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The Definition of a Permanent Establishment in the BEPS Era

An analysis of the introduction of commissionaire structures in Article 5(5) of the OECD Model Treaty

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## Abbreviations

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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>BEPS</td>
<td>Base erosion and profit shifting</td>
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<tr>
<td>CEN</td>
<td>Capital export neutrality</td>
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<td>CIN</td>
<td>Capital income neutrality</td>
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<tr>
<td>DA</td>
<td>Dependent agent</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<td>G20</td>
<td>Group of Twenty</td>
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<td>IBFD</td>
<td>International Bureau of Fiscal Documentation</td>
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<tr>
<td>MNE</td>
<td>Multinational enterprises</td>
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<tr>
<td>OECD</td>
<td>The Organisation of Economic Co-operation and Development</td>
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<tr>
<td>PE</td>
<td>Permanent establishment</td>
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<td>SME</td>
<td>Small and medium-sized enterprises</td>
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1 Introduction

1.1 Subject

One of the most important pillars of international taxation is the concept of a permanent establishment (PE).\(^1\) It divides the taxing rights between source states and resident states and is implemented in Article 5 of the OECD Model Convention with Respect to Taxes on Income and Capital (OECD Model Treaty\(^2\)).

The idea behind dividing taxing rights on behalf of PE status originates from a time when trade consisted in physical goods as well as physical presence of enterprises within states.

Modern business models, globalization and digitalization are only a few factors that challenge the PE concept. International tax rules are not keeping up pace with the modern business climate. This has led to a situation where international enterprises take use of mismatches in national and international tax laws in order to avoid taxation in high-tax states. In turn, governments are afraid of losing important tax revenues, resulting in a competition between states to keep the lowest corporate tax rates in order to attract foreign investors. A public dissatisfaction grows where people are questioning why large international enterprises manage to avoid taxation when smaller, national companies do not.\(^3\)

As a result of this development, the OECD/G20 Base Erosion and Profit Shifting (BEPS) project is promoting changes to the OECD Model Treaty and its commentaries. The amendments of Article 5 lower the threshold of the PE definition in order to prevent artificial avoidance of PE status. In November 2016 more than 100 jurisdictions concluded the negotiations of a multilateral instrument to ensure effective implementation of the amendments in the OECD Model Treaty (Implementation Convention\(^4\)), expected to be signed officially in June 2017.

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\(^2\) OECD *Model Convention with Respect to Taxes on Income and Capital* 2014.

\(^3\) See for example K. Andersson, *Vad är BEPS och vad innebär det för Sverige?*, Skattenytt 2016 s. 639; OECD *Addressing Base Erosion and Profit Shifting* 2013 p. 13.

In other words, the amendments of Article 5 are expected to be implemented in national tax laws in the near future. One of the biggest change is that so-called commissioner structures will be covered by the scope of the article and constitute PEs, unlike the situation of today. Therefore it is of great interest and importance to evaluate whether or not this change actually will lead to a prevention of artificial avoidance of PE status, if the amendments at the same time will lead to a taxation that is better aligned with business activity, what the consequences of this might become and whether or not there is a better option.

1.2 Objective of the thesis

The BEPS project is carried out by The Organisation for Economic Co-operation and Development (OECD) on behalf of the G20 countries (the 19 largest economies and the European Union). The project seeks to realign taxation to where the economic activity actually was created.\(^5\) BEPS Action 7, which identifies the amendments of Article 5, aims at preventing artificial avoidance of PE status.\(^6\) The thesis seeks to evaluate what costs may be payed in order to fulfil these goals.

For this purpose, the thesis will evaluate the principles behind the PE concept, discuss why the concept is problematic as such, and whether the inclusion of commissioners in the PE definition is in line with these principles. The amendments of Article 5(5) will therefore be analysed from legal principles such as clarity and predictability as well as from an international business perspective.

By discussing the amendments to Article 5(5) from the aspects mentioned above, it becomes possible to evaluate alternative solutions. The alternative solution in the form of a profit threshold will for this purpose be analysed in the last part of the thesis.


1.3 Outline

First of all, in Chapter 2, there will be an introduction to the OECD Model Treaty, the reasons behind the BEPS project and the initial principles behind dividing taxing rights between states. In the following part, Chapter 3, the concept of a PE will be closer examined, including the relevant proposed amendments of the definition in the OECD Model Treaty. The intention with this part is to highlight the essential challenges of the PE concept as well as those of Action 7. In Chapter 4, commissionaire structures will be analysed, followed by a discussion on whether or not these arrangements constitute artificial avoidance of PE status. In this part, there will be an analysis on the consequences of introducing commissionaire structures in the PE concept. Thereafter, in Chapter 5, the aspects of profit allocation in commissionaire structures will be discussed, as well as implementation aspects of Action 7 and alternative solutions to the proposed amendments of the PE concept. Lastly, in Chapter 6, there will be a conclusion of the analysis presented in the thesis in.

1.4 Delimitation

The scope of the thesis will cover international tax treaty law and will be held at a general international level. Thus there will be no examination of legal issues arising in specific countries, for example particular implementation problems or constitutional questions. The scope of the discussion will delimit to the member states of the OECD Model Treaty. European Union (EU) law will not be part of the analysis, however the EU plays an important role in preventing harmful tax practices and should not by any means be forgotten in the general discussion on the subject.

The main focus will be Action 7 and the amendments of Article 5 of the OECD Model Treaty that concern commissionaire arrangements. Thus the thesis will not deal with other changes to the article or the treaty. It is, nonetheless, in my opinion both the biggest and the most interesting change to Article 5, since commissionaire arrangements are so broadly used and at the same time becoming more and more controversial.
For reasons of space, there will not be any in depth analysis of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Transfer Pricing Guidelines) and the amendments that may derive from Actions 8-10 or 13 of the BEPS project. However, the thesis will touch upon the functional analysis and the attribution of profits, as it is an indispensible and important consequence of reaching PE status.

Action 7 of the BEPS work is to some extent a response to the digital economy. Action 1 puts light on the problems deriving from the digital economy and discusses possible solutions for taxation in general. Action 1 will not be assessed further as it falls outside the scope of the thesis, and since it is not necessary in order to answer the research questions above.

1.5 Method and materials

The thesis will mainly be based on a legal dogmatic method, thus a systematic review and a thorough analysis of the legal situation, by the use of relevant legal sources. Due to the political nature of the subject, the aspects carried out throughout the analysis will be strongly associated to the legal policy of the BEPS work in general, and to Action 7 in particular. Arguments based on business management perspectives will also be given room in the analysis.

Agreements between states can be made in different ways, but the most common legally binding form is through international treaties. International treaties become binding for states either directly when approved and ratified (states with a monistic approach), or by incorporation of the treaty into national law (states with a dualistic approach). In international tax law we talk about tax treaties, where the OECD Model Treaty plays an important part as it lays down a standardized tax treaty form member states often use when drafting tax treaties among each other.

The legal framework assessed throughout the thesis is thus mainly the OECD  

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7 For further information about the BEPS actions, see OECD’s website, BEPS Actions, http://www.oecd.org/ctp/beps-actions.htm 2017-02-16.
9 M. Dahlberg, Internationell Beskattning p. 249.
Model Treaty, in particular Article 5 (see Annex 1). The Commentaries on the Articles of the Model Tax Convention (The OECD Commentaries) is also of importance as a legal source since they give further description on how to interpret the articles. In general, member states accept and lean on the OECD Commentaries to a large extent when interpreting tax treaties, as they are both well known and easy to access.

Interpretation factors for international treaties, including the OECD Model Treaty, are found in the Vienna Convention on the Law of Treaties, Concluded in Vienna on 23 May 1969 (Vienna Convention), more specifically in Article 31. Article 31 lays down international treaty interpretation principles. The primary factor to assess according to the article is the “ordinary meaning” of the terms, i.e. the objective meaning of the terms of the treaty, “in their context and in the light of its object and purpose”.

The OECD has produced a lot of different official documents along the work with BEPS and it is important to understand the legal status of them. The degree of influence on national law differs depending on the sort of document. The documents’ position within national legal framework is not always clear, which causes a risk of legal uncertainty to some extent. The most common OECD documents are the following.

In general the OECD can make decisions that are legally binding on member states. These are not common within the area of tax law. Instead, the OECD tend to make recommendations, which are not legally binding per se but expected to be followed by member states through a so-called peer pressure. Amendments in the OECD Model Treaty and to the OECD Commentaries through the BEPS project constitute such recommendations. The amendments are thus expected to be implemented by states, via bilateral tax treaties and by the OECD Model Treaty

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10 M. Dahlberg p. 254.
11 A. Skaar pp. 45-46.
itself. This will evidently require changes in domestic laws.\textsuperscript{15}

Except from the recommendations, the BEPS project provides for plenty of \textit{reports}. These are not binding on states and do not bring the similar peer pressure as recommendations. The legal status of the reports are not completely clear. One can describe the reports as attempts to formulate best practices from different states’ national laws, in order to give solutions to states on how to solve envisaged issues. Some of them might also ultimately be published in the form of recommendations.\textsuperscript{16} Some reports are published on the responsibility of the Secretary-General of the OECD and provide important information concerning the BEPS project. These reports are used throughout the thesis as sources of information rather than legal sources, nonetheless they are expected to play a part in implementation and interpretational issues among member states.

The official documents provided by the OECD for the purpose of Action 7 are published on the OECD website.\textsuperscript{17} The documents consist of several drafts that have been commented on by interested parties (such as Multinational Enterprises (MNEs) and different associations) from 2014 until October 2015, resulting in a Final Report on Action 7 dated to 2015 (hereinafter Final Report). The Final Report was followed up by a discussion draft on additional guidance on the attribution of profits to PEs, intended to show how the amended rules ought to be applied in practice. In September 2016 the comments of interested parties on the discussion draft were published.

Moreover, case law provided in the International Bureau of Fiscal Documentation (IBFD) Tax Treaty Case Law database will to some extent serve as examples of interpretation guidance or disparities.

\textsuperscript{15} OECD/G20 \textit{Deliverables: Explanatory Statement} 2014 p. 10.
\textsuperscript{16} A. Hultqvist, B. Wiman pp. 322-323.
\textsuperscript{17} OECD’s website, \textit{BEPS Actions}, \url{http://www.oecd.org/ctp/beps-actions.htm} 2017-02-16.
2 The BEPS project and general principles in tax treaty law

2.1 Background of the BEPS project

2.1.1 The OECD Model Treaty and BEPS

The OECD is an international organisation consisting of 35 member states. The OECD has drafted a model convention that contracting states use in order to draft tax treaties with each other. The OECD Model Treaty consists of four parts; an introduction, the treaty provisions, a commentary and a recommendation from the OECD with guidance on how to apply the provisions and the commentary. The first version of the OECD Model Treaty was published in 1963 and was followed by an updated version in 1977.18

The BEPS project is established in a set of fifteen actions. These are all created in order for governments to tackle cross-border tax avoidance with domestic and international instruments.19 More specifically, the project aims to prevent erosion of the tax base in source countries and profit shifting to low-tax states. The idea is that the proposals in BEPS will make it possible for national tax legislations to stop taxpayers benefitting from double non-taxation, i.e. income not taxed in any state.20 In order to accomplish this, the BEPS project seeks to realign the taxation of profits to where economic activity generates them and to where the value is created.21

2.1.2 Reasons behind the BEPS project

International tax competition, globalization, digitalization, new business models

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18 M. Dahlberg pp. 253-254.
and the financial crises are all factors behind the BEPS project.\textsuperscript{22} Countries tend to lower their corporate tax rate in order to attract foreign investors and to keep the engagement of their own domestic corporations. Lower corporate tax rate leads to a higher degree of investing incentives, which in turn entails more labour and a higher consumption. The two latter are taxed at a much higher rate in many countries. Thus the more investors, the higher the national tax revenues. As a result of international tax competition, the corporate tax rate within the OECD countries has fallen on average 1 percentage each year since 1990.\textsuperscript{23}

International tax rules have not kept up speed with the cross-border economic integration, a result of the globalisation.\textsuperscript{24} Corporations are seldom attached to domestic boundaries, but organized in the most value efficient way. Traditionally large enterprises used to pay substantial domestic tax. Today, MNEs are using developed business models to divide business activity into different subsidiaries and value chains. The disparity between modern business conduct and international – as well as national – tax laws causes a public dissatisfaction questioning why small enterprises appear to pay more tax than large ones.\textsuperscript{25}

Furthermore, development countries are gaining more power and influence in the world economy. Both India and China often argue that the value of famous brands depends on sales in their countries, and are therefore demand a taxation of the profits there. This leads to a larger risk of international double taxation, as countries within the OECD still have the opinion that profit is created within their own states.\textsuperscript{26}

Another aspect behind the BEPS project is the economic digitalization. The concept of a PE, in particular, is subject to increased pressure in this aspect. Nowadays it is possible to engage in business activities across the borders via the internet, by \textit{electronic commerce} (e-commerce). This economic activity does not correspond to the physical presence required by the PE definition in the OECD

\textsuperscript{22} OECD/G20 Action Plan on Base Erosion and Profit Shifting 2013 pp. 9-11.
\textsuperscript{23} K. Andersson pp. 1-2.
\textsuperscript{24} OECD Addressing BEPS 2013 p. 5.
\textsuperscript{25} K. Andersson p. 4.
\textsuperscript{26} Ibid, p. 6.
Model Treaty, nor does it fulfil the criteria of dependent agent.\textsuperscript{27}

The international fiscal climate arguably seems to develop a positive attitude towards taxation more and more based on sales destination and closer to consumption, rather than a strict profit-based taxation. This development creates negative effects on smaller export-based countries where the internal national market is small.\textsuperscript{28}

\section*{2.2 Principles of dividing taxing rights}

In the 1960’s, the principle of neutrality in taxation became an important part of the fiscal doctrine. The idea of dividing taxing rights between jurisdictions was by that time – and is still today – discussed on the basis of \textit{inter-nation neutrality}.\textsuperscript{29} The principle is founded on the idea of an equal division of tax rights between states that are involved with income generated from international cross-border economic activity.\textsuperscript{30} More specifically, the principle aims at preventing taxation from distorting competition on the international market. For example, two enterprises may be resident in different countries but operating in the same country. If the taxing rights are allocated to that of the resident state – the two competitive enterprises will be subject to different tax rules and the competition between the two enterprises is affected, which in turn also affect the enterprises’ policy on allocation of investments. In this aspect, one would prefer a source state based taxation, as that would neutralise the effect taxation may have on competition. This is called \textit{capital-import neutrality} (CIN).\textsuperscript{31}

The situation may also occur where two enterprises are resident in the same country, but operate within two different jurisdictions. Applying source state taxation in this case, the two enterprises would be taxed differently depending on tax regulations of the different source states. Competition in the state of residence would be disrupted and would also in this case have an effect on the enterprises’

\textsuperscript{27} OECD Addressing BEPS 2013 pp. 35-36.
\textsuperscript{28} K. Andersson p. 647; Salo p. 857.
\textsuperscript{29} A. Skaar p. 27.
\textsuperscript{31} A. Skaar pp. 26-27.
investment policies. In this example, resident state taxation would be preferable, as that would create a neutral effect on investment policies. This results in *capital-export neutrality* (CEN).\(^{32}\)

The concepts of CIN and CEN can never be completely accomplished in practice, as the result of two countries’ different tax burdens cannot possibly result in neutrality.\(^{33}\) However, the CIN concept (source based taxation) is more often favoured in consideration of inter-nation neutrality.\(^{34}\) As long as the foreign enterprise is integrated to a certain extent in the source state, one may assume that the enterprise enjoys benefits in that state. Such benefits could for example be security (police, fire etc.), public health and education or beneficial policies creating possibilities to keep exchange rates stable and interest rates low in that state.\(^{35}\)

Consequently, the enterprise integrates with the state’s economy and may accordingly be assumed to owe a degree of economic allegiance to that source state. In other words, the enterprise is to compensate for the benefits in the form of taxation to the state, as the benefits are considered crucial for earning the income in the first place.\(^{36}\) CEN (resident based taxation) would in this aspect instead result in an unbalanced economic allegiance, as enterprises would be taxed according to their resident states when operating in another, i.e. engaging in another state’s economy by using its benefits without compensating for it.\(^{37}\) Vogel discussed this concept in the 1980’s, calling the balance between the taxes levied on the enterprise and the public goods received from the state *administrative net output*, arguing for source-based taxation. Scholars use different terms for this principle,\(^{38}\) however, for the purpose of this thesis it will be defined as the *principle of economic allegiance*. The concept of a PE became the legal threshold

\(^{32}\) A. Skaar pp. 27-28.

\(^{33}\) *Ibid* p. 28.


\(^{36}\) E. Lopez pp. 7-8.

\(^{37}\) *See* K. Vogel pp. 310-314; A. Skaar p. 29.

\(^{38}\) *See* for example R. Avi-Yonah *supra* n. 34, who calls it *the benefit principle*. 
to translate the principle of economic allegiance into practice.39

The so-called *supply approach* was used in order to define what source income actually is (as it is not a self-defining concept). It stems from the idea that the most accurate way to define where the profits derive from is the place where the factors that generate the income are located and operate. In other words, the PE threshold originates from the idea that source income is classified as where the factors that generate that income is operating, and not from the idea that profits are created in the state that provides for example merely the market for the goods or services.40

This is also the strong opinion of the OECD/G20 in the BEPS project, as the main goal is to align taxation to value creation (and not to where the market or consumption is located). We will return to the discussion of where profits actually can be said to derive from, later on in chapter 5.3.

The question arising is whether or not and if so, how, the PE concept complies with the principles of inter-nation neutrality and economic allegiance today. Firstly, we will therefore try to understand the problems of the PE concept in respect of modern businesses (in particular the e-commerce). Afterwards there will be an evaluation of whether or not the inclusion of commissionaires in Article 5(5) of the OECD Model Treaty leads to a PE concept better in line with these principles. Obviously, the inclusion of commissionaires in Article 5(5) of the OECD Model Treaty does not solve the problem of virtual PEs in the e-commerce. However, it is essential to understand the underlying problems of the PE concept *in general*, in order to discuss alternative solutions to the amendments of Article 5(5) *in particular*.

39 E. Lopez p. 7.
3 Permanent establishment in Article 5 of the OECD Model Treaty

3.1 The concept of a permanent establishment

3.1.1 Introduction

The idea behind the concept of a PE is to determine the right of a source state to tax profits of an enterprise.\(^{41}\) According to Article 5 of the OECD Model Treaty a contracting state cannot tax profits of an enterprise of another contracting state unless it carries on business activities through a permanent establishment situated in the source state.

The PE concept originates from Prussia in the late 19\(^{th}\) century. It was adopted by the League of Nations in 1921.\(^{42}\) As mentioned in the introduction, it was established in a time when economic cross-border activity consisted in the trade of physical goods. The business was carried out through local physical presence in foreign countries in the form of marketing, manufacturing and distribution. Thus the fixed element of a permanent, physical establishment was the most reliable taxable nexus, as its appearance was critical to conduct business in another state.\(^{43}\) However, the PE concept has been a discussed issue since the late part of last century.\(^{44}\) As presented above, new business models and advanced value chains alter both the idea of a physically present permanent establishment and the assumption that trade consists of physical goods.

The first test in order to assess whether or not a PE is established in a state is laid down in Article 5.1 and 5.2 of the OECD Model Treaty. A PE is deemed to exist where there is a “fixed place of business through which the business of an enterprise is wholly or partly carried on”. This step is based on three components, i.e. a specific place of business, which must be permanently fixed to some degree, and the business must be carried on through that fixed place of business. The latter

\(^{41}\) OECD Commentaries on the Articles of the Model Tax Convention, Commentary on Article 5 (hereinafter Commentary on Article 5) para. 1.
\(^{42}\) A. Skaar p. 65.
\(^{44}\) See for example A. Skaar, supra n. 1; R. Avi-Yonah. supra n. 34.
criteria meaning that the person who is dependent on the enterprise must conduct the business in the state where the fixed place of business is located. Article 5.2 provides a list of examples that prima facie can be regarded as PEs. However, it is not an exhaustive list by any means (see Annex 1).

3.1.2 Article 5(5) of the OECD Model Treaty

Once it is established that business activities in a source state cannot constitute a PE according to article 5(1) or 5(2), paragraph 5 provides for an alternative test.

Article 5(5) points out the generally accepted principle that an enterprise should be treated as having a PE, if a person is acting for a principal enterprise under certain conditions, but without a fixed place of business within the meaning of 5(1) and 5(2). Persons covered by Article 5(5) are called dependent agents (DAs). The idea is that the person has enough authority to conclude contracts on behalf of a principal, which binds the principal’s participation in the business activity within the state of the DA, which in turn justifies a PE to exist. DA-PEs may be either individuals or companies. The paragraph does not only cover agents who conclude contracts literally in the name of the enterprise, but also agents who enter into contracts which are binding on the enterprise. The provision intends to cover persons who have enough authority to “bind the enterprise’s participation in the business activity in the state concerned”. This was not always evident, and the commentary was redrafted 1994 to clarify the interpretation of the paragraph.

The authority to enter into contracts should refer to contracts relating to operations that constitute the actual business of the enterprise. Persons concluding contracts restricted to purposes in Article 5(4) should not be deemed to constitute a PE. The presence must be more than temporary in order to maintain a taxable presence in the taxing state and thus constitute a PE. The requirement of habitually concluding contracts is an underlying principle of the provision. The commentary

45 Commentary on Article 5 para. 2.
46 Commentary on Article 5 para. 31.
47 Commentary on Article 5 para. 32.
48 Commentary on Article 5 para. 32.
49 Commentary on Article 5 para. 33.
on Article 5 – as stipulated today – does not provide any clear guidance on what *habitually exercising* is in terms of extent and frequency. It depends on “the nature of the contracts and the business of the principal”.\textsuperscript{50} Factors of relevance for this assessment are those referred to in paragraph 6.

Paragraph 6 is inserted in Article 5 as a clarification that an agent of independent status cannot be taxed in the source state when carrying on business dealings for an enterprise, if the person does so acting in “the ordinary course of his business”. If an enterprise conducts its business through a broker, a general commission agent, or any other agent of independent status, in their ordinary course of business – the source state has no taxing rights of those dealings.\textsuperscript{51} However, if the agent does not reach the degree of independence, for example if it does not act within the ordinary course of its business when operating for the enterprise, it might be classified as a DA-PE instead.

The Commentary on Article 5 mentions a few factors of relevance for assessing the degree of independency. If the agent receives detailed instructions from the principal, he or she is for example not an independent agent. If the agent is responsible to the principal for the result of the work carried out, but not to any significant control on how, it is probably an independent agent within the meaning of paragraph 6. The Commentary on Article 5 also mentions that the circumstance that a principal relies on the agent’s specific skills or knowledge speaks for independency of the agent. Further on, the number of principals is of relevance. It is less likely to achieve independent status if an enterprise uses only one agent over a long period of time or even over the lifetime of the business.\textsuperscript{52} An agent is not said to act within the meaning of this paragraph if it performs activities, which belong to the economic area of the enterprise rather than to the agent’s own business. For example a commission agent that does not only sell products of the enterprise in his or her own name, but also acts as a permanent agent in the relation to the enterprise – as in having the authority to conclude contracts outside the ordinary course of its business – the agent would be deemed to have a PE in

\textsuperscript{50} Commentary on Article 5 para. 33.1.
\textsuperscript{51} Commentary on Article 5 para. 36.
\textsuperscript{52} Commentary on Article 5 para. 38.6.
respect of the latter activity.\textsuperscript{53}

3.2 Challenges of the PE concept

It is evident there is a need to change the PE definition in order for it to better suit with the modern business climate. There are, though, great challenges associated with the concept itself and it is worth high-lightening some of them. As already stated, the concept originates from a long time ago and one could argue that the PE concept does not fulfil its purpose anymore, especially in the light of inter-nation neutrality. The practical question becomes whether or not the PE concept should keep being amended, or if it is time to look at new alternatives to divide the taxing rights between member states.

As mentioned earlier, the idea of economic allegiance was to some extend realised through the PE concept; economic presence through a PE, assuming the use of benefits in a source state, which justified tax liability. Today, there might be no need to be classified as a PE in order to enjoy a state’s benefits (e.g. in the e-commerce). The essential principle behind the PE thus becomes undermined, as neither the principle of economic allegiance, nor inter-nation neutrality is accomplished. The arguments that initiated and justified the PE concept consequently become partly invalid. This inevitably speaks in favour of a new instrument (or at least a significant change of the PE definition) for the division of taxing rights, in order to reach inter-nation neutrality.

The concept of a PE is, on the other hand, is well established historically in all contracting states, which evidently speaks in favour of keeping the notion of PEs. It is most certainly the alternative that creates the greatest consensus between the member states and subsequently a degree of clarity and legal certainty. Keeping the history of the PE definition in mind, it would probably be an impossible task to leave it behind completely. At least it seems so, considering that the Action 7 does not promote any substantial reform of the PE concept.\textsuperscript{54}

\textsuperscript{53} Commentary on Article 5 para. 38.7.
\textsuperscript{54} J. Eisenbeiss p. 495.
3.3 BEPS Action 7

The BEPS Action 7 includes the changes to the PE definition in Article 5 OECD Model Tax Convention and to the Commentaries on Article 5. The aim is to “prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions”. The changes are supposed to restore taxation in contracting states where cross-border income would go untaxed or taxed at a very low rate as a result of the PE definition as it is today.

The amendments of Article 5(5) of the OECD Model Treaty, of interest for this thesis, are the following:

[The enterprise is deemed to have a PE in a contracting state, where a person…]

Article 5(5) before BEPS:

"Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent agent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts in the name of the enterprise."

Article 5(5) after BEPS:

"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 habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts 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

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property owned by that enterprise or that the enterprise has the right to use or

c) for the provision of services by that enterprise [emphasis added].”

As one can see, the redrafted version expands the scope of what conclusion of contracts is, and adds paragraphs b) and c) to the article. The provision in article 5(5) will therefore apply to more situations than before. Worth mentioning is also that the exemption rule in 5(6), on the other hand (see Annex 1), is limited in the redraft, meaning that fewer situations will be covered by the exemptions from PE status (agents acting within closely related enterprises will no longer constitute independent agents). That said, the changes will lead to a lower threshold of Article 5 and it will consequently become easier for business activities to fall under its scope and be classified as PEs.

The wording of Article 5(5) today is based on objective and formal criteria of the relation between the enterprise and the DA-PE. The new paragraphs b) and c) place more focus on the subject of the contract instead of who is bound by it. The importance of the contract and the economic link between the intermediary and the foreign enterprise is emphasized. Focus is placed on the transfer of the ownership of property that is held by the principal, or the principal’s provision of a service. Consequently, it becomes more difficult to avoid the scope of the article, as the application becomes more subjective.

A more substance-focused approach that opens up for subjective interpretation might on the one hand better prevent harmful tax planning situations, but it might on the other hand increase the risk for interpretation discrepancies between the member states. The future will tell whether implementation inconsistencies will become a consequence or not. However, it should be pointed out that clarity is essential for any well-functioning tax system in general and for an international model tax treaty in particular. Along with clarity comes predictability and legal certainty, two fundamental principles of law. These aspects are also proven to be

57 J. Eisenbeiss p. 487.
58 Ibid p. 489.
59 Ibid p. 487.
60 R. Salo, Predictability in BEPS and fight against aggressive tax planning, SvSkT 2015:10 pp. 861-862; J. Eisenbeiss p. 487.
exceptionally important for investors when deciding where to invest.\textsuperscript{61}

It is shown that companies do not only consider effective tax rates as the most crucial factor when establishing business activity abroad. Predictability and a collaborative tax authority are usually considered even more important. After all, compliance with the law is the general interest among the majority of enterprises.\textsuperscript{62} Therefore, a lack of clarity must be given serious concern. If the implementation of the redrafted Article 5 leads to less predictable tax regulations, international investment activities would be hindered to some extent. Subsequently the BEPS project would work against its own purpose – namely to modernise tax treaty law in order to better fit within the current business environment.

Historically, Article 5 has already been subject to interpretation disparities among national courts. It used to be unclear whether the foreign principal ought to be legally bound of the contract the intermediate concluded, or if it was enough to be economically bound.\textsuperscript{63} The introduction of paragraphs b) and c) enables a PE to exist based on objective economic relations between the foreign enterprise and the presumed PE.\textsuperscript{64} According to paragraphs b) and c), a legally binding contract does not need to exist in order for a PE to occur; an economic binding contract would be enough. Thus the amendments of Article 5(5) provide a certain degree of clarity to an issue that was previously subject to confusion. It is, therefore, possible to argue that the amendments in this aspect make the article clearer.

Commissionaire agreements, which will be further explained below, will fall under either paragraph b) or c) of the amended Article 5. However, the new reading of the article are by some considered vague enough to include arrangements other than commissionaires. Targeting other arrangements than those intended causes obvious concern among operators in the business sector.\textsuperscript{65}

\textsuperscript{61} R. Salo p. 861.
\textsuperscript{62} Ibid p. 863.
\textsuperscript{64} OECD/G20 Action 7 – Final Report 2015 pp. 15-19.
\textsuperscript{65} See for example Consideration Fiscale Europeenne and Asia Oceania Tax Consultants’ Association, Comments Received on Public Discussion Draft, BEPS Action 7: Prevent the
It must therefore be concluded that it is a great challenge for Action 7 to manage a balance between the aim of preventing enterprises’ avoidance of formal, clear and predictable definitions on the one hand, and on the other hand introducing subjective criteria, which provide less clarity, but make it easier for tax authorities in source countries to target tax planners.

3.4 Preliminary conclusions

The principle of economic allegiance does no longer exclusively justify a separation of source and resident taxation based on today’s PE concept. The PE concept has a strong historical background though, which speaks for amending and updating the definition instead of introducing a completely new model. This is also what the OECD has attempted to do in Action 7.

The great challenge of Action 7 can be said to manage a balance between clear and predictable rules that make it harder for tax authorities to target tax planners on the one hand, and on the other hand the introduction of subjective rules that make it easier to prevent tax avoidance, but that may create interpretation disparities and hinder cross-border investors.

All in all, one may conclude that the PE concept is not perfectly designed to align taxation with economic activity within the modern business environment, nor does it fulfil the underlying principles of dividing taxing rights between states. Therefore, we will now turn to discuss if the inclusion of commissioner structures in the definition of a PE can lead to a better-aligned taxation, and whether the changes will make the PE comply better with the principles of inter-neutrality and economic allegiance.

Artificial Avoidance of PE Status (Jan) 2015.
4 Commissionaire structures

4.1 Introduction

Commissionaire structures have been used for tax planning purposes since the 1990’s. A commissionaire agreement can be described as an arrangement where a person in one state sells a product in its own name, but on behalf of an enterprise in another state, which is the owner of the actual products. As the person does not own the products that it sells, the person cannot be taxed of the profits deriving from the sales. In other words the person does not constitute a PE. It may be taxed on the received remuneration for the service preformed instead. The contract between the agent and the principal is called commissionaire agreement.

The buyer of the goods might not have any knowledge about the structure behind the purchase. In case there is any default of the product, the buyer will complain to the agent and not to the principal.

Commissionaire structures in civil law countries imply that the commissionaire is not bound by the principal. In common law jurisdictions, where the concept of indirect representation does not exist, the contract would instead state that the parent company is not bound. Structures in common law countries that are constructed that way are called synthetic commissionaires. They are considered similar structures as ordinary commissionaires and treated the same way fiscally. The two concepts will be treated equally under the definition of commissionaire arrangements in this thesis.

The arrangement is often used by MNEs in business restructurings in order to maximize profits. The OECD describes commissionaire arrangements as a structure used preliminary to avoid taxation, e.g. erode taxation in the state where the sales take place. Therefore, the OECD promoted for the changes of the

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68 Ibid.
70 J. Eisenbeiss p. 486.
71 M. Cotrut p. 199.
definition of a PE in Article 5(5) and 5(6). It is stated in the Final Report that the activities carried out by the intermediary in this situation – where the intention is to regularly conclude the contracts on the behalf of a foreign enterprise – that enterprise is deemed to have sufficient economic activity and accordingly a taxable nexus in that other state. The situation is evidently not applicable in case an intermediary is carrying out the business as an independent agent.  

4.2 The structure in practice

4.2.1 The structure of a traditional distributor

In order to fully understand why commissaire arrangements are unconventional from international tax law perspective, it is relevant to have a closer look at how the distribution of goods works in a traditional way.

A traditional, local distributor acquires goods from the principal and becomes the actual owner of the goods. The local distributor will then take responsibility for managing the sales. For example, the local distributor could itself own marketing and know-how, it may manage the employments and distribute through shops or warehouses belonging to the distributor itself. Moreover, the traditional distributor bears the risk of lost and damaged products, exchange differences as well as bad debt risks or a drop of market demand.

Profits are attributed to the traditional distributor according to the arm’s length principle under the Transfer Pricing Guidelines. The principle is based on a so-called functional analysis, which involves an assessment of the functions performed, the risks assumed and assets used. Since the distributor in this scenario controls its own business activity, bears the above-mentioned risks of sales and holds the title of the goods, the analysis would result in substantial profit allocation to the local distributor. A significant taxable income would thus appear in State B in figure 1 below.

73 M. Cotrut p. 194.
4.2.2 The structure of a commissionaire arrangement

A typical set up of a commissionaire structure consists of a principal engaged in manufacturing and distribution of tangible property. The principal is often strategically located in a low-tax state. A typical example would be a manufacturing enterprise in Ireland, selling products to high-tax jurisdictions within Europe through commissionaires. The commissionaire in turn, can be a subsidiary or any affiliate to the principal, created in the high-tax state and under the laws of that country. As the commissionaire acts in its own name, customers often believe that they are buying products from a local enterprise and not from a principal based in another country.\(^{75}\)

When the commissionaire and the customer enter into a sales contract, the commissionaire issues an invoice to the customer and a corresponding back-to-back purchasing invoice to the principal. The legal title is transferred from the principal to the customer directly. The delivery of goods might be done either by the commissionaire or an international carrier.\(^{76}\)


\(^{76}\) Ibid.
The commissionaire is paid a so-called *commission* from the principal. The commission usually consist of a percentage of the sales proceeds (around 5-15%77). The remuneration may also be calculated according to a cost-plus basis or another formula. The commission is in the end what is subject to taxation in the high-tax state, and is much less than what would be taxed in the case of a traditional distributor.78

![Diagram of Commissionaire structure.](image)

*Figure 2: Commissionaire structure.*

In the Final Report on Action 7, the OECD/G20 illustrate the use of commissionaire based on a court decision,79 where the court found that the foreign enterprise did not reach PE status. A practical example can therefore be illustrated as the following, based on the example in the Final Report: X CO, a company resident of State X, specialises in the sale of medical products. These medical products are sold to clinics and hospitals by Y CO in another state – State Y (the low-tax state in *figure 2*) – until the year 2000. Both companies are members of the same MNE. In the year 2000, Y CO changes from being a traditional sales distributor of the medical products into a commissionaire and a commissionaire contract is concluded. Y CO transfer its customer base, the fixed assets and its stock to X CO. Y CO agrees to sell the medical products of X CO in state Y, in its

77 J. Eisenbeiss p. 484.
78 Ibid.
79 The Final Report does not clarify what court case exactly, however the circumstances are very similar to the Zimmer case referred to above.
own name but for the account of X CO. X CO also stands the risks. The taxable profits in Y CO in state Y are reduced by this procedure.\textsuperscript{80}

The commercial idea behind using commissionaire arrangements when conducting business is in general to centralise business risks, which was also the case in the example above. According to that scenario, these risks would have been attributed to the traditional distributor in the situation before the year 2000. The structure thus centralises the purchase and production of – as well as the distribution of – the goods, which in turn reduces back office costs.\textsuperscript{81}

The structure is common especially in Europe and the arrangement is subject to a beneficial tax position when the resident state of the principal provides a low tax rate (\textit{see} figure 2). Which kinds of business sectors that use commissionaires may vary. Recent case law shows us everything from sales of computers,\textsuperscript{82} distribution of orthopaedic products,\textsuperscript{83} sales promotion of minerals\textsuperscript{84} and sales of on air advertising during telecasts\textsuperscript{85}.

4.3 Do commissionaire structures constitute artificial avoidance of PE status?

4.3.1 Artificial avoidance

In the Final Report of Action 7, the OECD describes the aim as preventing “artificial avoidance of PE status through commissionaire arrangements and similar strategies”.\textsuperscript{86} The report thus describes these arrangements as being artificial avoidance of PE status as such, but it does not further explain what the actual meaning of the wording \textit{artificially avoiding} is. It does, however, stress the finding that enterprises that used to conduct sales through traditional distributors

\textsuperscript{80} OECD Action 7 – Final Report 2015 p. 15.
\textsuperscript{82} Dell Products \textit{v.} Tax East, HR-2011-02245-A (sak nr. 2011/755), 2 December 2011, IBFD Tax Treaty Case Law.
\textsuperscript{83} Zimmer \textit{Ltd.} \textit{v.} Ministre de l’Économie, des Finances et de l’Industrie, Cases 304715 and 308525, 31 March 2010, IBFD Tax Treaty Case Law.
\textsuperscript{84} Borax \textit{Ltd.} \textit{v.} Spain, Agencia Estatal de la Administración Tributaria, Case 1933/2011, 18 June 2014, IBFD Tax Treaty Case Law.
\textsuperscript{86} OECD Action 7 - Final Report 2015 p. 9.
today tend to replace them with commissionaire subsidiaries (see the example referred to above in 4.2.2). This results in a shift of profits without any substantive change of the functions performed of the enterprise in the source country. The report addresses this as “common tax avoidance strategies” which needs to be prevented through an amended PE definition.\(^{87}\)

It could be argued, from an objective reading of the Final Report, that the aim as presented by the OECD/G20 is to prevent enterprises from changing (i.e. replacing) their business conducts from traditional distributors into commissionaires (with the purpose to avoid taxation). Unfortunately, not only those enterprises that go through this change will fall under the new PE scope. All commissionaires will be considered PEs and not only those created for tax evasion purposes.

That said, the new PE definition will not result in a situation where commissionaires are treated fiscally the same way as traditional distributors, only because they are classified as PEs. The risk allocation will differ for a commissionaire PE and result in lower profit taxation in the source country, than would be the case for a traditional distributor. If the intention of the OECD/G20 actually were to prevent enterprises from restructuring their businesses from traditional distributors into commissionaires, one would assume the idea of Action 7 is to keep taxing the intermediary as if it was a traditional distributor PE. This will obviously not be done by including commissionaires in the PE definition, as long as the risks attributed to the commissionaire are fewer than those attributed to traditional distributors.

On the one hand, this speaks against that Action 7 fulfils its purpose, as falling under the classification of a commissionaire PEs might still not hinder these kinds of business restructurings (from traditional distributors into commissionaire structures). Using commissionaire arrangements will still lead to lower taxation in the source state than would be the case for a traditional distributor, and would consequently be the deliberate economical choice of a modern international enterprise. On the other hand, the outcome of Action 7 is with this reasoning in line with the BEPS over all goal of realigning taxation with value creation, as the

intermediaries will be treated as what they actually are and the profits would be allocated accordingly.

Whether or not artificial avoidance is supposed to cover the actual transfer from a traditional distributor into a commissionaire arrangement, or the structure as such, the latter is exactly what is going to fall under the scope of the new PE definition.

Commissionaires existed in civil law countries before the concept of PE. A commissionaire is therefore, in contrast to what the OECD seems to assume in the work of Action 7, not an artificial arrangement by the very nature. Unfortunately, with the new wording of Article 5, the structure as such is deemed to be an artificial avoidance of PE status. This raises the question if it is justified that all commissionaire structures are deemed to be avoiding tax liability (in an artificial way) and falling under the scope of the article.

4.3.2 A theoretical dilemma

The concept of a PE as such is subject to criticism by academics worldwide for being obsolete and problematic. Jiménez argues that it may be inherently difficult to establish avoidance of a PE status, since the PE concept itself constitute an exemption to the general rule – which is that of resident taxation (see Article 21 of the OECD Model Treaty). The result of avoidance of PE status is no liability to pay tax in the source country, which would be in compliance with the main rule of resident taxation. Strictly applied in practice, economic activity will not constitute a PE if it does not fulfil the criteria of Article 5 of the OECD Model Treaty, no matter how much activity that is actually carried out. In such a case the general rule of resident taxation would apply instead.

An argumentation that a transaction in line with the general rule constitutes artificial avoidance of an exemption rule makes the wording of artificially avoiding PE status a core consideration of Action 7. Jiménez points out that it is hard to accomplish the policy goal of BEPS – to align taxation to the source

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88 J. Eisenbeiss p. 492.
90 A. Jiménez p. 9; see also J. Eisenbeiss p. 484.
countries – when the PE concept itself, according to him, is designed to: “avoid as much source taxation as possible”.\footnote{A. Jiménez p. 9.} He therefore argues that the PE concept has the effect in practice that it segregates taxable income from where the economic activity was generated. Subsequently, the above-mentioned policy goal is, in his opinion, difficult to achieve.

As Eisenbeiss observes, the underlying problem is not only the increasing artificial avoidance of PE status, but the PE concept itself that gives rise to the dislocation of the taxation of the modern economic activity.\footnote{J. Eisenbeiss p. 494.}

4.3.3 Valid arguments for using commissionaires

In the process of drafting the new version of Article 5, the OECD welcomed interested parties to comment on their published works. In these comments, one can find a raised concern that the amendments do not respect how commissionaires are used in practice. It is argued that selling products and services through networks of local sales agents is the most efficient way to target customers in foreign states. The question has consequently been raised whether or not the broadening of the PE concept will affect structures that are not artificially avoiding taxation, but based on economic substance and subsequently should not be under the BEPS scrutiny.\footnote{See for example ABB, Comments on Discussion Draft (Jan) 2015; Petrofac, Comments Received on Public Discussion Draft, BEPS Action 7: Prevent the Artificial Avoidance of PE Status (June) 2015.} In such a case, the aim of Action 7 would to some extent be accomplished, as commissionaire structures that avoid PE status would be covered. At the same time, however, a lower PE threshold hinders enterprises which are not artificially avoiding a PE status to conduct their business in an economically efficient way. It must be argued to be a severe consequence if the amended Article 5 in practice hinders business activities that are in line with policy goals of the OECD Model Treaty (i.e. not avoiding tax liability). In any case, the outcome will depend on the future implementation and application of the article.

It is also questionable whether or not a commissionaire arrangement should be
deemed to exist on the premise to artificially avoid PE status when the state of the principal is not a low tax jurisdiction.\textsuperscript{94}

Another argument of conducting business through the structure of commissionaires is that of reducing transfer-pricing administration costs. In an ordinary distributor structure each product might become subject to a separate analysis and documentation of a transfer price at arm’s length. Some argue that by using a commissionaire, this administrative burden is reduced. Instead of assessing transfer price for each and every product, an arm’s length remuneration for the affiliated commission can be established.\textsuperscript{95}

Eisenbeiss points out that there are plenty of valid arguments for small and medium sized enterprises (SMEs) to use commissionaire arrangements. He summarises these arguments as: cost reductions when the market in the source state is limited, less compliance costs (such as transfer pricing documentation and VAT filing), delegation of responsibility and lastly centralisation of the control over the value chain.\textsuperscript{96} He believes that it must be difficult for MNEs to justify the use of commissionaire agreements by the use of these arguments.\textsuperscript{97}

Considering the above-mentioned motives, there are reasonable grounds to say that both MNEs and SMEs may have acceptable arguments for using commissionaire arrangements. Nevertheless, MNEs seem to use them more frequently as tool to escape corporate taxation than SMEs.

4.3.4 Conflict of taxing rights

Some believe that the focus of the debate has changed from that of dividing taxing rights between source and resident states into a conflict between countries trying to keep as much taxing rights as possible. Countries are afraid of losing their tax base as due to the international tax climate of today.\textsuperscript{98}

\textsuperscript{94} See Rödl & Partner, \textit{Comments on discussion draft} (Jan) 2015.
\textsuperscript{95} See Rödl & Partner, \textit{Comments on discussion draft} (Jan) 2015.
\textsuperscript{96} See also C Kraus, \textit{Comments on discussion draft} (Jan) 2015.
\textsuperscript{97} J. Eisenbeiss p. 492.
\textsuperscript{98} J. Eisenbeiss p. 481, who points out that this was acknowledged by A. Skaar already in 1995.
The PE concept has become an instrument in this conflict. It is likely that the concern of losing taxing rights is an underlying factor to the BEPS work, as the loss of tax bases is a result of obsolete tax regulations. But if this debate fits within the competence of redrafting Article 5 in the OECD Model Treaty is a question per se. After all, the PE definition in the OECD Model Treaty is created as a tool to divide taxing rights and not as a tool in a political game of protecting them. Most of all, the concept was based on the idea of creating inter-nation neutrality.

4.4 Preliminary conclusions

It could be questioned what Action 7 intends by the wording artificial avoidance. Action 7 seems to be founded on the idea that artificially avoiding PE status is in fact the transfer from the use of traditional distribution chains into commissionaire structures. The result, however, is that the commissionaire structure as such will be covered by the PE scope and is deemed to be artificially avoiding PE status by its very nature. In this regard, Action 7 will lead to the prevention of any kind of avoidance of PE status through commissionaire agreements. Thus, it may be concluded that the goal of Action 7 will be fulfilled.

If the transfer pricing is done accurate (which is a question per se), there are reasons to assume that the taxation will be accurately aligned with economic activity in the case of commissionaire structures.

The PE concept itself also creates theoretical dilemmas when a transaction in line with the general rule can constitute artificial avoidance of an exemption rule, only because the wording of the exemptions does not cover it.

The cost that is paid in order to fulfil the purpose of Action 7 should be subject to criticism though. On the one hand, there are valid reasons to assume that plenty of the MNEs are avoiding PE status in order to lower their taxation on profits. However, this is not proven to be the case for all enterprises using commissionaire arrangements. It is an overwhelming risk that also enterprises that use commissionaire structures for business reasons fall under the scope of the amended Article 5. If the contracting states manage to interpret and apply the amended
article in a unified way – which is not self-evident at all – this could result in a tax
treaty law harmful for the international business environment, as arrangements
based on economic efficiency (and not tax planning) purposes will be covered by
the BEPS project. Also in this regard, the BEPS package risks leading to contra-
productive results, as this result would work against modern business conducts
instead of approaching them. By all means, one can perceive signals from the
governments that the importance of keeping their tax revenues have become a
more urgent topic than dividing the taxing rights between them.

5 Aligning economic activity – theory and practice

5.1 A transfer pricing issue?
If we conclude that artificial (or any kind of) avoidance of PE status by the use of
commissionaire arrangements will be prevented in the future, the subsequent
question becomes whether or not this leads to a taxation better aligned with value
creation.

The attribution of profits to the post BEPS PE is of interest for the discussion, as
that decides how much tax will be levied on the PE arising in the source state.
Current transfer pricing rules would require a functional analysis under the arm’s
length principle for that purpose. The allocation of functions, assets and risks etc.
might lead to the new commissionaire PEs performing over all very few
functions.99 As a result, only limited profits are attributed to the PEs. If the profits
are allocated accurately, however, this speaks for a taxation better aligned with
value creation. However, this conclusion assumes that profits deriving in the
source state are calculated according to the supply approach (where the factors
generating the income are located, see chapter 2.2). It may still be questionable
whether or not the consequences of the amendments overweigh the intervention on
enterprises.

99 M. Cotrut p. 66.
Furthermore, some argue that the concern of Action 7 should be treated as a transfer pricing issue rather than a PE issue.\textsuperscript{100} As the new amendments of Article 5 will create many new PEs, it should definitely be stressed that attribution principles must be updated, so the amendments actually result in increased taxable profits in source states. Otherwise, the advantages of the inclusion of commissionaires under the PE definition risks not overweighing the disadvantages.

The new PE definition will probably lead to a better-aligned taxation with the economic activity conducted by the commissionaires, as the profits allocated to the PE will not depend on whether or not there is a legal bond between the commissionaire and the principal, but a substantial economic relation.

It is worth mentioning that the Transfer Pricing Guidelines is subject to update through BEPS Actions 8-10. Action 8 focuses on transfer pricing issues related to transactions of intangibles, Action 9 on contractual allocation of risks and Action 10 on high risk areas such as uncommercial transactions and misuse of certain types of payments within MNEs. However, the thesis will not further assess these actions in detail.

### 5.2 Implementation aspects

In order to prevent the problem of base erosion and profit shifting in international business taxation, the importance of a uniform approach in implementation and application of the amendments cannot be stressed enough. The significance of the implementation mechanism is also emphasized by OECD/G20 in the BEPS project. The task of amending the 3,000 bilateral tax treaties that exist today evidently requires an innovative and efficient implementation approach.\textsuperscript{101} If the implementation is not coordinated, enterprises may take advantage of the discrepancies between member states, rendering the aim of aligning taxation to business creation impracticable.

Yet another practical issue is the administration costs that come with the amount of

\textsuperscript{100} See for example BDI The Voice of German Industry, \textit{Comments on Discussion Draft} (June) 2015.

\textsuperscript{101} OECD \textit{Addressing Base Erosion and Profit Shifting} 2013 pp. 7-8.
new PEs that have to be registered. Both tax payers and tax authorities will have to cope with this consequence, and some believe that this effect will cost more than what is gained from taxing the commissioneer PEs. It is, therefore, of importance that tax authorities are able to focus on scrutinising activities that actually increase the tax collection.

5.3 Alternative solution - A de minimis threshold?

Cotrut argues that introducing a quantitative profit threshold in order to identify a PE could be a better route than expanding the PE scope in the way proposed in the BEPS work. She states, however, that there is no obvious solution of changing the PE definition to fit smoothly within the current system. She also points out the fact that Greece, Hungary and the United Kingdom already have introduced tax liability for foreign enterprises based on national laws, even when a PE status is not achieved according to Article 5 OECD Model Treaty. From a business perspective this is undoubtedly harmful due to the international double taxation that occurs. According to her, one possible solution would be to amend tax treaties that include a definition of PEs as they are defined in these national laws.

A de minimis threshold based either on revenue, time or frequency, is also suggested by parties in the Public Discussion Draft. Specific concern is given to smaller enterprises considering to expand internationally for the first time, and where the amount of tax would be small anyway. Also Avi-Yonah points out that a threshold should exclude businesses that are so small that the compliance costs would become too high for them. It should, however, according to her be high enough to make sure that the income deriving from the source state is high enough to pay the compliance costs.

In line with both Cotrut’s and Avi-Yonah’s argumentation above, one could argue

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102 See for example ABB, Commentary on Discussion Draft 2015 (Jan).
103 M. Cotrut p. 213.
104 Ibid p. 67.
105 Ibid.
106 See for example Deloitte, Commentary on Discussion Draft 2015 (Jan); Chartered Institute of Taxation, Commentary on Discussion Draft 2015 (Jan).
107 Deloitte, Commentary on Discussion Draft 2015 (Jan).
that the profit threshold could be created by separating MNEs from SMEs in Article 5. By deeming MNEs commissionaires as PEs and allow SMEs commissionaires to exist as they do today would perhaps lead to a result better in line with the policy goal of the BEPS work on a whole. However, this might also increase the complexity that already comes with the PE definition and give rise to new loopholes in tax regulations that enterprises may take advantage of.

Avi-Yonah discusses in the context of e-commerce that the PE concept ought to change in order to be in compliance with the principle of economic allegiance.\textsuperscript{109} He argues for the introduction of a de minimis threshold based on gross sales (as that, according to him, is the easiest for administrative reasons), deriving from the source jurisdiction to the residence state. In order to determine the amount of gross sales, he continues, it is essential to also determine what actually constitute sales into a state. Avi-Yonah is of the opinion that, regarding business customers, this should be the location where the product was used.\textsuperscript{110} Thus he argues for a type of destination based source rule.\textsuperscript{111} The intention is not to further discuss this approach, as it tend to fall outside the scope of the thesis. It is in my opinion, however, an interesting point that Avi-Yonah makes, as this sort of destination based source rule approach challenges the idea of the supply approach, which is essential for the principle of economic allegiance as we discuss it today (\textit{see} above chapter 2.2).

It appears that a quantitative monetary threshold is desired for both commissionaires reaching PE status, as well as the PEs within the e-commerce. I would like to argue that this would lead to a result better in line with the principle of inter-nation neutrality and the idea of economic allegiance for PEs in general. For the specific case of commissionaires, these principles are to some extent already accomplished by the amendments in Article 5(5) as long as the transfer pricing is accurate. A profit threshold would perhaps distort the compliance with economic allegiance amongst the smaller enterprises that fall under the threshold and do not need to attribute (as much) profits to their commissionaires and thus not pay as much tax back to the source state for using its benefits.

\textsuperscript{109} R. Avi-Yonah p. 535.
\textsuperscript{110} \textit{Ibid} p. 536.
\textsuperscript{111} \textit{Ibid} p. 537.
However, the economic efficiency win for the business sector and the administrative cost reductions for tax authorities (in the extension the states’ economies) would evidently speak in favour of this alternative. The outcome of the BEPS work would also in this regard not become contra-productive. Assuming that most enterprises over the threshold avoid PE status of tax reasons, and that smaller enterprises falling under it do not – would make this alternative better in line with the goal of Action 7.

The backside of an introduction of a profit threshold would likely be that it is a relatively new concept that creates legal uncertainty for a while. A strict rule would also risk loopholes for tax avoiders (see the discussion on subjective/formal approach in chapter 3.3). However, as a profit threshold is predictable, clear and would favour an international investment climate, I support this alternative in respect of PEs in general, and for commissionaire structures in particular.

5.4 Preliminary conclusions

It is important that transfer pricing is done accurately in order for the amendments presented in Action 7 to fulfil the goal of the BEPS project. The implementation aspect, as well as the administrative aspect, are both important factors in the analysis of the consequences. The outcome in this regard will be shown in the near future. Last but not least, an alternative solution in the form of a profit threshold could serve as a better option than the proposed amendments to the PE concept. It is not evident, but one may argue that this would be better in line with the principles of dividing taxing rights as well as a modern business climate on a whole.
6 Conclusions

There are plenty of aspects included in the discussion of what the consequences may be when amending Article 5(5) in the proposed way. Legalisation principles (clarity, predictability etc.), international principles of the division of tax rights, transfer pricing aspects and alternative solutions to the PE concept all play a significant part of the discussion.

One great challenge to Action 7 is to balance the interest of clear and predictable rules that make it harder for tax authorities to target tax planners on the one hand, and on the other hand the introduction of subjective rules that make it easier to prevent tax avoidance, but that may create interpretation disparities and hinder cross-border investments. The latter effect would stand in stark contrast to the overall ambition with BEPS; namely to modernise international tax treaty law in order to keep pace with the current global business environment.

The principle of economic allegiance does no longer exclusively justify a separation of source and resident taxation based on today’s PE concept. International neutrality is therefore difficult to achieve through the PE definition as it is formulated today. The PE concept has a strong historical background though, which speaks for amending and updating the definition instead of introducing a completely new model.

Artificial avoidance is in several occasions a problematic classification and it is not clear what the actual intention of the term is. OECD/G20 gives the impression that the intention is to hinder business restructurings that creates commissionaires. This is, however, not the outcome of the amended Article 5(5) of the OECD Model Treaty. The term artificial avoidance also creates a theoretical dilemma when a transaction in line with the general rule can constitute artificial avoidance of an exemption rule, only because the wording of the exemptions does not cover the situation.

The assumption that commissionaire structures constitute avoidance of PE status
must be questioned. Some do indeed, why the aim of preventing artificial avoidance through commissionaire agreements will be reached through the redrafted Article 5. However, there obviously are situations where commissionaire agreements exist on other premises than tax avoidance. Therefore, the redrafted article should be subject to criticism as including changes falling outside of the scope of both BEPS and Action 7. Even in this regard, in a situation where commissionaire structures that are based on valid business considerations fall under the classification as artificially avoiding PE status, the BEPS project works against its own purpose as it impedes modern business conducts instead of approaching them.

If the amendments of Article 5 will lead to a taxation better realigned with value creation depends to a great extent on transfer pricing regulations and not only PE status. The amount of PEs created by the amended article will create administrative costs for both the business sector and tax authorities, costs that perhaps do not overweigh the final tax income for source states.

To conclude, my findings are that the effects of the proposed amendments to Article 5(5) of the OECD Model Treaty may come at the price of a healthy and modern international business environment. I am therefore inclined to suggest an alternative in the form of a quantitative profit threshold for reaching PE status. This alternative would, in my opinion, lead to a result better in line with the principles of inter-nation neutrality and economic allegiance in general. For commissionaires in particular, this could also lead to a definition of PE status not contra-productive for the BEPS project.

It should be noted though, that there is of course no clear answer to what the best alternative to a modern definition of a PE would be. If there were, this thesis would not have been written. It is, however, with great interest and excitement I look forward to the implementation and application phase of the amended Article 5(5) of the OECD Model Treaty.
7 List of sources

7.1 Literature


7.2 Articles

K. Andersson, Vad är BEPS och vad innebär det för Sverige?, Skattenytt s. 639, No. 9, 2016.


H. Oyama, Countering BEPS: Preventing Abusive Commissionaire Arrangements,
Tax Notes International 2014.


7.3 Legal documents

7.3.1 International conventions


7.3.2 OECD Reports

OECD Addressing Base Erosion and Profit Shifting 2013.


7.3.3 Case Law

*Borax Ltd.* v. Spain, Agencia Estatal de la Administración Tributaria, Case 1933/2011, 18 June 2014, IBFD Tax Treaty Case Law


7.3.4 Internet sources


8 Annex 1

Article 5 of the OECD Model Treaty:

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

   a) a place of management;
   b) a branch;
   c) an office;
   d) a factory;
   e) a workshop, and
   f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

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.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the 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. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.