Papers on Selected Topics in Protecting the Tax Base of Developing Countries

Contents

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Preventing the Artificial Avoidance of PE Status

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1. Introduction

At first sight, Action 7 of the OECD BEPS Action plan may seem of limited relevance. A closer analysis, however, reveals that this Action refers to very complex issues, both from a theoretical and practical perspective. From an academic viewpoint, it affects, first, one of the most relevant and complicated institutions of international taxation, the permanent establishment ("PEs") and art. 5 OECD / UN MC, and, second, attribution of profits to PEs and art. 7 OECD / UN MC, another intricate and controversial issue. Third, there is a direct connection of this topic with transfer pricing issues and international taxation of group of companies. From a practical perspective, having or not having a PE in a jurisdiction is crucial for tax administrations and taxpayers since the threshold effect of the PE concept marks whether a taxpayer obtaining business profits is subject to tax or not in such a jurisdiction and pays taxes there. The conceptual difficulties connected with PEs and attribution of profits to PEs and their evolution have an important impact upon practical situations: lack of clarity and different interpretations of the same concepts mean that there is a wide margin for conflict between tax administrations and taxpayers, on the one hand, and tax administrations themselves, on the other. Still, tax administrations, in general and developing countries in particular, should be able to identify when a taxpayer is conducting a relevant business activity within its territory and avoids having a PE there: taxes are lost in that case for the country concerned. For taxpayers, it is also critical to know when they may have a PE in a given jurisdiction to avoid undesired surprises and disputes, manage tax risk and, in the end, pay the correct taxes that are due to every jurisdiction where economic activity is conducted.

Therefore, it is crucial for tax administrations in developing countries to understand that Action 7 will have impact upon a domain that is extremely complex, subject to scrutiny and discussion in the international tax arena, where there are controversial issues that have not been fully closed, and, as a consequence, disputes may often arise. In this context, it is difficult to speak about "artificial avoidance of PE status": if the concept of PE, a central institution of international taxation, is not completely clear, it is hard to fix the contours of avoidance of PE status.

That basic idea has conditioned the structure of this paper. Before trying to define what is abusive in terms of avoiding a PE, it is essential to discern, first, the scope and context of Action 7 and the importance of PEs for tax administrations and taxpayers (section 2 tries to answer the question why action in this field is needed and what may be the reach of such an action). Second, it is difficult to grasp when there may be artificial avoidance of PE status if the main features and configuration of PEs over time are not known, which requires to carefully study the historical evolution of this institution in the OECD context (section 3). Only after that study is done a sort of anti-avoidance standard of art. 5 OECD MC can be described (section 3.6). This complex, although necessary exercise, seeks to explain that some consequences of applying art. 5 OECD MC do not result in artificial avoidance when they are inherent to the configuration of the PE institution that, in the end, presents an important bias, for the reasons that will be explained, in favour of residence countries. Sections 2 and 3 focus on Article 5 OECD MC (1963-2014) because the evolution of PEs took place, for many years, in the context of the OECD MC. The paper then moves on in section 4 to study the contribution of art. 5 UN MC 2011 in this field and the relevant differences between the anti-avoidance standard of PEs in the UN and the OECD MCs. Last but not least, potential solutions and tools for developing countries to fight against artificial avoidance of PE status are explored in Section 5.

It should remarked that the effects of Action 7 go beyond the strict boundaries defined for such an Action and there is an important overlap and direct connection with other parts of the OECD BEPS Action Plan (e.g. Action 1 on addressing the challenges of the digital economy, Action 6 on preventing treaty abuse, the transfer pricing Actions, n. 8-10 and 13) and chapters of this book (e.g. taxation of services). This paper will, however, try to focus on the main problems of avoidance of PEs from the perspective of Action 7 BEPS and touch on other Actions only indirectly.

2. BEPS Action 7 on artificial avoidance of PE status: context and scope

2.1 Introduction

This section describes the scope of Action 7 of the OECD BEPS Action Plan on artificial avoidance of PE status and explains the policy and practical problems behind it. First, reference is made to the OECD documents were Action 7 is dealt with. Second, some reflections are added on the policy difficulties behind this Action. Last, Action 7 is connected with the current problems faced by taxpayers and tax administrations (including those in developing countries) regarding PEs, which are very intensively connected with the policy issues and problems behind Action 7. The aim of this section is to explain that the scope of Action 7 is more complex than it may be though at first sight since it touches core issues of international taxation.

2.2 The scope of Action 7 OECD BEPS Action Plan

Action 7 should be read in the context of the main policy goal of the BEPS Action Plan:

> "No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it"[1].

Therefore, Action 7 should be expected to deal with disaggregation between business activity in a country and taxation in that country produced by the concept of PE or, rather, by artificial avoidance of PE status: substantial activity in a jurisdiction avoids having a PE there with the consequence that such a jurisdiction may not have any right to tax business profits generated within its borders.

However, in the first OECD document on BEPS, *Addressing Base Erosion and Profit Shifting* (12 February 2013), the issue of artificial avoidance of PE status was not directly mentioned, only some general references to the problems of PEs were

[1] OECD BEPS Action Plan, p. 10.

made.[2] Artificial avoidance of PEs came, therefore, as a sort of new issue –not surprisingly though—in the *OECD Action Plan on Base Erosion and Profit Shifting* (19 July 2013). Action 7 of the OECD Action Plan on BEPS explained and proposed the following:

> "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

2.4 The importance of managing PEs risks for companies and tax administrations, specially in developing countries

The limited response to the invitation

ambiguity on the interpretation of key concepts of art. 5 OECD MC have created the breeding ground for more aggressive interpretations of the PE concept by tax administrations[18].

In the end, creative interpretation of the PE concept by tax administrations of some developed countries reveals not only that there is scope for different interpretation and application of the same concept, but also that there is tax planning going on in this domain and that something should be done. There is also some evidence that avoidance of PE status is not only a problem for developed countries but it is also affecting developing countries. A recent IMF paper explains in this regard:

> "For example, a large proportion o

bring a part of the tax base to the source country, but identifying the existence of PEs may be an alternative to that route (sometimes an even more productive or easier one)

At first sight, the function of the PE concept is clear, its interpretation and application is not. The Commentaries to art. 5 OECD MC can be read in different --

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less active defence of the situs or origin principle, this Report initiated a change in the status quo when it proposed a move to resident-state taxation. The PE principle was one of the exceptions to residence-state taxation, and, as such, it has remained from the 1920s until today (with the only exception of the Mexico Model that regarded the PE as an example of source taxation and not as an exception to the main principle that was followed by the model).

The reasons behind the acceptance of the residence taxation principle as a general rule and the PE principle as an exception were not so clearly explained neither in the League of Nations materials nor later on in the OEEC / OECD documents. The main arguments to defend the change of status quo were that tax treaties embraced the residence only principle and that it is difficult to tax foreign enterprises efficiently and equitably if they do not have a PE in the source country. The fear of industrialized countries to give up revenue in favour of source countries probably was an additional driving force behind the position adopted, first, by the League of Nations and later on by the London and OECD Models accounts of the head office, therefore creating a burden on foreign enterprises. In order to avoid that burden, subsidiaries were incorporated, but some countries even tried to pierce the veil of the local subsidiary to reach the profits of the foreign parent[31]. The desire to promote commerce, avoid double taxation, and the economic context of the time in the most industrialized countries (after World War I and the Great Depression international commerce was reduced dramatically) probably had an impact in the situation of international taxation and the definition of PEs.

As an exception to the residence principle, it was assumed source countries should be able to tax business profits attributable to production factors located within their territory. Since these production factors were immobile in the 1920s and extractive, industrial and commercial establishments were the predominant industries (transportation industries were given a special treatment from the beginning, like, to some extent, banks due to the differences between 'creditor' and 'debtor' States), the source country should only tax profits attributable to the 'fixed elements' (*rectius* production factors) present within her territory. That explains why the 1928 Draft Model and the 1933 work of the League of Nations relied on a concept of PE that focused on fixed places of business[32].

Even if local subsidiaries first were regarded as a PE of their parent / sister subsidiaries in the 1927 Draft Convention of the League of Nations[33], the reference to them was eliminated in 1928 Drafts[34] probably to limit the above mentioned expansive theories of some tax administrations of the time that tried to attract the benefits of the foreign parent / affiliates into the tax base in the source State. In 1933, "subsidiaries" appeared together with the list of examples of fixed presence constituting a PE but to make clear that they were not PEs[35].

At this time, agencies were also conceived of as fixed establishments, included within the list of examples of PE in the 1927, 1928 and 1933 Draft Conventions, only independent agents were excluded from the definition of PEs. There seems to be no trace of the modern debate on whether they were agents in a legal sense or regarding the substance of their acting. However, as Vann points out, it seems that the context points in the direction that economic substance was not accepted, context suggests a rather legal interpretation of 'agents'[36]. This idea is clear in the

[31] Carroll (1939), p. 7: "In order to avoid this burden, corporations quite generally organised a local company, so that the business assets within the country might be readily segregated. If the subsidiary showed losses, its separate legal existence did not daunt the ingenious collectors of taxes. They evolved theories which justified extending the fiscal arm to cover the foreign corporation and bring it within the jurisdiction of their courts: the subsidiary company was held to be a mere "organ" of the foreign corph ofIn old-9( )-16(a)-10([Tc 0.034 Tw 0.217 0 Td[(C

reflections of Carroll on whether subsidiaries

The concept of PE was born as recognition of the source country rights in a scenario where taxation in State of residence was proposed and fostered as a rule to eliminate double taxation and favour international commerce. Two developments affected the future configuration of PEs dramatically of an enterprise may contribute to the final profit of it, administrative considerations / facilitation of international relations explain the three main changes to PEs in comparison with the period of the League of Nations: itinerant business were difficult to tax and relatively not important, the (non-exhaustive) list of preliminary and auxiliary activities should not be taxed to foster international commerce and for convenience of administration and was conceived of as an exception to the general definition to limit its scope,[48] only dependent agents having a certain degree of intervention in the source country on behalf of the non-resident should be able to qualify as PEs[49].

This represented a fundamental shift from the League of Nations' works, still one that reinforces in an important fashion the rights of resident countries and opens up new possibilities of having presence in a country without being taxed there: art. 5.3 (at the time there was no construction paragraph in art. 5), with the exception for preliminary and auxiliary activities, recognized that a fixed presence in the source country should not give rise to taxation, art. 5.5. that not every dependent agent acting in the source country should be attributed a portion of the profits of the enterprise; the exclusion of itinerant merchants also stressed that more or less permanent presence if not fixed could not give rise to source country rights.

At the same time, the changes built on the concept of (legal) independence of the works of the League of Nations. Therefore, subsidiaries were regarded

1963 OECD Draft MC. The right of residence countries and the limits of source countries, therefore, were consolidated and enhanced with regard to the previous period.

A full picture of this period would not be complete without a reference to the works on attribution of profits since they contributed to further define and explain the PE concept. The Report on Attribution of Profits to PEs and Subsidiaries of Working Party 7, 4 September 1958, FC/WP7 (58) 1, OEEC, proposed a per PE taxation, and formally rejected the force of attraction principle, with the consequence that the various presences of a foreign taxpayer in a jurisdiction could give rise to more than one PE to which profits should be attributed. The reasons for that approach were explained in Appendix II (commentaries to the draft article on business profits and associated enterprises), para. 5:

> “The working group, in common with most countries of the OEEC, rejected the [illegible]

from inflicting demands for information on foreign enterprises which are unnecessarily onerous'[53].

In modern language it could be said that the 1958 Report assumed that anti-avoidance doctrines and norms should be applied as an exception to the PE principles and that, as a matter of fact, the separated consideration of PEs should be the rule and disregard of splitting of activities an exception that should be applied with great caution. It should be stressed that the system of attribution of profits was designed in a context where the State of residence rights were further reinforced by stating in art. 5.3. that preliminary and auxiliary activities were not to be taxed at source (and this included the maintenance of stock) and that agents or subsidiaries were not, per se, PEs unless they had the authority to conclude contracts and habitually exercised it.

It should be recalled that the same 1958 Report proposed what later would become art. 9 OECD MC to accept the arm's-length principle for dealings between companies of the same group. This was the explicit acceptance of Carroll's system of attribution of profits, which, as explained, also reinforced the rights of residence countries whede3(f)d[T(ed)6(e3(a4( )-1 d Tw 4.o44)9(cl4d(h)9(f)11.17]TJn Tc si)1f)7(ed)(cl4d.174v16.al1(at)e

3.3.2. The 1977 OECD MC

was an essential part of the business operations of the enterprise, it could not be covered by art. 5.3. OECD MC[58].

- As to the meaning of independence with regard to agents, the document expressed some doubts on how this term should be interpreted (legal and economically independence?) and suggested to clarify the issue in the Commentaries[59].

- Combination of activities: The point of departure was the separate consideration of the different tests and activities in art. 5 since the attribution of profits had to be done per PE, but accumulation was possible under some circumstances. There is one limit to the interpretation proposed: combination of activities refers to those taking place within the same place of business[60]. Some principles are relevant:

    - Exceptions in art. 5.3 OECD MC (1963) are there for activities of an auxiliary nature (incomplete portion of operations of the enterprise), if, however, combination makes that portion economically significant, an 'economically self-contained function' is carried out and no privileges should be granted.

    - The same considerations apply with regard to combination of activities that, by themselves, would not constitute a PE (e.g. dependent agent without power to enter into contracts and auxiliary and preliminary activities).

    - The guiding principle should be that combinations 'will have to be

but only if they were carried out through the same place of business.[64] In the same vein, activities of a dependent agent (not authorized to conclude contracts) in a place of business at the disposal of the foreign taxpayer may also give rise to a PE[65]. The 1977 Commentaries did not include any reference to 'economic substance', 'self-contained economic activities' but certainly assumed a substantial part of the 1970 Report. By so doing, the 1977 Commentaries to art. 5 left a fundamental doubt: whether they should be interpreted literally or in a more substantial form as the German delegate proposed. His proposals, however, referred to a single place of business and were of limited scope. Therefore, it could be assumed that with regard to different places of business the same principles of the 1958 Report still applied (anti-avoidance norms as the way to attack fragmentation of activities, business reasons / economic models as a shield that protected the taxpayer).

However, a less formalistic interpretation of art. 5.1. and the, by then, brand new art. 5.3 (added by the 1977 OECD MC) was included in the Commentaries to art. 5 OECD 1977 in line with the 1970 Report: the 'link to a site' was made more flexible in the case of fixed placed PEs and the time spent at a site by subcontractors was to be taken into account in art. 5.3. OECD MC 1977.

As a consequence, the Commentaries to art. 5 OECD MC (1977) seem to reflect a tension or ambiguity that it is difficult to solve. On the one hand, the more legalist construct of the separate attribution of profits to PEs and independence of legal entities governed the relations between different PEs, especially if they classify under different paragraphs of art. 5 OECD MC, and between PEs and subsidiaries within the same jurisdiction (as long as they are not located within the same place of business). In these cases, the 1958 Report acknowledged that different places of business could only be regarded together if avoidance was identified, but there was a presumption of respect for different business models.

On the other hand, a more substantialist view was breaking ground in the interpretation of art. 5.1., art. 5.3 and art. 5.4. in the Commentaries to art. 5 OECD MC (1977): the fixed place of business of art. 5.1. was more flexible and covered geographical points, with the consequences that several fixed places could be accumulated within the same PE, the construction works to be taken into account for the 12 months period were those not totally unconnected (if they were a single project, they form a coherent whole commercially and geographically), some mobile activities could qualify for the test of art. 5.1. if they moved from one place to another as a consequence of the project undertaken, and art. 5.3., as well as, art. 5.4 admitted a more substantial interpretation when several preliminary or auxiliary activities are combined within the same place. As it will be explained below, this tension has not disappeared today.

[64] The example in the 1970 Report, p. 34 illustrates this conclusion: "Mineral oil supplied by enterprise A is processed by enterprise B (e.g., a subsidiary) into fuel oil or petrol; subsequently, these products are stored in bunkers of enterprise A for delivery to buyers. The above operations –processing, storage and delivery—constitute a process which is economically –though not legally—self contained and which could lead to the existence of a PE. In this connection, it appears to be irrelevant whether or not the delivery of operations are carried out by an agent of the enterprise within the meaning of paragraph 4. This case may possibly have to be considered differently if the processing by enterprise B merely constitutes and insignificant portion of the overall production of that enterprise".

[65] 1970 Report, p. 38-39.

3.4 *Interim conclusions on the function of PEs and the standard for avoidance of PEs*

Several forces – economic theory and certainly an economic context based on physical presence, promotion of free trade, administrative simplicity and reliance on legal form-- joined in the years studied to push all in the same direction: the attribution of taxation rights to the State or residence at the expense of source States. At the same time, drafters of the models were well aware of the fact that the PE threshold could be avoided, commissionaire structures and artificial fragmentation already existed from the beginning of the century [illegible] services

having a business presence or agent in a territory, the per PE approach and the legal independence of companies within a group, there is considerable margin to minimize taxation in the source country.

Second, the problem of dependent and independent agents of art. 5.5 and 5.6. OECD MC was there from the very beginning of the works of the League of Nations and the OEEC / OECD but it aggravated with the economic and technological changes of the last three decades:

- In a more mobile world, with better telecommunications, connecting the PE dependent agent to the conclusion of contracts 'in the name / behalf' of the enterprise does not make much sense. At the time of the League of Nations or the OEEC, probably, it was assumed that the agent was, more or less, immobile (a fixed place), but in the new world after the 1990s it is easy to avoid this requirement either by concluding the contract outside the country of source or by making the principal to finally sign the contract while at the same time avoiding the fixed place of business requirement[72]. Moreover, a person only having dependent agents not empowered to conclude contracts or independent agents, or a combination of both, in a country can avoid having a PE as long as this person does not meet the fixed place of business test[73].

- Reliance on legal dependence (as opposed to economic one) made subsidiaries to (almost always) be considered as 'independent' creatures of the other companies of the same group. As long as their activity was remunerated at arm's-length and they are not dependent agents PEs of art. 5.5. OECD MC, substantial business profits could be stripped from the country of source as long as they were attributable to a non-resident company, which could be located in a low tax country[74], take advantage of hybrid structures[75] or ring-fenced regimes[76] to reduce taxation.

- Article 5.4. also had incidence in this context: a subsidiary or another person could carry on auxiliary and preliminary activities without them being accumulated, in principle, to those of other persons within the same jurisdiction, especially if they took place in different locations.

In this context, already in the 1990s and before, fragmentation of eatadiarm7l1(y)15t, als12( )3

threshold. In fact, this change picks up the spirit of the 1970 Report which, already with regard to art. 5.4. OECD MC, considered the possibility of accumulating several activities taking place at the same place of business, or of the 1958 Report that admitted that, in cases of artificial fragmentation, anti-avoidance theories had a role to play. However, there are other considerations that push in another direction and limit the effects of this 'abuse test': the per PE approach and separate consideration of business sites --which has interpretative problems of its own in this context (what is a coherent and commercial business whole interpretation of dependent agent PEs. Ambiguity, however, permitted the Commentary to accommodate different interpretations, and the commissionaire saga in different countries (*Zimmer, Dell Norway, Roche, Dell Spain etc.*) reveals that the issue was not put to rest with this changes[83].

3.5.2.c) The 2002-2003 'reform' to art. 5 (and 1) OECD MC

Changes to art. 5.1., 5.3. and 5.4. OECD MC

As a consequence of the 2002 Report,[84] the Commentaries to art. 5 OECD MC were substantially amended. It is important to give an overview of the new commentaries in order to check whether there was any change of position on artificial avoidance of PEs.

Allegedly, the most relevant and controversial changes in 2002 were those relating to the relationship between the enterprise and the fixed place of business, since the 2002 document and the 2003 Commentaries got rid of 'disposal' in a legal sense of the place of business in favour of a more factual test of use of an amount of space in the source State (para. 4.1. Commentaries to art. 5.1). With this change, apart from the controversy it has generated (especially with reference to the painter example in the Commentaries), it appeared that a more substantialbs us89an

These changes in para. 5.1. ff. of the Commentaries to art. 5 OECD MC represented a move in two different directions. The first and most obvious one is that the term 'fixed' is given a looser interpretation. In this regard, this move is aligned with the more flexible interpretation of the 'disposal test' mentioned above. How far this interpretation can go to capture some, per se, not fixed activities (e.g. activities on board of a ship) is not fully clear in the Commentaries. Probably a natural evolution would be that fixed be given a geographical meaning, so that what matters is the constant business presence in a certain area[87].

The second move, however, is not fully coherent with the first. By importing (from art. 5.3.) the 'geographical *and* commercial coherence' test into the Commentaries to art. 5.1., it was recognized that the activities of a single taxpayer within a jurisdiction could only be accumulated where there was a coherence whole commercially *and* geographically. In order to explain how to apply this principle in the context of art. 5.1. the OECD took refuge in examples which, contrary to the less formalistic interpretation of the concept of PE suggested by other changes to the Commentaries to art. 5.1., contributed to revitalize the per PE approach: there is no commercial coherence for the (in)famous painter that works in the same office building for different clients but coherence exists if work in the same building is performed under a single contract (para. 5.3.); there is no geographical coherence if a

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presence in the source country does not entail the signature of any contract *and* there is no fixed place of business. In these cases, it is enough to sign contracts abroad in order to avoid taxation in the source country, even if significant activities are conducted there.

Second, the meaning of the authority to 'conclude contracts' was clarified as a

Fourth, changes in the Commentary to art. 5.6. OECD MC were very relevant in order to make clear when an agent is independent[98]. For this aspect, it is enough to say that the changes continued to reaffirm legal independence of companies of a group even if they were economically dependent and to separate the problem of dependency from the issue of whether a company was a PE of another.[99] These changes were very much in line with the new para. 27.1 which, as explained above, only permitted combination of business with regard to the same taxpayer as long as there was commercial and geographical coherence so even if a subsidiary was regarded as a dependent agent of the foreign principal, this would not involve that other activities of the principal in the jurisdiction (i.e. through other dependent or independent agents or fixed places of business) could be attracted and accumulated with that of the subsidiary (even if they were carried on in the same place). Relaxation of the 'disposal criterion' of art. 5.1 OECD MC, however, inevitably raised the issue –for which a solution was not provided until 2005-- of whether the premises of the dependent agent subsidiary were at the disposal of the foreign principal.

Interim conclusions on the 2002 Commentaries to art. 5 OECD MC and connection with the new Commentaries to art 1 OECD MC

A reference should be made to the new Commentaries to art. 1 OECD that in 2003 admitted the possibility of application of domestic anti-avoidance provisions in the context of DTCs. Regardless of the opinion on these controversial changes, they represented a shift in direction by the OECD from a more formal understanding or tax treaties to a more substantial one.

It may be thought that this anti-avoidance analysis entered also the Commentaries to art. 5 OECD MC, but, as explained above, this is far from true. By maintaining

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In this context, other changes with regard to art. 5.1., 5.3. OECD MC that appear to favour a more flexible, less legal or formal, interpretation of art. 5 OECD MC (e.g. the controversial factual test of disposal of a place) do not seem to be aligned with the trend identified above on fragmentation of activities / commissionaire like agreements. In view of this conflicting positions of the Commentaries to art. 5 OECD MC (a more formal versus a more substantialist view of PEs), the risk of different and not always compatible interpretations of the Commentaries increased.[100]. The *Philip Morris* basis of a deemed agency or place of business"[103]. In this regard, the 2005 additions are aligned with the 2002 changes to the Commentaries to art. 5 OECD MC that reinforced the per PE principle and the formal interpretation of para. 1, 3, 4, and 5 of art. 5 OECD MC.

If the Italian court was simply trying to apply a substance over form principle, this was not inconsistent with the OECD MC, especially after the Commentaries to 1 accepted the compatibility of anti-abuse rules and doctrines with DTCs,[104] and the factual 'at the disposal test' admitted after 2003. However, it is true that the *Philip Morris* decision was not very much in line with the formal (fragmentation friendly) interpretation of para. 1, 3, 4, and 5 of art. 5, which was reinforced after 2002, and it is natural that the OECD wanted to clear the doubts the Philip Morris decision created. More tensions would soon appear, and cases like *Roche* or *Dell Spain* are sons of the contradictory evolution of the Commentaries in this regard and the dissatisfaction of some countries with the situation. To make the matters worse, the same OECD document that explained the changes to para. 33, 41, 41.1., 42 as a reaction, on request of business, to *Philip Morris* announced further changes as a consequence of the work in the OECD on business restructuring, this would include examining 'commissionaire arrangements' after the OECD seemed to give such arrangements its blessings in the 2002 Report[105].

3.5.2.d) The OECD works on attribution of profits to PEs and the OECD Transfer Pricing Guidelines

Although attribution of profits to PEs, as well as transfer pricing, is not an issue to be dealt with in this paa28 Tm()-3(.0(,)3 -1.172(er)13 Tw 2)-4((i)-3 B[(orw 2.61(in)aB.61(in)a)10(c)

To the extent that the PE threshold, as explained, does not provide a measure of economic presence in the source country or permits to avoid taxable presence there, it produces a similar result to transfer pricing: the residual taxable base goes to the residence country at the expense of source countries. As a matter of fact, fragmentation and commissionaire structures use both transfer pricing and PE thresholds as mutually reinforcing tax planning tools.

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removing more profit from that jurisdiction if ‘services’ are provided there. Probably, this approach is flawed because it tends to ignore that a company is much more than ‘significant people’ and that all parts of the firm, and especially employees but also other associated companies and subcontractors, contribute to profits[112]. Combined with the theory, other solutions would be more theoretically desirable, the curr individual subsidiaries is taken as the useful parameter[121],(2) the configuration of the arm's-length principle in itself since, as long as, comparable transactions can be used as a benchmark, it cannot be argued that the transaction should be disregarded even if, as a whole, it contains elements of artificiality.

Chapter IX is in line with art. 5 OECD MC, especially with para. 6 and 7, and the legal independence principle to which it serves. As a matter of fact, it can be said that it can act as a shield for much of the tax planning business restructuring based on contract-manufacturing and commissionaires[122]. But above all, Chapter IX explains why some tax administrations have identified PEs strategies as a useful tool to attack tax planning based on business restructuring conducting to fragmentation and commissionaire agreements: if well prepared and executed, those transactions are difficult to attack from a transfer pricing perspective.

3.5.2.f) *The more recent works by the OECD on art. 5 and PEs*

As known, right before the BEPS Action Plan, the OECD published two dra3 Tf3(s)-4(7-1(d)2(u)-(.)10

of art. 5.4. OECD MC[127], refusal to clarify the meaning of independence because it may require changes to art. 5.6 and further study[128]) whereas others seem to assume a more economically or substance oriented approach (e.g. deeming home with these situations in the context of anti-avoidance measures is understandable and connects with the traditional view in the 1958 Report that fragmentation of activities could be deal with anti-avoidance provisions when an exclusive tax motive was identified.

The recommendation also sheds light upon the fact that the 2012 Draft has also affected (or tries to put to rest) the strategy of some tax administrations of finding PEs of foreign companies in situations of typical tax planned business restructuring. Many of the changes –described above as reinforcing legal independence-- regarding the relationship between parent and subsidiaries in the document have this goal. What is really striking is that (1) para. 104 compares the situation with that of fragmentation of contract in para. 18 Commentaries to art. 5 OECD MC, which refers to the very different problem of computation of the 12 months threshold, although this reference should probably be interpreted with the meaning that it recognizes an entry gate for domestic anti-avoidance doctrines, but then, what is the effect of the geographical coherence test?; (2) para. 105 refers back, as the preferred alternative, to transfer pricing rules when Chapter IX OECD Transfer Pricing Guidelines clearly revealed the limits of transfer pricing rules in cases of business restructuring and they can be used as a shield against attacks by the more aggressive tax administrations.

In a nutshell, the OECD Drafts on art. 5 seem to continue the tradition of history and, above all, the 2002-2003 changes. If any, the reaction to fragmentation of activities must come from the angle of anti-avoidance doctrines, but, as explained above, after the 2002-2003 changes, the scope for those doctrines in the context of art. 5 OECD is very limited unless it is interpreted that they are downplaying the role of geographical coherence, which would be a very relevant innovation. On the other hand, explicit recognition of a more economically oriented approach to dependent agents PE goes in the opposite policy direction, and can only contribute to create ambiguity, uncertainty and different interpretations of art. 5 OECD MC.

3.6. Conclusion: The standard for 'artificial avoidance' of PEs in the OECD MC

The historical evolution of the PE concept shows that it was born and has evolved, like Janus, as a two-

important factor that permits disaggregation between presence in a country and income taxed there.

- Art. 5.3. OECD is an exception to independence of associated companies and, for the first time as far as this author is aware, it recognized a case of abuse where ‘contracts’ were divided in several parts among companies of the group in order to avoid the 12 month threshold. This exception has a limited scope for the following reasons:

    - This limit applies within the context of a single project with commercial and geographical coherence, a test that is also required by art. 5.3. (with the same difficulties and problems of art. 5.1), but not with regard to other projects which are not connected geographically *and* commercially. This mea0.65live2(i(ng[(Th)live2(i1(c)3(3(6(h)-2(iJ-0[

No doubt, the Commentaries to art. 5 OECD MC are not binding differences between the PE and the fixed base concepts for some countries are also arguments to retain art. 14 UN MC in tax treaties.

- Art. 5.4. UN MC, unlike art. 5.4. OECD MC, excludes delivery of goods from the preliminary and auxiliary activities of letters a) and b). In this regard, the not apply where an enterprise 'is able to demonstrate that the sales or business activities where carried out for reasons other than obtaining treaty benefits' which 'recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment' (para. 7 Commentaries to art. 7 UN MC).

Last but not least, the current work of the UN on the possibility of adding a service article in tax treaties is very relevant since, in the end, it will considerably lower the threshold for taxation of activities in the host State. The current work on connected projects for the purposes of art. 5.3.b) UN MC may also help accumulate several business presences in the source State.

4.2. The anti-abuse standard for PE avoidance of the UN MC

The first effect that can be observed in the UN MC is that by lowering the PE threshold the source country has more rights and less profits escape their tax net. Especially relevant in this regard are the insurance provision, the warehouse agent PE fiction and the service PE rule.

Art. 5.3.b) UN MC deserves a special mention. If adopted, this article reduces the problems of fragmentation of fixed places of business because the geographical coherence5(ec)9 -1.18 er(er)-4(n)6(eo)-1(g)17(s)-4(pN0.8 er)2(.18 er)(f)5(op)3(e)1 ausef un4g in(e

which limits the margin for application of anti-avoidance doctrines or regulations. The remark in para. 35, therefore, seems a reminder or clarification.

Therefore, despite the fact that the UN MC is clearly bent towards more recognition of source country rights and, in this regard, it may reduce vulnerability of source countries to artificial avoidance of PE status, it has inherent limitationdm

adopted nowadays, and, especially to fragmentation of activities / commissionaire agreements.

- A withhold and refund system may be designed but only certain expenses are permitted (e.g. those incurred in the source country, a closed list of most relevant expenses etc.) for all types of services or only some of them.

Since most of those systems require legislation that cannot be accommodated easily

The clause –which admits several variations in drafting-- permits to overcome two

- The application of the clause to 'substantial or identical activities' leaves room for discussion of when this condition is met.

- The reference to art. 9 is not very fortunate since it only includes associated enterprises one in a contracting State and another one in the other, when, in these cases, the splitting is likely to take place between two or more non-resident companies, a situation that is not covered by art. 9 OECD MC. In order to avoid this problem some treaties provide a definition of associated

5.2.4.e) Anti fragmentation and commissionaire clauses

Clauses against the most common avoidance structures of PE status have been used in tax treaties for a long time by some countries. In this respect, the Australian experience –one of the first countries which had judicial decisions on this type of tax planning transactions-- is a useful example[149]. Australia adds three different types of clauses:

- A deemed PE for non-residents having contract-manufactures / maquila services in the other country, which adopts two forms. It is either included in the equivalent of art. 5.3.[150] or in art. 5.6. OECD MC within a tax treaty, they make clear the anti-avoidance standard of PEs accepted in that treaty and prevent any potential discussion on it. However, separate consideration of PEs is still the rule, which leaves some room for avoidance that should be deal with domestic antiavoidance doctrines or rules or with other relevant clauses. The issue of attribution of profits to PEs / associated companies also needs attention in these cases and may cause some conflict. But, specially, any country opting for these solutions should be sure functions different to those inherent to the maquila process, there may be a

For the AN, art. 5.3. UK-Spain tax treaty, equivalent to art. 5.4. OECD MC, is not applicable in this case because the activities carried on by the subsidiary cannot be considered in isolation (e.g. warehousing) but should be regarded as parts of a chain

‘employee’[164] or ‘dependent agent’ subsidiary’ is a fixed place PE (art. 5.1. OECD MC). The fixed PE reasoning is based, however, on another even more-far reaching presumption. Despite the legal independence of the Spanish subsidiary, its economic dependence from Swiss Co was crucial to create the fiction that there was a fixed place of business in Spain

Business restructurings in which the same activity remained in Spain with a contractual shift of risks to the foreign entity was the common thread of all the cases decided in Spain. In all of them, there was a flavour of predominant tax reasons behind the restructurings and a certain element of artificiality: the same outcome as before was reached by stripping risk at the stroke of a pen by simply signing a contract with the local subsidiary.

Contrary to what has drawn the attention of international scholars[169], the economic interpretation of the PE dependent agent, the activism of the Spanish administration and courts is more important because of their creative interpretation of art. 5.1. OECD MC with use of the concepts of 'complex operating settlement' and closure of a business cycle in Spain, as well as the presumption that the premises and human means of a subsidiary are at the disposal of the foreign parent.

That is not to say that the interpretation of art. 5.5 OECD is not relevant: beyond the mistakes made by the Courts (AN and Supreme Court) on the interpretation of that article, there is a clear view that a legal interpretation of in the name / on behalf of is not valid in Spain since what the tax administration and courts will look at is whether, in the end, the activity of the Spanish Co determines the sale activity in Spain and if the configuration of the transaction and activities in Spain mean that, in fact, the parent company is acting through the Spanish subsidiary.

In the end, the reading by the tax administration of art. 5.1. and art. 5.5 OECD MC has a perfect symmetry: substantial activity in Spain through a subsidiary, which concentrates a contract-manufacturing and commissionaire function, will imply that there is a PE in Spain that will attract within its tax base all the activities carried on within the jurisdiction. In this context, it seems that activities of a subsidiary above and beyond contract manufacturing plus warehouse (e.g. package and handling, managing stock, warranty, issuing invoices etc.) may give rise to a PE.

Will the splitting of the activity among several dependent and independent parties (one acting is probably more nuanced. As explained above, the OECD historical materials provide support for application of tax avoidance norms when exclusively tax reasons dominate the structure or transaction. Therefore, inasmuch as tax and artificial elements could be identified in the transactions considered by the tax administration, its position is probably not as exotic as it may seem in a cursory reading of the decisions.

There is, however, a very important problem in the form the Spanish administration and courts have made a substantive reading of the PE concept. By using interpretations that are either simply wrong in reasoning or are at odds with the more orthodox reading of the Commentaries, they are transmitting a wrong message internationally: that Spanish authorities and Courts are overtly aggressive, technically not very sophisticated, and that legal certainty is at risk when transactions are done in Spain[171]. Having that experience, it is difficult to recommend that developing countries follow the same path because being too creative in interpreting the PE clause may be more risky in terms of attracting or keeping investment than tumbling down a few 'creative' structures implemented by taxpayers.

In the end, if Spain had used its domestic GAAR to attack the dual structures of contract-manufacturing and commissionaire agreements, probably the outcome would have been the same but more saleable and acceptable from an international perspective. And this is a lesson for other countries to learn. If artificial structures regarding PEs are to be attacked, it is probably more advisable to do so, as the OECD and UN recommend, under the anti-avoidance principles commonly accepted in a jurisdiction or the antiavoidance clauses generally admitted in that country. After all, this is the reaction that the Commentaries to art. 5 OECD / UN MC admit.

However, the merits of substantialist interpretation of art. 5

- The substantialist interpretation should be applied in a special procedure, such as the one usually used for GAARs, or in the context of GAARs.

- A clearance procedure to give the foreign taxpayer a preliminary opinion on whether the structure used is a PE or not. This sort of advance agreement on whether there may be a PE or not is also a risk-management tool that permits countries to concentrate on taxpayers that have not approached the tax authorities. In several developing countries, compacts with taxpayers are admitted so, for these countries, it should be easy to expand the procedures to PEs / attribution of profits to PEs.

- Tax legislation or administrative instructions or circulars should announce and fix the main principles regarded as the correct interpretation of, at least, the most severe cases. This strategy has several advantages: (1) provides legal certainty to foreign investors; (2) unifies the criteria of the different offices in a country; (3) depending on its form, may also have an important effect upon courts when interpreting tax treaties; and (4) if consulted with treaty partners (competent authorities), also provides certainty in the application of tax treaties and reduces conflicts with those jurisdictions.

5.4 GAARs and artificial avoidance of PE status

As explained, applying anti-avoidance rules or doctrines has been the preferred option for the OECD to fight PE avoidance, together with the sacrosanct respect of business models. Therefore, in this regard, domestic anti-abuse rules and doctrines should take into account the standard of avoidance internationally accepted or followed by the tax treaty being applied, which may reduce their efficacy[172].

However, since less formal interpretations of the art. 5 OECD / UN MC than the one defended by the OECD are possible, there is some scope for using domestic anti-avoidance rules or doctrines, for instance, for giving a more economic view of independence and groups of companies. In this context, GAARs should be preferred to administrative or judicial doctrines[173]. Although this is not the place to study the advantages and disadvantages or GAARS, which are often (a bit unfairly) charged with creating uncertainty, suffice it to say that they have proved their effectiveness in developing countries, which already have experience in their application or are . ITd[(l)4(o(i)1h(h

(‘safe-harbors’) to taxpayers[180]--, the main disadvantages are that it may give rise to double taxation if the outcome is not accepted by the other States and may produce unfair results in some cases, i.e. transactions with higher or lower margins can be over-valued or mispriced, therefore, creating obstacles to trade between countries and unfair results[181]. These disadvantages can be overcome by allowing distributors and companies to proof that structures are not designed to maximize profit allo

6. Bibliography

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