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Comments on the OECD PE Interpretation Paper – Draft of October 12, 2011

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Dear Ms. Perez-Navarro,

We are pleased for the opportunity to submit our comments on the subject matter. The continuing and consistent contribution by the OECD to increase common understanding and sharing of views on controversial international tax topics such as transfer pricing and permanent establishments is invaluable help to tax authorities, multinationals and tax advisors. Documents such as Chapter 9 on Business Restructurings, as added to the TP Guidelines and the October 12, 2011 Draft on the Interpretation and Application of Article 5 of the OECD Model Tax Convention (the “PE Interpretation Paper”), do provide effective guidance and directions to manage challenges arising from any cross-border arrangement.

OECD reports and documents are very significant sources to manage complexities arising from re-characterization of facts *ex post*, i.e., a different interpretation of contracts and effects of evolving business models.

In the wake of the *Philip Morris* series of cases, PE claims have increased significantly. Groups have converted their local full-fledged subsidiaries into low-risk entities by adopting European-wide models scrutinised from several standpoints, including PE. It is not only business restructurings under challenge. It is largely any sales model whereby the local subsidiary acts as a service provider, i.e., including plain agency models.

For the above, although the PE Draft Paper under discussion analyzes many cases with clarifications that will be beneficial to tax certainty and common understanding, our notes below will focus on the paragraphs of the Paper related to Agency-PE claims.

Agency-PE claims *de facto* re-characterize as PEs subsidiaries acting, by contrast, as commissionaires, low risk distributors, other forms of intermediary services, and sometimes low risk manufacturers and other service providers. Low-risk entities are re-characterized as full-fledged ones based on their history or by being deemed as dependent agents. Under the AOA approach to dependent agent PEs under paragraph D-5 of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments, indeed, it is the *profits* attributable to the foreign enterprises for the functions performed on its behalf by the dependent agent that should be subject to tax in the host country (Cfr. Paragraph D-5, # 232). Practically, an Agency-PE challenge may lead to the imputation of gross revenues and related costs to the local PE *as if* local customers were billed by a deemed local sales team, as far as agencies and other service companies are concerned. Similar results apply to commissionaires and limited risk distributors, although sales are ordinarily booked by the local entity, both for corporate tax and VAT with respect to LRDs and only with respect to VAT, as far as commissionaires are concerned. In all cases, the deeming local sales approach implies that the revenues will be attributed to a local PE.

Paragraph 3 – Contract manufacturing

Sub-paragraphs 17 through 21 of the PE Interpretation Paper clarify that contract manufacturing arrangements do not create a PE of the foreign principal. The local contract manufacturer should be respected as a separate stand-alone entity acting as a low-risk service provider, consistently indeed with the positions taken by the OECD TP Guidelines from long time. The inclusion of the penultimate sentence to paragraph 4.2 of the Commentary - *Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise* - may facilitate implementation and management of those manufacturing models.

The clarification provided by sub-paragraph 21 that same approach should be taken if a former full-fledged supplier were converted into a contract manufacturer as a result of business restructurings under Chapter 9 of the TP Guidelines is equally beneficial.

Although it should be clear that same conclusion applies to other forms of limited risk manufacturing businesses, eg, the so-called toll arrangements, reference to them may avoid uncertainty and conflicting approaches.

The purchase of raw materials and other assets by the foreign principal rather than the local manufacturer, in fact, should not affect the PE analysis. Comments under sub-paragraph 20 of the PE Draft Paper should equally apply to contract and toll manufacturers, as well as any further form of manufacturing business under limited risk models.

Paragraph 18 – Fragmentation of activities

Groups may have in a given country a commercial business only, or a manufacturing business only, or a combination thereof. In the context of business restructurings, they may decide to convert a full-fledged subsidiary into one or more subsidiaries under a low risk model. Subsidiaries may be two or more depending on whether further support functions are carried out locally and the shareholders decides to segregate the support functions into a separate subsidiary or shared service centre.

Low risk business models are not different from full-fledged ones from a structural standpoint. Groups may have one low-risk subsidiary carrying manufacturing and commercial functions at the same time. They may have a two-company model whereby a low-risk subsidiary focuses on commercial business while another one carries the manufacturing one, and sometimes a third or fourth subsidiary carry R&D activity and other support functions, eg, a local shared service centre.

The concept of fragmentation of activities within the context of business restructurings looks different from the basic scenario envisaged under paragraph 27.1 of the Commentary whereby a foreign company applies the notions of preparatory and auxiliary activities by not being subject to taxation in the host country.

Business restructurings implementing a Regional-wide management model with limited risk entities in various jurisdictions, by contrast, do remain subject to tax in the host country. Whenever multinationals have one or more subsidiaries, they do have *more than a PE* in any given Country. They have separate companies doing business by their own, whether on a single-company basis or in a fragmented way. Segregating different functions all remunerated through separate contractual arrangements at arm's length should not be perceived as abusive whereby the related functions are managed and rewarded consistently within the framework as outlined by Chapter 9 of the TP Guidelines.

Business restructurings whereby a low-risk model is implemented under a limited risk approach, eg, a toll manufacturing arrangement, a commissionaire, an R&D contract and other service contracts for further service functions should not be deemed as an undisclosed PE because the separate entity structures do allocate the business to specific subsidiaries with full disclosure of facts and circumstances and a revenue allocation based on consistent contractual arrangements.

Paragraph 18 of the Draft PE Paper may not provide sufficient clarity. It includes a positive conclusive sentence under sub-paragraph 106 whereby it is stated that *in practice, a better approach will often be to examine whether the various local companies have received an arm's length consideration for their activities*. However, the language in prior paragraphs somehow show concerns about abuses by multinationals whereby reference is made to legislative or judicial anti-abuse rules.

We would expect that fragmentation may be deemed as abusive if it leads to avoid host country taxation through the exploitation of the preparatory and auxiliary PE exceptions. Whereby taxation at source is ensured through the separate service company model, by contrast, host country taxation is ensured. At most, one could argue that the tax charge is mitigated by transfer pricing policies but

tax authorities do have adequate tools in their transfer pricing legislation to challenge the purported margin allocation.

As a result, we would hope that, whenever a transfer pricing adjustment is possible, no PE claim should be raised with respect to low-risk business models. PE claims should be deemed as a residual concept to preserve taxation at source by foreign companies escaping local taxation. Different scenarios being the ones arising from business restructurings or structuring under the separate service company model.

Paragraph 19 – Commissionaire arrangements

Commissionaire arrangements have recently been under challenge from a PE standpoint. The concept of commissionaire dates back to Roman Law if not earlier. It implies a split between economic and legal ownership. It is no much different, if any, from the concept of limited-risk distribution contracts or LRDs. Its underlying economics may take different legal forms. The economic rationale is the same. It splits asset ownership and asset management, like the scenarios described under Chapter 9 of the OECD Commentary when describing risk allocation and risk control (paragraphs 9.22 ff., in particular up to 9.33.)

Similarly to what discussed above with respect to the fragmentation of activities under a business restructuring scenario, we doubt that a subsidiary acting as a ordinary commissionaire could be re-characterized as an Agency-PE. There is no hidden activity. It is all disclosed. The income of the commissionaire is subject to tax. In an intragroup scenario, if the subsidiary is not a commissionaire *de facto* because it carries out more functions than a typical commissionaire does, tax authorities may challenge the level of taxable income in the host country under the transfer pricing rules. In such a case, it may be claimed that the local subsidiary is a *de facto* full-fledged distributor.

Taxing a deemed PE because the commissionaire in some jurisdictions *binds* the foreign principal under the general legal concepts of their legislation attributes an overwhelming weight to formal legal features whereby allocation of taxing rights should privilege economic functions.

Chapter 9 of the TP Guidelines have clearly recognized low risk models as an ordinary way of doing business from a transfer pricing standpoint. Challenging as a PE arrangements that are accepted from a transfer pricing approach would be contradictory.

Re-characterizing commissionaire agreements as Agency-PEs may restrict the cross-border intra-group commercial activity to a buy-sell model with full risks. Indeed, commissionaire and similar arrangements are very common between third parties in a domestic scenario.

Challenging a commissionaire as a PE in a cross-border scenario may even raise EU Freedom principles issues as cross-border transactions between companies of different EU countries would not be given the same freedom of establishing themselves as commissionaire in a foreign country whereby domestically this is allowed.

For all the above, it is hoped that commissionaire arrangements are acknowledged as contractual arrangements constituting an ordinary way of doing business that does not create a PE exposure, let

alone pathological scenarios whereby they are clearly exploited as a means to avoiding host country taxation.

PE claims are tools to challenge cases of avoidance or evasion of host country taxation. Transfer pricing adjustments should be seen as the natural tools to challenge the level of taxation and its share between host and home country with respect to intragroup transactions, also on the basis of the proportionality principle.

Use of PE claims on a residual basis only (whereby transfer pricing adjustments are not possible) would be a welcome development to trace a line between the scenarios whereby PE vs TP challenges should be made. Ambivalence of either doctrine to same fact pattern creates a high degree of uncertainty.

Business restructurings and PE claims

The concept of PE is not exclusive to scenarios of common ownership, contrary to transfer pricing. The latter is purported to prevent manipulation of profits allocation between group entities on the assumption that common control may lead to arbitrary fixing of prices. The former goes beyond transactions between companies under common control. Article 5 applies regardless of any group relationship. By contrast, transfer pricing requires common control.

Business restructurings do imply relocation of functions and assets, as well as shifting of risk allocation from one or more Countries to other(s). In the '90s and the first decade of the 21st century, many groups have increasingly centralized their way of managing foreign subsidiaries, particularly within Europe. The persistence of years of economic uncertainty may even lead to re-thinking the striving towards centralization as it may cause inefficiencies.

Chapter 9 of the Transfer Pricing Guidelines has thoroughly analyzed those trends by providing useful guidance on the assessment of their tax implications. For its scope, Chapter 9 addresses the transfer pricing impact of business restructurings from all standpoints, including conversion of business model and post-restructuring policies.

The PE Interpretation Draft under discussion does provide insight on some aspects, e.g, the discussion of contract manufacturing arrangements under Paragraph 3. By contrast, as noted above, comments on business fragmentation and commissionaire arrangements are ambivalent and can be stretched in different and even opposite directions.

As noted earlier, claiming Agency-PEs following a business restructuring into a centralized Principal model *de facto* rejects the possibility of implementing low risk business models. Agency-PE claims in such scenarios are based on the exploitation of the concepts of economic and legal dependence, as well as on the *Philip Morris* doctrine that participation to clients negotiations may imply a *de facto* authority to conclude contracts on behalf of the foreign principal that are economically if not legally binding for the latter.

Business restructurings towards a centralized business model merely reflect the material changes in the way of doing business in the globalized economy in the digital era and follow political,

economic and technical changes we see in our every day life but have difficult time to acknowledging.

Country-specific business models whereby a multinational sets up one subsidiary in a given country to have it in charge of all manufacturing and commercial functions is a legacy of the last century. Many businesses grew up at times where major entry barriers applied to cross-border transactions, such as exchange control restrictions, custom duties, import VAT regimes within single EU Countries, different currencies, and other commercial barriers such as a less developed transportation network and the lack of the sophisticated IT systems available nowadays that allow to manage supply-chain, inventory and receivables, for example, on a regional or global basis.

The developments in the last twenty years of the 20th century and in the last decade have changed the way of setting up business structures by allowing for centralized business models following the developments within Europe, and most of all within the European Union, both in the internal market and the external relationships.

The concentration of functions and reallocation of risks to a central location, therefore, can be seen as the result of the economic developments that have made the per-country business model not anymore adequate in a number of cases.

The principal-service provider model is indeed common even in a domestic context. Many local companies do outsource business functions to third parties by entering into contract manufacturing arrangements for the products sold under design and brand of the local owner. Many consumer products are manufactured by third parties under such outsourcing arrangements. Similarly, on the distribution business, low risk, commissionaire and agency contracts are very common.

PE claims against low-risk models essentially would restrict the possibility of doing cross-border sales business under a full-fledge model. That is, either the local distributor takes full risk and, therefore, full margin potential, or there is a PE because of the economic and legal dependence allegedly attributed to the stripped distributor.

Sales business, however, is not only buy-sell, conceptually. Sales may be managed in various different ways. We all purchase newspapers at the news kiosk (although digital downloading is increasingly become common) but the kiosk owners do not take inventory risk. They only keep a commission for sales and the inventory risk is borne by the publisher. Same applies to digital kiosks, indeed. We may buy e-news and e-magazines by downloading them on our tablets and PCs but we buy them from service providers that do take a royalty or commission while the reminder goes to the publisher, which is the risk-taker, the Principal that may make a profit or a loss from the transaction. Chemical companies sell products through third party agents domestically whereby it is the agent that manages the client relationship but the sale is made by the principal, who will bear the client and receivable risk. Similar arrangements are common in the pharma industry and many others, with variances related to specific regulatory or commercial attributes of the specific business.

Another example: in the automotive business, we all purchase cars from the dealer, which generally purchases by a local wholesale subsidiary acting on behalf of the parent company in a three-tier sales model. The conversion of the local group company of the automotive producer acting as

wholesale distributor into a service provider would simply convert a three-tier distribution model into a two-tier one whereby the wholesale company would become a service provider intermediating between the car manufacturer and the car dealer. Only the latter is the real seller in the market. Wholesale business may be arranged either as a buy-sell or as a service model in a cross-border scenario in as much the three-tier or two-tier model is common within domestic businesses. What may seem artificial and arranged for tax purposes may at any time become a common commercial practice.

Sales business just requires a two-tier model, manufacturer and final customer. Any third-tier or fourth-tier, etc. distribution model may freely be replaced by a two-tier model because distribution business may be arranged in a centralized or decentralized way irrespectively. It is the most effective sales model from a commercial standpoint driving the decision as to the distribution model to implement. As a result, sales business may be a service business, not necessarily a buy-sell one as noted above.

The participation to contract negotiations as service providers

Economy in the digital era is more and more based on service business. The weight increasingly attributed to participation to clients negotiation as a symptom of an Agency-PE does conflict with commercial reality whereby the conclusion of deals is the result of a combination of activities by various players.

Nowadays, in many businesses, the success of sales of products and services in a given territory is the result of a combination of elements variable case-by-case based on the specific business at stake.

Third party sales are often facilitated by intermediaries that do not take title on the property or bear the risk from sale, product warranty, etc. Those intermediaries remain service providers and are not treated as *de facto* salesmen from a tax standpoint in a domestic scenario.

By contrast, multinationals are being challenged because they market their products through local personnel and entities acting as service providers. If local personnel participates to meetings, this is allegedly seen as an indicium of a buy-sell role.

The OECD has promptly amended the Commentary to Article 5 of the OECD Model after the *Philip Morris* case by emphasizing that the *mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise* (paragraph 33 of the Commentary to Article 5).

Countries such as Italy have made reservations about such a policy statement (paragraph 45.10 of the Commentary to Article 5).

If an agent liaises between purchaser and seller, it is clear to everyone who the risk-takers and asset-owners are, who should be rewarded for their functions and risks while the agents should be remunerated for their risk-free liaison role.

It is hoped that the OECD Committee on Fiscal Affairs will further increase consensus amongst its member Countries that will eventually lead to a unitary position about Agency-PEs and related issues that will restrict the use of such a doctrine to specific cases of abuse whereby host country taxation is avoided altogether and, specifically, to scenarios whereby transfer pricing rules will not allow to achieve a fair balance of taxing rights allocation between host and home country.

Conclusions

The PE Interpretation Paper addresses positively a number of cases whereby guidance on the concept of PE was missing, e.g., Paragraph 7 on the presence of foreign enterprise's personnel in the host country.

Welcome also are the clarifications on contract manufacturing arrangements even in the context of business restructurings.

It is hoped that an increased level of consensus and clarity will be reached with respect to scenarios such as the business fragmentation within the context of business restructurings and the concept of Agency-PEs, which will hopefully restrict its application to specific cases where tax authorities may not achieve a fair allocation of taxing rights and revenues collection through other sets of rules such as transfer pricing, as it should ordinarily be the case for commissionaire and other low risk arrangements if intragroup.

Agency-PE claims may have draconian effects on multinationals doing business in a given country where, for example, a criminal exposure arises as a result of re-characterization of a service business model into a buy-sell one, which should indeed ideally be challenged only in specific scenarios of abusive sham transactions.

A recommendation to member countries to implement administrative policies in order to allow multinationals to submit their business models for advance clearing from a PE standpoint will also be welcome. While most countries do allow advance ruling procedures on matters of law interpretation or transfer pricing, PEs may not be admitted for ruling procedure. While Material-PE claims are pure matters of facts, Agency-PE claims are very often matters of re-characterization of contracts and business models. As a result, we would hope that business restructurings and any service business model such as the low risk ones, e.g., commissionaire, toll manufacturer, etc., should qualify for advance ruling, let alone the rights of tax authorities to challenge any facts and circumstances inconsistent with the ones submitted for ruling clearance.

Finally, we wish to thank the Tax Treaty Unit of the OECD for the opportunity to express our views on these very controversial topics and for the work pursued to facilitate cross-border business by clarifying the related tax aspects.

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