

7. More than 850 pages of comments were received on that discussion draft<sup>4</sup> and a public consultation meeting was held on 21 January 2015. Working Party 1 on Tax Conventions and Related Questions (the subsidiary body of the OECD Committee on Fiscal Affairs that deals with tax treaty issues) met in March 2015 to review the options included in the October 2014 discussion draft in light of these written comments and the discussions at the public consultation meeting. The main objective of that meeting was to move from a series of alternative options to one specific preferred proposal with respect to each PE avoidance strategy previously identified.

8. This second discussion draft reflects the proposals that resulted from that meeting and on which the Committee on Fiscal Affairs is now inviting comments. The discussion draft and comments received on it will be discussed at the Working Party 1 meeting of 22-26 June 2015, when the Working Party will be asked to finalise the changes to the OECD Model Tax Convention that will be proposed as the result of the work on Action 7. It should be noted that nothing in the proposals included in this discussion draft should be interpreted as reflecting the views of the OECD or of any country concerning the interpretation of the existing provisions of the OECD Model Tax Convention and of treaties in which these provisions are included.

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

9. A *commissionnaire* arrangement may be loosely defined as an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without having a permanent establishment to which such sales may be attributed for tax purposes; since the person that concludes the sales does not own the products that it sells, it cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission).

10. BEPS concerns arising from *commissionnaire* arrangements may be illustrated by the following example, which is based on a court decision that dealt with such an arrangement and found that the foreign enterprise did not have a permanent establishment:

- XCO is a company resident of State X. It specialises in the sale of medical products.
- Until 2000, these products are sold to clinics and hospitals in State Y by YCO, a company resident of State Y. XCO and YCO are members of the same multinational group.
- In 2000, the status of YCO is changed to that of *commissionnaire* following the conclusion of a *commissionnaire* contract between the two companies. Pursuant to the contract, YCO transfers to

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4 These comments are available at <http://www.oecd.org/tax/treaties/public-comments-action-7-prevent-artificial-avoidance-pe-status.pdf>.

XCO its fixed assets, its stock and its customer base and agrees to sell in State Y the products of XCO in its own name, but for the account of and at the risk of XCO.

- As a consequence, the taxable profits of YCO in State Y are substantially reduced.

11. The application of the existing definition of permanent establishment to *commissionnaire* arrangements has been extensively debated over the last few years. The debate has focused on the legal interpretation of the phrase “authority to conclude contracts in the name of”, which is found in Art. 5(5). Other issues that have been debated in relation to such arrangements are

- the extent to which Art. 5(5) may apply where contracts are substantially negotiated in a State but are finalised or authorised abroad, and
- the exact scope and historical purpose of the “independent agent” rule in Art. 5(6).

12. Putting aside these interpretation issues, Action 7 requires a policy re-evaluation of the existing permanent establishment definition in relation to *commissionnaire* arrangements and similar strategies.

13. It is clear that in many cases *commissionnaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place. Changes to the wording of paragraphs 5 and/or 6 of Article 5 are therefore needed in order to address such strategies. As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business.

14. The October 2014 discussion draft included four alternative Options (Option A to D) for changes to paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention that were intended to reflect that policy without allowing the types of avoidance strategies that have taken place under the current wording of the Article.

15. The comments received on that discussion draft reflected a number of concerns with respect to Options A to D:

- **Option A:** Most of the concerns expressed related to the uncertainty of the concept of “habitually engages with specific persons in a way that results in the conclusion of contracts”. Many commentators objected to the reference to “specific persons” and argued that the explanations, which referred to “a causal relation between engagement and conclusion of contracts”, seemed to suggest another test which was also unclear and overreaching. A large number of objections were also received on the part of Option A that referred to “the supply of goods owned by the enterprise or for the provision of services by the enterprise”: it was suggested that this phrase was also unclear and overreaching. A few commentators, however, identified avoidance arrangements that might not be caught by that option.
- **Option B:** Most of the concerns expressed related to the uncertainty of the concept of “negotiates material elements of contracts”. Commentators also repeated their objections to the part of Option B that reproduced the Option A wording on “the supply of goods owned by the enterprise or for the provision of services by the enterprise”. One commentator, however, noted that the conclusion of standardized contracts might not be caught by the provision.
- **Option C:** As this option reproduced parts of Option A, comments focussed on the differences, which were essentially the phrases “by virtue of a legal relationship” and “contracts ... on the account and risk of the enterprise”. Commentators objected that these phrases were uncertain and potentially very broad.

- **Option D:** As this option was a combination of parts of Options B and C, there were few specific additional comments on that option.

16. The comments received on each option also included many examples of possible unintended effects and suggestions for possible changes.

17. The vast majority of commentators who expressed a preference for one of the options supported Option B (more than twice as many commentators than for the three other options combined). In many cases, however, support for one of the options was qualified by conditions as to changes that should be made or clarifications that should be provided.

18. There were also a number of general comments applicable to the four options. A frequent complaint was the uncertainty of many new concepts put forward in these options. Some comments also related to the perceived uncertainty of the word “habitually” (even though that word already appears in Art. 5(5)).

19. A complaint that was also found in many comments and that was made during the consultation meeting was that these options (as well as many of the other options included in the discussion draft) would create a multitude of PEs to which no or little profits could be attributed. Many of the interventions at the consultation meeting focussed on the important compliance and administrative burden that the creation of these PEs would generate; it was argued that business needed certainty and needed to know in advance whether a PE existed.

20. The comments also included strong objections to the proposed restriction (common to the four options) of the “independent agent” exception in Art. 5(6). It was argued that the proposed changes disregarded the fundamental concept of the independence of legal entities and seemed to assume a level of coordination among associated enterprises that might not correspond to reality. It was also suggested that the changes might not be justified where the agent is remunerated at arm’s length and economic and legal independence can otherwise be demonstrated. A few comments also put forward the view that the concept of “associated enterprises” was too broad for the purpose of the four options and should be replaced by a narrower concept of related parties. Finally, many commentators expressed strong objections with respect to the automatic exclusion from Art. 5(6) of an unrelated agent acting exclusively for one enterprise: the comments included a few examples of the unintended effects of such a rule (*e.g.* in the case of a start-up company).

21. When Working Party 1 discussed these comments at its March 2015 meeting, the majority concluded that Option B was preferable to Options A, C and D and there was general support for the changes proposed, under all options, to the independent agent exception of paragraph 6. It was agreed, however, that the concept of “associated enterprises” used in paragraph 6 should be replaced by a narrower concept and that paragraph 6 should not automatically exclude an unrelated agent acting exclusively for one enterprise.

22. The Working Party also agreed, however, that it would be important to provide additional Commentary guidance on the changes that would be made to paragraphs 5 and 6. It also agreed that the changes to Art. 5(5) were not intended to address BEPS concerns related to the transfer of risks between related parties through low-risk distributor arrangements, acknowledging that these concerns are best addressed through the work on Action 9 (Risks and Capital) because they are different from the concerns that arise from situations where (unlike what happens in a distributor arrangement) sales generated by a local sales workforce are not attributed to a resident taxpayer.

23. The following proposal, on which comments are invited, reflects the conclusions reached at the meeting:

**PROPOSAL 1: CHANGES TO PARAGRAPHS 5 AND 6 OF ARTICLE 5**

*Replace paragraphs 5 and 6 of Article 5 by the following (changes to Option B as it read in the October 2014 discussion draft appear in **bold italics** for additions and ~~striketrough~~ for deletions):*

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, that are

- a) in the name of the enterprise, or
- b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
- c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent ~~acting on behalf of various persons~~ and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of **one or more enterprises to which it is connected** ~~one enterprise or associated enterprises~~, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

b) ***For the purpose of this Article, a person shall be connected to an enterprise if one possesses at least 50 per cent of the beneficial interests in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate voting power and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise. In any case, a person shall be considered to be connected to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.***

**Proposed changes to the Commentary on Article 5**

*Replace paragraphs 31 to 39 of the Commentary on Article 5 by the following (changes to the existing text of the Commentary appear in **bold italics** for additions and ~~striketrough~~ for deletions):*

**Paragraph 5**

31. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. ~~The paragraph was redrafted in the 1977 Model~~

Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether or not employees of the enterprise, who *act on behalf of the enterprise and* are not *doing so in the course of carrying on a business as an* independent agents falling under paragraph 6. Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person *any person undertaking activities on behalf of the enterprise* would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons *habitually concluding contracts or habitually negotiating the material elements of contracts that are in the name of the enterprise or that are to be performed by the enterprise* having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person's *actions on behalf of the enterprise are sufficient to conclude that* has sufficient authority to bind the enterprise's participation in *at* the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person ~~makes use of this authority~~ *concludes contracts or negotiates the material elements of contracts* repeatedly and not merely in isolated cases.

**32.1** *For paragraph 5 to apply, all the following conditions must be met:*

- *a person acts in a Contracting State on behalf of an enterprise;*
- *in doing so, that person habitually concludes contracts, or negotiates the material elements of contracts; and*
- *these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.*

**32.2** *Even if these conditions are met, however, paragraph 5 will not apply if the activities performed by the person on behalf of the enterprise are covered by the independent agent exception of paragraph 6 or are limited to activities mentioned in paragraph 4 which, if exercised through a fixed place of business, would be deemed not to create a permanent establishment (since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes should not create a permanent establishment either).*

**32.3** *A person is acting in a Contracting State on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the State concerned. This will be the case, for example, where an agent acts for a principal, where a partner acts for a partnership, where a director acts for a company or where an employee acts for an employer. A person cannot be said to be acting on behalf of an enterprise if the enterprise is not directly or indirectly affected by the action performed by that person.*

**32.4** *The phrase "concludes contracts" focusses on situations where a contract is legally concluded by a person. A contract may be concluded without any active negotiation of the terms of that contract; this would be the case, for example, where a contract is concluded by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise. Also, a contract may be concluded in a State even if that*

*contract is signed outside that State; where, for example, the conclusion of a contract results from the acceptance, by a person acting on behalf of an enterprise, of an offer to enter into a contract made by a third party, it does not matter that the contract is signed outside that State.*

*32.5 The phrase “or negotiates the material elements of contracts” is aimed at situations where contracts that are essentially being negotiated by a person in a given State are subject to formal conclusion, possibly with further approval or review, outside that State. The fact that the key ingredients of the contractual relationship have been determined in the relevant State is sufficient to treat these contracts in the same way as if they had been formally concluded in that State. For the purposes of that rule, “the “material elements” of contracts” may vary depending on the nature of the contract concerned but would typically include the determination of the parties between which the contract will be concluded as well as the price, nature and quantity of the goods or services to which the contract applies.*

*32.6 The phrase “concludes contracts or negotiates the material elements of contracts” must be interpreted in the light of the object and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise. The paragraph applies to a person who acts as the sales force of the enterprise and, in doing so, makes or accepts contractual offers even if standard contracts are used for that purpose. The paragraph would therefore apply where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions. The following is another example that illustrates the application of paragraph 5. RCO, a company resident of State R, distributes various products and services worldwide through its websites. SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO’s employees promote RCO’s products and services and are responsible for large accounts in State S; these employees’ remuneration is partially based on the revenues derived by RCO from the holders of these accounts. When one of these account holders agrees to purchase a given quantity of goods or services promoted by an employee of SCO, the employee indicates the price that will be payable, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO’s contracts, including the fixed price structure used by RCO, which the employee is not authorised to modify. When concluding that contract online, the account holder is offered a choice of payment options. In this example, SCO’s employees are negotiating the material elements of the contracts that are concluded with RCO. The fact that SCO’s employees cannot vary the terms of the contracts does not mean that there is no negotiation but rather means that the negotiation of the material elements of the contracts is limited to convincing the account holder to accept these standard terms.*

*32.7 The wording of subparagraphs a), b) and c) ensures that paragraph 5 applies not only to contracts that create rights and obligations that are legally enforceable between the enterprise on behalf of which the person is acting and the third parties with which these contracts are concluded but also to contracts that create obligations that will effectively be performed by such enterprise rather than by the person contractually obliged to do so.*

*32.8 A typical case covered by these subparagraphs is where contracts are concluded with clients by an agent, a partner or an employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and these clients. These subparagraphs also cover cases where the contracts concluded by a person who acts on behalf of an enterprise do not legally bind that enterprise to the third parties with which these contracts are concluded but are contracts for the transfer of the ownership of, or for the granting of the right to use, property owned by that*

*enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise. A typical example would be the contracts that a “commissionnaire” would conclude with third parties under a commissionnaire arrangement with a foreign enterprise pursuant to which that commissionnaire would act on behalf of the enterprise but in doing so, would conclude in its own name contracts that do not create rights and obligations that are legally enforceable between the foreign enterprise and the third parties even though the results of the arrangement between the commissionnaire and the foreign enterprise would be such that the foreign enterprise would directly transfer to these third parties the ownership or use of property that it owns or has the right to use.*

*32.9 The reference to contracts “in the name of” in subparagraph a) does not restrict the application of the subparagraph to contracts that are literally in the name of the enterprise; it may apply, for example, to certain situations where the name of the enterprise is undisclosed in the contract.*

*32.10 The crucial condition for the application of subparagraphs b) and c) is that the person who concludes the contracts or negotiates the material elements of the contracts is acting on behalf of an enterprise in such a way that the parts of the contracts that relate to the transfer of the ownership or use of property, or the provision of services, will be performed by the enterprise as opposed to the person that acts on the enterprise’s behalf.*

*32.11 For the purposes of subparagraph b), it does not matter whether or not the relevant property existed or was owned by the enterprise at the time of the conclusion of the contracts between the person who acts for the enterprise and the third parties. For example, a person acting on behalf of an enterprise might well sell property that the enterprise will subsequently produce before delivering it directly to the customers. Also, the reference to “property” covers any type of tangible or intangible property.*

*32.12 The cases to which paragraph 5 applies must be distinguished from situations where a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises. In these cases, the person is not acting “on behalf” of these other enterprises and the contracts concluded by the person are neither in the name of these enterprises nor for the transfer to third parties of the ownership or use of property that these enterprises own or have the right to use or for the provision of services by these other enterprises. Where, for example, a company acts as a distributor of products in a particular market and, in doing so, sells to customers products that it buys from an enterprise (including an associated enterprise), it is neither acting on behalf of that enterprise nor selling property that is owned by that enterprise since the property that is sold to the customers is owned by the distributor. This would still be the case if that distributor acted as a so-called “low-risk distributor” as long as the transfer of the title to property sold by that distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold).*

~~32.1 Also, the phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse~~

from which goods are delivered and where the foreign enterprise routinely approves the transactions.

33. The ~~authority to conclude~~ contracts *referred to in paragraph 5* must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person ~~had authority to conclude employment contracts~~ engage employees for the enterprise to assist that person's activity for the enterprise or if the person ~~were authorised to conclude~~, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the ~~authority has to be~~ *person must* habitually ~~exercise~~ *conclude contracts or negotiate the material elements of contracts* in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. ~~A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation.~~ The mere fact, ~~however~~, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has ~~exercised in that State an authority to conclude~~ *contracts or negotiated the material elements of contracts* in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. ~~Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.~~

33.1 The requirement that an agent must "habitually" ~~exercise an authority to conclude~~ *contracts or negotiate the material elements of contracts* reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "~~habitually exercising~~" *concluding contracts or negotiating the material elements of contracts* ~~contracting authority~~ will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, *i.e.* not only to the extent that such a person ~~exercises the authority to conclude~~ *contracts or negotiates the material elements of contracts* in the name of the enterprise.

35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

#### **Paragraph 6**

36. Where an enterprise of a Contracting State carries on business dealings through ~~a broker, general commission agent or any other agent of an independent status~~ *agent carrying on business as such*, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of ~~his~~ *that* business (see paragraph 32 above). ~~Although it stands to~~

~~reason that~~ *The activities of* such an agent, *who* representing a separate *and independent* enterprise, ~~cannot constitute a~~ *should not result in the finding of a* permanent establishment of the foreign enterprise, ~~paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.~~

~~37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:~~

- ~~– he is independent of the enterprise both legally and economically, and~~
- ~~– he acts in the ordinary course of his business when acting on behalf of the enterprise.~~

*37. The exception of paragraph 6 only applies where a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent. It would therefore not apply where a person acts on behalf of an enterprise in a different capacity, such as where an employee acts on behalf of her employer or a partner acts on behalf of a partnership. As explained in paragraph 8.1 of the Commentary on Article 15, it is sometimes difficult to determine whether the services rendered by an individual constitute employment services or services rendered by a separate enterprise and the guidance in paragraphs 8.2 to 8.28 of the Commentary on Article 15 will be relevant for that purpose. Where an individual acts on behalf of an enterprise in the course of carrying on his own business and not as an employee, however, the application of paragraph 6 will still require that the individual do so as an independent agent; as explained in paragraph 38.6 below, this independent status is less likely if the activities of that individual are performed exclusively on behalf of that enterprise.*

38. Whether a person *acting as an agent is* independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. *Notwithstanding these explanations, the last sentence of subparagraph a) of paragraph 6 provides that in certain circumstances a person shall not be considered to be an independent agent (see paragraphs 38.6 to 38.11 below).* ~~38.2~~The following considerations should be borne in mind when determining whether an agent *to whom that last sentence does not apply* may be considered to be independent.

38.1 In relation to the test of legal dependence, it should be noted that, *subject to the application of the last sentence of subparagraph a) of paragraph 6 where a subsidiary acts exclusively or almost exclusively for connected enterprises*, the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5 (*see also paragraph 38.11 below*). ~~But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.~~

38.23 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.34 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is

determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.45 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

~~38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.~~

38.57 *An independent agent* Persons cannot be said to act in the ordinary course of their own its business *as such when it performs activities that are unrelated to the business of an agent* if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5 *company that acts as a distributor for a number of companies to which it is not connected also acts as an agent for a connected enterprise, the activities that the company undertakes as a distributor will not be considered to be part of the activities that the company carries on in the ordinary course of its business as an agent and will therefore not be relevant in determining whether the company is independent from the connected enterprise on behalf of which it is acting.*

~~38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.~~

*38.6 The last sentence of subparagraph a) provides that a person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is connected. That last sentence does not mean, however, that paragraph 6 will apply automatically where a person acts for one or more enterprises to which that person is not connected. Paragraph 6 requires that the person must be carrying on a business as an independent agent and be acting in the ordinary course of that business. Independent status is less*

*likely if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are connected to each other) over the lifetime of that person's business or over a long period of time. Where, however, a person is acting exclusively for one enterprise, to which it is not connected, for a short period of time (e.g. at the beginning of that person's business operations), it is possible that paragraph 6 could apply. All the facts and circumstances would need to be taken into account to determine whether the person's activities constitute the carrying on of a business as an independent agent.*

*38.7 The last sentence of subparagraph a) applies only where the person acts "exclusively or almost exclusively" on behalf of connected enterprises. This means that where the person's activities on behalf of enterprises to which it is not connected do not represent a significant part of that person's business, that person will not qualify as an independent agent. Where, for example, the sales that an agent concludes for enterprises to which it is not connected represent less than 10 per cent of all the sales that it concludes as an agent acting for other enterprises, that agent should be viewed as acting "exclusively or almost exclusively" on behalf of connected enterprises.*

*38.8 Subparagraph b) explains the meaning of the concept of "person connected to an enterprise" for the purpose of the rule in the last sentence of subparagraph a). That concept is to be distinguished from the concept of "associated enterprises" which is used for the purposes of Article 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent.*

*38.9 Under the first part of subparagraph b), a person is considered to be connected to an enterprise if either one possesses at least 50 per cent of the beneficial interests in the other or if a third person possesses at least 50 per cent of the beneficial interests in both the person and the enterprise. In the case of a company, this condition is satisfied where a person holds at least 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company.*

*38.10 The second part of subparagraph b) includes a more general rule according to which a person shall be considered to be connected to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. That second part constitutes an alternative rule applicable to cases not covered by the first part of subparagraph b); it would cover, for example, situations where a person or enterprise indirectly controls another enterprise through a controlling participation in a third enterprise or controls directly an enterprise by virtue of a special arrangement that allows that person to exercise rights that are similar to those that it would hold if it possessed at least 50 per cent of the beneficial interests in the enterprise. As in most cases where the plural form is used, the reference to the "same persons or enterprises" at the end of subparagraph b) covers cases where there is only one such person or enterprise.*

*38.11 The rule in the last sentence of subparagraph a) and the fact that subparagraph b) covers situations where one company controls or is controlled by another company does not restrict in any way the scope of paragraph 7 of Article 5. As explained in paragraph 41.1 below, it is possible that a subsidiary will act on behalf of its parent company in such a way that the parent will be deemed to have a permanent establishment under paragraph 5; if that is the case, a subsidiary acting exclusively or almost exclusively for its parent will be unable to benefit from the "independent agent" exception of paragraph 6. This, however, does not imply that the parent-subsidiary relationship eliminates the requirements of paragraph 5 and that such a relationship could be sufficient in itself to conclude that any of these requirements are met.*

39. According to the definition of the term “permanent establishment” an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD member countries *before [next update]* include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. *Also, the changes to paragraphs 5 and 6 made in [next update] have addressed some of the concerns that such a provision is intended to address.* Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

## **B. Artificial avoidance of PE status through the specific activity exemptions**

24. The reference to the “specific activity exemptions” is a reference to the list of exceptions included in Art. 5(4) of the OECD Model Tax Convention, according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph.

25. The October 2014 discussion draft dealt with the following issues related to Art. 5(4) that were seen as potentially raising BEPS concerns:

- The fact that the exceptions are not restricted to preparatory or auxiliary activities
- The reference to “delivery” in subparagraphs *a)* and *b)* of paragraph 4
- The exception for purchasing goods or merchandise or collecting information
- The fragmentation of activities between related parties

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

26. The October 2011 and 2012 discussion drafts on the clarification of the PE definition<sup>5</sup> included a proposed change to paragraph 21 of the Commentary on Article 5 according to which, under the current wording of Article 5, paragraph 4 applies automatically where one of the activities listed in subparagraphs *a)* to *d)* is the only activity carried on at a fixed place of business. The Working Group that produced that proposal, however, invited Working Party 1 to examine “whether the conclusion that subparagraphs *a)* to *d)* are not subject to the extra condition that the activities referred therein be of a preparatory or auxiliary nature is appropriate in policy terms”. This reflected the views of some delegates who argued that the proposed interpretation did not appear to conform with what they considered to be the original purpose of the paragraph, *i.e.* to cover only preparatory or auxiliary activities.

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5 See <http://www.oecd.org/tax/treaties/48836726.pdf> (2011 discussion draft) and <http://www.oecd.org/ctp/treaties/PermanentEstablishment.pdf> (2012 discussion draft).

27. Regardless of the original purpose of the exceptions included in subparagraphs *a)* to *d)* of paragraph 4, it was considered important to address situations where these subparagraphs give rise to BEPS concerns. The first approach that the October 2014 discussion draft identified in order to do so was to amend Art. 5(4) so that all its subparagraphs would be subject to a “preparatory or auxiliary” condition (Option E). The discussion draft also indicated, however, that if Option E was not adopted, it would be possible to address BEPS concerns specifically related to subparagraphs *a)*, *b)* and *d)* of Art. 5(4) through the following three options:

- Option F: removing the reference to “delivery” from subparagraphs *a)* and *b)*.
- Option G: amending subparagraph *d)* of Art. 5(4) so as to remove the exception for purchasing.
- Option H: deleting subparagraph *d)* of Art. 5(4) so as to remove both the exception for purchasing and the exception for collecting information.

28. Although the comments received on the October 2014 discussion draft indicated that there were strong objections to Options E-F-G-H, Option E was generally considered to be preferable to the other options. A large number of commentators, however, complained about the uncertainty of the phrase “preparatory or auxiliary” and requested that more guidance and examples be provided as regards the meaning of that phrase. Many commentators also argued that, as in the case of Options A to D, there would be little or no profits attributable to the PEs that would result from any of the options for changes to Art. 5(4).

29. The comments included a large number of examples of alleged unintended effects. There were also a number of suggestions for alternatives or changes; one such alternative dealing with Option E was to transform Art. 5(4) into a rebuttable presumption.

30. A number of objections focussed on Option H, which would have removed the exception for the collection of information: many commentators argued that the collection of information was inherently a preparatory activity. Some concerns were also expressed as regards the negative effect that this option could have in the case of some digital businesses, such as where a digital business merely collects data in one country and incorporates that data in large databases that can be accessed by customers in that country and elsewhere. Similar concerns were expressed with respect to situations where an analyst or fund manager might collect information for the purpose of investment decisions of a collective investment vehicle that might be made abroad.

31. When Working Party 1 discussed these comments at its March meeting, the majority concluded that Option E was preferable to Options F, G and H and, therefore, that Art. 5(4) of the OECD Model should be modified so that each of the exceptions included in that paragraph would be restricted to activities that are otherwise of a “preparatory or auxiliary” character. The Working Party also agreed, however, that it would be important to provide additional Commentary guidance, primarily through examples, concerning the meaning of the phrase “preparatory or auxiliary”.

32. The following proposal, on which comments are invited, reflects the conclusions reached at the meeting:

***PROPOSAL 2: MAKING ALL THE SUBPARAGRAPHS OF ART. 5(4) SUBJECT TO A “PREPARATORY OR AUXILIARY” CONDITION***

*Replace paragraph 4 of Article 5 by the following:*

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment”

shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character,~~

***provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.***

Replace paragraphs 21 to 30 of the existing Commentary on Article 5 (changes to the existing text of the Commentary appear in **bold italics** of additions and ~~strikethrough~~ for deletions):

#### **Paragraph 4**

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which ~~are not~~, ***when carried on through fixed places of business, are not sufficient for these places to constitute*** permanent establishments, ~~even if the activity is carried on through a fixed place of business.~~ ***The final part of the paragraph provides that these exceptions only apply if the listed activities have a preparatory or auxiliary character.*** The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in ~~Since~~ subparagraph e) ***applies to any activity that is not otherwise listed in the paragraph (as long as that activity has a preparatory or auxiliary character), the provisions of the paragraph*** which actually amounts to a general restriction of the scope of the definition ***of permanent establishment*** contained in paragraph 1 and, when read with that paragraph, provide a more selective test; by which to determine what constitutes a permanent establishment. To a considerable degree, ***these provisions*** ~~it~~ limits the definition ***in paragraph 1*** and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business ***fixed places of business which, because the business activities exercised through these places are merely preparatory or auxiliary,*** should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. *[the last two sentences and the last part of the preceding one have been moved from paragraph 23 to this paragraph]* Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, ***subject to the condition, expressed in the final part of the paragraph,*** ~~provided that~~ the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it ***only*** carries on ~~in that other State,~~ activities of a purely preparatory or auxiliary character in that State. ***The provisions of paragraph 4.1 (see below) complement that principle by ensuring that the preparatory or auxiliary character of activities***

*carried on at a fixed place of business must be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or connected enterprises carry on in the same State.*

**21.124.** It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.

**21.2** *As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.*

**21.3** *Subparagraphs a) to e) refer to activities that are carried on for the enterprise itself. A permanent establishment, however, would therefore exist if such activities were performed on behalf of other enterprises at the same fixed place of business—the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency enterprise that maintained an office for the advertising of its own products or services were also to engage in advertising for on behalf of other enterprises at that location, that office would be regarded as a permanent establishment of the enterprise by which it is maintained.*

**22.** *Subparagraph a) relates only to the case in which an enterprise acquires the use of to a fixed place of business constituted by facilities used by an enterprise for storing, displaying or delivering its own goods or merchandise. Whether the activity carried on at such a place of business has a preparatory or auxiliary character will have to be determined in the light of factors that include the size of the facilities used for that purpose and the overall business activity of the enterprise. Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, being an essential part of the enterprise's sale/distribution business, do not have a preparatory or auxiliary character. Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Subparagraph c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph d) is intended*

to include the case of the newspaper bureau which has no purpose other than to act as one of many “tentacles” of the parent body; to exempt such a bureau is to do no more than to extend the concept of “mere purchase”.

22.1 *Paragraph 4 would also not apply where* ~~A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers and, in addition, where, in addition, it for the maintenance or repairs of such machinery, as this would go beyond the pure delivery mentioned in subparagraph a) of paragraph 4 and would not constitute preparatory or auxiliary activities. Since these after-sale activities constitute organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones [the preceding two sentences have been moved from paragraph 25 to this paragraph]~~

22.2 ~~26.1~~ *Issues may arise concerning the application of the definition of permanent establishment to* ~~Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where these facilities constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether subparagraph a) paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph a), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph e) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph a) would be applicable. An additional separate question is whether the cable or pipeline could also constitute a permanent establishment for the customer of the operator of the cable or pipeline, i.e. the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.~~

22.3 Subparagraph b) relates to the *maintenance of a stock of goods or merchandise belonging to the enterprise* stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. *This subparagraph is irrelevant in cases where a stock of goods or merchandise belonging to an enterprise is maintained by another person in facilities operated by that other person and the enterprise does not have the facilities at its disposal as the place where the stock is maintained cannot therefore be a permanent establishment of that enterprise. Where, for example, an independent logistics company operates a warehouse in State S and continuously stores in that warehouse goods or merchandise belonging to an enterprise of State R, the warehouse does not constitute a fixed place of business at the disposal of the enterprise of State R and subparagraph b) is therefore irrelevant. Where, however, that enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, subparagraph b) is applicable and the*

*question of whether a permanent establishment exists will depend on whether these activities constitute a preparatory or auxiliary activity.*

*22.4 Subparagraph c) covers the situation—~~case in which~~—where a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. As explained in the preceding paragraph, the mere presence of goods or merchandise belonging to an enterprise does not mean that the fixed place of business where these goods or merchandise are stored is at the disposal of that enterprise. Where, for example, a stock of goods belonging to RCO, an enterprise of State R, is maintained by a toll-manufacturer located in State S for the purposes of processing by that toll-manufacturer, no fixed place of business is at the disposal of RCO and the place where the stock is maintained cannot therefore be a permanent establishment of RCO. If, however, RCO is allowed unlimited access to a separate part of the facilities of the toll-manufacturer for the purpose of inspecting and maintaining the goods stored therein, subparagraph c) will apply and it will be necessary to determine whether the maintenance of that stock of goods by RCO constitutes a preparatory or auxiliary activity. This will be the case if RCO is merely a distributor of products manufactured by other enterprises as in that case the mere maintenance of a stock of goods for the purposes of processing by another enterprise would not form an essential and significant part of RCO's overall activity. In such a case, unless paragraph 4.1 applies, paragraph 4 will deem a permanent establishment not to exist in relation to such a fixed place of business that is at the disposal of the enterprise of State R for the purposes of maintaining its own goods to be processed by the toll-manufacturer.*

*22.5 The first part of subparagraph d) relates to the case where premises are used solely for the purpose of purchasing goods or merchandise for the enterprise. Since this exception only applies if that activity has a preparatory or auxiliary character, it will typically not apply in the case of a fixed place of business used for the purchase of goods or merchandise where the overall activity of the enterprise consists in selling these goods. The following examples illustrate the application of paragraph 4 in the case of fixed places of business where purchasing activities are performed:*

- Example 1: RCO is a company resident of State R that is a large buyer of a particular agricultural product produced in State S, which RCO sells from State R to distributors situated in different countries. RCO maintains a purchasing office in State S. The employees who work at that office are experienced and well-paid buyers who visit producers in State S, determine the type/quality of the products according to international standards and enter into different types of contracts (spot or forward) for the acquisition of the products by RCO. In this example, although the only activity performed through the office is the purchasing of products for RCO, which is an activity covered by subparagraph d), paragraph 4 does not apply and the office therefore constitutes a permanent establishment because that purchasing function forms an essential and significant part of RCO's overall activity.*
- Example 2: RCO, a company resident of State R which operates a number of large discount stores, maintains an office in State S during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow RCO to establish stores in State S. During that period, employees of RCO occasionally purchase supplies for their office. In this example, paragraph 4 applies because subparagraph f) applies to the activities performed through the office (since subparagraph d) and e) would apply to the purchasing, researching and lobbying activities if each of these was the only activity performed at the office) and the overall activity of the office has a preparatory character.*

*22.6 The second part of subparagraph d) relates to a fixed place of business that is used solely to collect information for the enterprise. An enterprise will frequently need to collect information before deciding whether and how to carry on its core business activities in a State. If the enterprise does so without maintaining a fixed place of business in that State, subparagraph d) will obviously be irrelevant. If, however, a fixed place of business is maintained solely for that purpose, subparagraph d) will be relevant and it will be necessary to determine whether the collection of information goes beyond the preparatory or auxiliary threshold. Where, for example, an investment fund sets up an office in a State solely to collect information on possible investment opportunities in that State, the collecting of information will be a preparatory activity and the office will therefore be deemed not to be a permanent establishment.*

23. ~~Subparagraph e) provides that a fixed place of business maintained solely for the purpose of carrying on, for the enterprise, any activity that is not expressly listed in subparagraphs a) to d); as long as that activity through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, that place of business is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions—the activities to which the paragraph may apply, the examples listed in subparagraphs a) to d) being merely common examples of activities that are covered by the paragraph when they have a preparatory or auxiliary character. Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1—[the following part of the paragraph has been moved to paragraph 21): and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of business activities which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.]~~ Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character. [that last sentence has been moved to paragraph 23]

24. ~~It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity [the preceding three sentences have been moved to paragraph 21.1].~~ Examples of places of business covered by subparagraph e) are fixed places of business *used* solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character [this sentence currently appears at the end of paragraph 23]. **Paragraph 4 would not apply, however,** This would not be the case, where, for example, if a fixed place of business *used for the supply of information would* does not only give information but *would* also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case ~~apply~~ if a research establishment were to concern itself with manufacture [these two sentences currently appear at the end of paragraph 25]. **Similarly,** ~~Where, for example,~~ the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of **paragraph 4** ~~subparagraph e)~~. A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a

preparatory or auxiliary activity, for such a managerial activity exceeds this level. If *an* enterprises with international ramifications establishes a so-called “management office” in *a* States in which *they* it maintains subsidiaries, permanent establishments, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, *subparagraph e) will not apply to that “management office” because a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a “place of management” within the meaning of subparagraph a) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4.*

~~25.— A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph a) of paragraph 4. Since these after sale organisations perform an essential and significant part of the services of an enterprise vis à vis its customers, their activities are not merely auxiliary ones. Subparagraph e) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.~~

~~26.— Moreover, subparagraph e) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph e).~~

~~26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph a), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph e) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph a) would be applicable. An additional question is whether the cable or pipeline could also constitute a permanent establishment for the customer of the operator of the cable or pipeline, *i.e.* the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or~~

pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph *f)* of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in subparagraphs *a)* to *e)* of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary, a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion “preparatory or auxiliary character” is to be interpreted in the same way as is set out for the same criterion of subparagraph *e)* (see paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a)* to *e)*, disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words “provided” to “character” in subparagraph *f)*.

27.1 Subparagraph *f)* is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a)* to *e)* provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

28. The fixed places of business mentioned into which paragraph 4 *applies do not* cannot be deemed to constitute permanent establishments so long as *the business activities performed through those fixed places of business* are restricted to the *activities referred to in that paragraph* functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on these business *activities* are concluded by those in charge of the places of business themselves. *The conclusion of such contracts by these employees will not constitute a permanent establishment of the enterprise under* The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5 *as long as the conclusion of these contracts satisfies the conditions of paragraph 4 (see paragraph 33 below)*. A case in point would be a research institution *An example would be where the manager of which a place of business where preparatory or auxiliary research activities are conducted* of which is authorised to concludes the contracts necessary for *establishing and maintaining that place of business* the institution and who exercises this authority within the framework *as part of the activities carried on at that location* functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

29. If, *under paragraph 4*, a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise’s

activity *at that place* in such installation (see paragraph 11 above and paragraph 2 of Article 13). ~~Since~~ *Where*, for example, the display of merchandise during a trade fair *or convention* is excepted under subparagraphs *a)* and *b)*, the sale of ~~that~~ merchandise at the termination of ~~the~~ trade fair or convention is covered by *subparagraph e)* *as such sale is merely an auxiliary activity* ~~this exception~~. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

30. *Where paragraph 4 does not apply because a* ~~A~~ fixed place of business used *by an enterprise* ~~both~~ for activities *that are listed in that* ~~which rank as exceptions of~~ (paragraph 4) *is also used* ~~and~~ for other *activities that go beyond what is preparatory or auxiliary, that place of business* constitutes a single permanent establishment *of the enterprise and the profits attributable to the permanent establishment with respect to* ~~as regards~~ both types of activities *may be taxed in the State where that permanent establishment is situated*. ~~This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.~~

## 2. *Fragmentation of activities between related parties*

33. Paragraph 27.1 of the Commentary on Article 5 currently deals with the application of Art. 5(4)f) in the case of what has been referred to as the “fragmentation of activities”:

27.1 Subparagraph *f)* is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a)* to *e)* provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

34. It has been suggested that the logic of the last sentence (“[a]n enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity”) should not be restricted to cases where the same company maintains different places of business in a country but should be extended to cases where these places of business belong to related parties.

35. The October 2014 discussion draft concluded that, given the ease with which subsidiaries may be established, some BEPS concerns related to paragraph 4 of Article 5 could be addressed by a rule that would take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by associated enterprises at different places or at the same place. The discussion draft included two alternative versions of that rule: one that applied only to situations where one of the enterprises maintains a fixed place of business that constitutes a permanent establishment (Option I) and one that did not include that requirement and could therefore apply where none of the places to which it referred constituted a permanent establishment but the combination of the activities at the same place or at different places went beyond what is preparatory or auxiliary (Option J).

36. Whilst a few commentators supported the idea of an anti-fragmentation rule and one commentator argued that the proposal did not go far enough, the vast majority of commentators expressed strong objections to Options I and J dealing with the fragmentation of activities. Some of the main concerns that were expressed related to the uncertainty of the concept of “complementary functions that are part of a cohesive business operation”, the fact that the options seemed to ignore the separate entity principle, the possible overreach of these options, the fact that the options could result in a multitude of

new PEs and the risks of double taxation. It was also argued that Options I and J failed to recognize that modern global businesses use separate business units for many legal, regulatory, and commercial reasons. Some commentators also suggested that Options I and J would be equivalent to the force-of-attraction principle or even to unitary taxation. The comments included a number of examples of possible unintended effects.

37. As with other proposals that referred to the concept of “associated enterprises”, commentators argued that this concept was too broad for the purposes of the proposed rule.

38. With a few exceptions, commentators who referred to Option J were of the view that Option I would be more practicable, even though it was argued that both options would be difficult to apply in practice.

39. Suggestions for changes and alternatives included relying on transfer pricing rules to address fragmentation, dealing with the issue of fragmentation through the PPT rule, limiting the application of the options to fragmentation between non-resident enterprises, limiting the application of the rules to enterprises that “act together” and replacing the phrase “cohesive business operation” by “coherent whole commercially and geographically with respect to that business” or “consistent economic and functional whole”.

40. When Working Party 1 discussed this issue at its March meeting, a majority of delegates considered that, despite these comments, it was essential to have an anti-fragmentation rule in order to address BEPS concerns related to Art. 5(4) and that such a rule would be the logical consequence of the view that Art. 5(4) should only apply to activities of “preparatory and auxiliary” character because it was relatively easy to use related companies in order to segregate activities which, when taken together, went beyond that threshold. For similar reasons, delegates expressed a preference for Option J, which would apply whenever the relevant business activities exceeded the threshold of preparatory or auxiliary, regardless of whether any of the enterprises had a permanent establishment.

41. The following proposal, on which comments are invited, reflects the conclusions reached at the meeting:

### **PROPOSAL 3: NEW ANTI-FRAGMENTATION RULE**

*Add the following new paragraph 4.1 to Article 5 (changes to Option J as it read in the October 2014 discussion draft appear in **bold italics** for additions and ~~strike through~~ for deletions):*

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or **a *connected***~~a *associated*~~ enterprise carries on business activities at the same place or at another place in the same Contracting State and

- a) that place or other place constitutes a permanent establishment for the enterprise or the ***connected***~~*associated*~~ enterprise under the provisions of this Article, or
- b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or ***connected***~~*associated*~~ enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or ***connected***~~*associated*~~ enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

***Proposed changes to the Commentary on Article 5 (changes to the existing text of the Commentary***

appear in ***bold italics*** for additions and ~~strikethrough~~ for deletions)

Replace existing paragraph 27.1 of the Commentary on Article 5 by the following:

27.1 ***Unless the anti-fragmentation provisions of paragraph 4.1 are applicable (see below),*** ~~Subparagraph f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs a) to e) provided that they are separated from each other locally and organisationally,~~ as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. ~~Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.~~

Add the following new paragraphs to the Commentary on Article 5:

#### ***Paragraph 4.1***

30.1 ***The purpose of paragraph 4.1 is to prevent an enterprise or a group of connected enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. Under paragraph 4.1, the exceptions provided for by paragraph 4 do not apply to a place of business that would otherwise constitute a permanent establishment where the activities carried on at that place and other activities of the same enterprise or of connected enterprises exercised at that place or at another place in the same State constitute complementary functions that are part of a cohesive business operation. For paragraph 4.1 to apply, however, at least one of the places where these activities are exercised must constitute a permanent establishment or, if that is not the case, the overall activity resulting from the combination of the relevant activities must go beyond what is merely preparatory or auxiliary.***

30.2 ***The concept of “connected enterprises” that is used in paragraph 4.1 is defined in subparagraph b) of paragraph 6 of the Article (see paragraphs 38.8 to 38.10 below).***

30.3 ***The following examples illustrate the application of paragraph 4.1:***

- ***Example A: RCO, a bank resident of State R, has a number of branches in State S which constitute permanent establishments. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of RCO in State R where other employees analyse the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (i.e. any of the other branches where the loan applications are made) constitutes a permanent establishment of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e. providing loans to clients in State S).***
- ***Example B: 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, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph 4 a), applies to the warehouse. The conditions for the application of paragraph 4.1 are met because*

- *SCO and RCO are connected enterprises;*
- *SCO's store constitutes a permanent establishment of SCO (the definition of permanent establishment is not limited to situations where a resident of one Contracting State uses or maintains a fixed place of business in the other State; it applies equally where an enterprise of one State uses or maintains a fixed place of business in that same State); and*
- *The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions that are part of a cohesive business operation (i.e. storing goods in one place and selling these goods through another place).*

### **C. Splitting-up of contracts**

42. The splitting-up of contracts in order to abuse the exception in paragraph 3 of Article 5 is discussed in paragraph 18 of the Commentary on Art. 5:

18. ... The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

43. The October 2014 discussion draft concluded that BEPS concerns related to the splitting-up of contracts in order to circumvent the restrictions imposed by paragraph 3 of Article 5 could be addressed either through an “automatic” rule that would take account of any activities performed by associated enterprises (Option K) or through the “Principal Purposes Test” rule proposed as a result of the work on Action 6 (Option L).

44. The written comments received on the October 2014 discussion draft included objections to both Options K and L. Among those who expressed a preference, however, there was a clear majority in support of Option L. Many of the commentators who supported the “automatic” rule of Option K did so because of a general objection to the PPT rule and argued that Option K was more predictable. The commentators who objected to Option K, however, argued that it disregarded the separate entity principle and would be very difficult to administer. They also referred to a number of examples where the rule could affect legitimate business operations. Some commentators also objected that the reference to “associated enterprises” in Option K was too broad and should be replaced by some concept of related parties. A number of commentators supported the inclusion of an exception for short-term presences, although it was generally considered that 30 days was too short. With one exception, commentators who addressed the

issue of the possible extension of the anti-splitting rule of Option K to service-PE provisions opposed such an extension.

45. The comments received included a few suggestions aimed at narrowing down the scope of Option K. For instance, it was argued that the “automatic” rule proposed under Option K should be restricted to cases where associated enterprises perform similar activities. Another suggestion was that there should be an exception for cases where there was no intention to abuse the PE threshold. There were also a few suggestions concerning changes to the example referred to under Option L.

46. These comments were reviewed at the March 2015 meeting of Working Party 1. It was then concluded that the addition of an example in the Commentary on the PPT rule (as proposed under Option L) would address the splitting-up of contracts issue but that, in the case of States that could not address the issue through domestic anti-abuse rules, a more automatic rule based on Option K should be included in the Commentary as a provision that should be used in treaties that would not include the PPT or as an alternative provision to be used by countries concerned with the splitting-up of contracts issue. At the same time, however, it was agreed that the following drafting changes should be made to this alternative provision:

- It was agreed that the concept of “associated enterprises” would be too broad for the purposes of that provision and it was decided to use the different concept of “connected enterprises” (which is based on the definition of “person connected to an enterprise” proposed above for the purpose of Art. 5(6)).
- Given the business support for having a minimum time threshold under which the provision could not apply to a given connected enterprise, it was agreed to add this threshold to the provision.
- Similarly, it was agreed to follow the suggestion, found in many comments, to restrict the application of the rule to cases where the enterprises perform “connected activities”.

47. The following proposal, on which comments are invited, reflects the conclusions reached at the meeting:

**PROPOSAL 4: CHANGES DEALING WITH THE SPLITTING-UP OF CONTRACTS**

1. Add the following example to the Commentary on the PPT rule proposed in the Report on Action 6:

*Example E: RCo is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. The contracts with RCO and SUBCO provide that both companies are jointly and severally liable for the performance of the contract concluded with SUBCO.*

*In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract under which SUBCO agreed to perform part of the construction project was for RCO and SUBCO to each obtain the benefit of the rule in paragraph 3 of Article 5 of the State R-State S tax convention. Granting the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph as the time limitation of that paragraph would otherwise*

*be meaningless.*

2. *Replace paragraph 18 of the Commentary on paragraph 3 of Article 5 by the following (consequential changes will be required to paragraphs 42.45-42.48 of the Commentary):*

18. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses). *[rest of the paragraph is moved to paragraph 18.1]*

**18.1** The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period of less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, ~~countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.~~ *these abuses could also be addressed through the application of the anti-abuse rule of paragraph 7 of Article [X], as shown by example E in paragraph [X] of the Commentary on Article [X]. Some States may nevertheless wish to deal expressly with such abuses. Moreover, States that do not include paragraph 7 of Article [X] in their treaties should include an additional provision to address contract splitting. Such a provision could, for example, be drafted along the following lines:*

*For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded,*

- a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during periods of time that do not last more than twelve months, and*
- b) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises connected to the first-mentioned enterprise,*

*these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.*

*The concept of “connected enterprises” that is used in the above provision is defined in subparagraph b) of paragraph 6 of the Article (see paragraphs 38.8 to 38.10 below).*

**18.2** *For the purposes of the alternative provision found in paragraph 18.1, the determination of whether activities are connected will depend on the facts and circumstances of each case. Factors that may especially be relevant for that purpose include:*

- whether the contracts covering the different activities were concluded with the same person or related persons;*
- whether the conclusion of additional contracts with a person is a logical consequence of*

*a previous contract concluded with that person or related persons;*

- whether the activities would have been covered by a single contract absent tax planning considerations;*
- whether the nature of the work involved under the different contracts is the same or similar;*
- whether the same employees are performing the activities under the different contracts.*

#### **D. Insurance**

48. The October 2014 discussion draft included two options (Options M and N) aimed at situations where foreign insurance companies do large-scale business in a State without having a permanent establishment in that State. The first option, Option M, was to include in the OECD Model Tax Convention a provision similar to Art. 5(6) of the UN Model, according to which an insurance enterprise is deemed (except with respect to re-insurance) to have a permanent establishment in the other Contracting State if it collects premiums or insures risks situated therein through a person other than an agent of an independent status. Option N was to refrain from adopting any specific rule for insurance enterprises and to rely instead on the more general changes proposed to Art. 5(5) and 5(6) in order to deal with *commissionnaire* arrangements and similar strategies (see Section A above).

49. The October 2014 discussion draft also noted that insurance (including re-insurance) raised difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed and that a change to the PE threshold would not address cases where the remuneration of risk is shifted through the payment of insurance or re-insurance premiums to an associated enterprise that performs no functions in a State. The discussion draft suggested that it might therefore be more appropriate to address the BEPS concerns related to such cases through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted. This could be done through transfer pricing or special measures (*e.g.* addressing the deductibility of insurance or re-insurance premiums paid to related parties), as contemplated under Actions 4 and 9 of the Action Plan.

50. The vast majority of the written comments that were received on Options M and N and a large number of interventions during the public consultation meeting of 21 January 2015 put forward the view that there should be no special rules applicable to insurance, which should be treated like other businesses. For the large majority of commentators, Option N was therefore preferable to Option M (only a few commentators supported Option M). Arguments that were put forward against Option M included the fact that many States levy a tax on insurance premiums, that Option M would create a misalignment with the regulatory framework applicable to insurance (especially in Europe), that insurance was heavily regulated and that the mere fact of collecting premiums in a country did not create a sufficient taxable nexus.

51. Many commentators also argued that there would be little or no profits attributable to PEs that would result from Option M. Some commentators added that Option M would likely result in some countries trying to attribute too much profits to any PE found to exist under that option, even though the amount of profits attributable to such a PE would likely be low or zero because no KERT functions would be carried on in the State of source. Such excessive taxation would create significant risks of double taxation. It was also suggested that any BEPS concerns related to insurance should be addressed through transfer pricing rules. Cases of delegated underwriting authority and quota insurance were mentioned among the situations where Option M could have unintended effects. Finally, a few alternative approaches were included in the comments received (*e.g.* aligning the determination of whether a PE exists with the local law approach for determining whether an insurance company is subject to local insurance regulation;

recognising that countries that wished to tax insurance could simply exclude insurance from the business profits Article and providing that a taxable presence should only arise in a country if the insurance company would be carrying on a key entrepreneurial risk taking function in that country).

52. Based on these comments and the analysis already included in the October 2014 discussion draft, it was concluded that **Option N was the better approach and, therefore, that no specific rule for insurance enterprises should be added to Article 5**, which means that concerns related 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 Art. 5(5) and 5(6) (see section A above).

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

53. The October 2014 discussion draft indicated that the preliminary work on Action 7 that was done with respect to attribution of profit issues had focussed on the determination of additional profits that would be allocated to the State of the PE as a result of the changes that could be made to the definition of PE under the various options included in the discussion draft and on interactions between the work on the PE threshold and ongoing work on other parts of the Action Plan dealing with transfer pricing, in particular the work related to risk and capital referred to in Action 9. The discussion draft added that whilst that preliminary work had identified a few areas where additions/clarifications would be useful, it had not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in the discussion draft were adopted. It was acknowledged, however, that the work on other parts of the BEPS Action Plan, in particular Action 9 (Risks and capital), might involve a reconsideration of some aspects of the existing rules and guidance.

54. A large number of comments that were received on the October 2014 discussion draft focussed on attribution of profits to PEs. A significant number of commentators indicated that more work should have been done on attribution of profit issues and expressed the view that changes to the PE rules should not proceed without further work on how much additional profits would be captured by lowering the PE threshold. Many comments argued that Article 7 was difficult to apply; it was also noted that countries interpreted that Article differently because many of them had not adopted or had even rejected the AOA. A large number of comments also suggested that PEs resulting from the various options included in the discussion draft would generate little or no additional profits but that some countries might be tempted to tax profits that were not really attributable to the PE, which would create risks of double taxation and increase the number of cross-border disputes.

55. One of these comments put forward the view that there was currently inadequate guidance on the attribution of profits to permanent establishments in sectors other than financial services and suggested that “... additional guidance on assets, risks and internal dealings in relation to other trading activities will be needed to ensure that businesses and tax authorities take a consistent approach *[for the]* prevention of dispute.... Particular areas of concern that require further guidance include: Application of OECD principles where there is a stock of goods held outside of an entity’s home country but no ‘significant people functions’ in the country where the stock is located ... Application of OECD principles where a sales agent outside of an entity’s home country is remunerated on an arm’s length basis for sales activity, and where there are no other ‘significant people functions’ in the country of the sales agent ... Application of OECD principles to agency arrangements which do not involve contracts for sales.”

56. As already indicated, the October 2014 discussion draft acknowledged that, although the existing rules of Article 7 would be appropriate for determining the profits of any additional PE arising under the options included in the discussion draft, there was a need for additional guidance on how these rules would apply to such PEs, in particular outside the financial sector. The discussion draft also stressed that there

was a need to take account of the results of the work on other parts of the Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital. Work on attribution of profit issues related to Action 7 cannot, therefore, realistically be undertaken before the work on Action 7 and Actions 8-10 has been completed.

57. For these reasons, and based on the many comments that have stressed the need for additional guidance on the issue of attribution of profits to PEs, **it has been decided that follow-up work on attribution of profits issues related to Action 7 will be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7.**