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CONFEDERATION OF SWEDISH ENTERPRISE

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Position Paper: Confederation of Swedish Enterprise – Comments on the OECD Public Discussion Draft entitled "BEPS Action 7: Preventing the Artificial Avoidance of PE Status 31 October 2014 to 9 January 2015"

Dear Marlies,

The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft regarding the prevention of artificial avoidance of PE status (hereinafter referred to as the Draft).

The Confederation of Swedish Enterprise acknowledges the fact that this area constitutes a challenge from a BEPS perspective. However, in our view, the current draft does not sufficiently distinguish between BEPS and the allocation of taxing rights between the source state and the residence state. Under the mandate of the BEPS-project, any new standards should in our view be limited to addressing only the former topic. Where a taxpayer is appropriately taxed in the state of residence, it is typically not a matter of BEPS but one of "splitting the cake". Even though there is a strive within the project to better align taxation to value creation, this should in our view only be done within the framework of BEPS. This needs to be better reflected in the document and in the proposed actions.

We are concerned that the proposals in the Draft will result in a lowering of the PE threshold that goes far beyond the specific problems related to BEPS in general and the digital economy in particular. PE issues often result in double taxation and all efforts to provide additional clarity to the OECD Model Tax Convention are naturally

of interest to business. Unfortunately, we believe that the proposals are likely to induce additional ambiguity into an already complex area resulting in a dramatic increase in PEs with allocation disputes and double taxation as the end result.

Although companies face many challenges in relation to PE issues, the list in Article 5.4 still mitigates administrative costs and facilitates the determination of when a PE is at hand. Compliance costs in relation to a PEs are significant and increased uncertainty in this area is likely to have a negative impact on cross border trade and investment.

In addition, and as acknowledged in the UN Model, some of the activities may generate little income and due to divergent treaty application, lead to prolonged litigation regarding how much income should be attributed to the PE.

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

The Draft proposes the following four alternatives to address abuse in relation to commissionaire structures and similar arrangements:

A. *(Para 5.5): Add a reference to contracts for the provision of property or services by the enterprise; replace "conclude contracts" by "engages with specific persons in a way that results in the conclusion of contracts";*

   (Para 5.6): strengthen the requirement of "independence"

B. *(Para 5.5): Add a reference to contracts for the provision of property or services by the enterprise; replace "conclude contracts" by "concludes contracts, or negotiates the material elements of contracts";*

   (Para 5.6): strengthen the requirement of "independence"

C. *(Para 5.5): Replace "contracts in the name of the enterprise" by "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise"; replace "conclude contracts" by "engages with specific persons in a way that results in the conclusion of contracts";*

   (Para 5.6): strengthen the requirement of "independence"

D. *(Para 5.5): Replace the phrase "contracts in the name of the enterprise" by "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise"; replace "conclude contracts" by "concludes contracts, or negotiates the material elements of contracts";*

   (Para 5.6): strengthen the requirement of "independence"

As a starting point it is essential that any initiative to counter abusive cases is targeted and provides clear guidance so as to avoid application also in relation to non-abusive cases or cases involving allocation of taxing rights rather than BEPS. In general, tests based on objectivity provide far more certainty and predictability than

those based on subjectivity. Regrettably, a common feature of all four proposals seems to be that they all add additional subjectivity into the PE test.

All four proposals entail a more restrictive interpretation of the independent agent concept by basically disqualifying the use of associated enterprises in commissionaire arrangements and also by removing the possibility to be an independent agent if acting exclusively or almost exclusively on behalf of an enterprise. In relation to the proposed changes in the dependent agent test we are concerned that the proposals may affect not only commissionaire arrangements but also other principal sales structures.

According to our understanding all of the above examples are based on the presumption that a restructuring of a sales company to a commissionaire structure will substantially reduce the taxable profits in the country of the commissionaire. Although this clearly constitutes a concern, we think it should rather be addressed as a transfer pricing issue than a PE issue. If a proper functional analysis is made which establishes that the subsidiary is essentially performing the same functions before and after the restructuring, tax authorities should have a good argument not to allow a drop in profits without having to reclassify the subsidiary as a PE. Indeed, in a direct sales situation following a restructuring to a commissionaire, the turnover may be reduced which depending on method used (notably Return on Sales) will reduce the profit level and the taxable income. However, this should in our view rather translate into a discussion about appropriate remuneration method and Profit Level Indicators than that of the existence of a PE. The fact that this is sought to be resolved by extending the PE-concept will most likely give rise to a significant increase in disputes and administrative problems. Therefore, in order to avoid undue administrational consequences and risk of disputes, the notion of a subsidiary as a taxable person should be upheld to the largest extent possible.

Additional clarity on the wording “engages with specific persons in a way that results in the conclusion of contracts”, “material elements of contracts” as well as examples on what is to be considered as “similar arrangements” is necessary. As previously indicated we find the proposed options too far-reaching since they go beyond the commissionaire structures and can involve buy-sell distributors and/or even pure marketing activities.

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

We acknowledge the fact that it is possible to be heavily involved in the economic life of another country by doing business via the internet and that this may open up for abusive cases. However, in trying to find ways to tackle this, it is of utmost importance not to amend the PE threshold to the detriment of traditional business engaged in non-abusive situations.

Although it might be desirable to address situations of artificial avoidance of PE status it needs to be acknowledged that there are still valid and perfectly legitimate reasons for the exceptions that are currently found in Article 5.4 of the Model Tax Convention.

For a great number of MNEs the exceptions in Article 5.4 facilitate less administration and cost by enabling a relatively simple and consistent approach to the determination of whether or not a PE exists. Companies report that whenever they are considered to have a PE, there is the inevitable dispute on how much

income should be attributed to that PE. On many occasions this results in long litigations and large costs.

Since the kinds of activities mentioned under 5.4 traditionally have been recognized as not generating any material income, it will be quite difficult to allocate income to such a PE. Hence, with the proposed amendments, disputes in this area are likely to increase significantly.

The exceptions are not restricted to preparatory or auxiliary activities

In option E in the Draft it is suggested to make all of the activities in para 5.4 subject to a preparatory or auxiliary condition.

Although the activities listed in 5.4 in many cases are of a preparatory or auxiliary character, it is acknowledged in para 21 in the Commentary to Article 5 that this is not always the case. To introduce an explicit reference to "preparatory or auxiliary activity" will affect traditional businesses and the number of PEs would no doubt increase dramatically.

In addition, the concept of "preparatory or auxiliary activity" is vague and opens up for ambiguity and divergent interpretation. Para 24 in the Commentary to Article 5 also states that "it is often difficult to distinguish between activities which have a preparatory or auxiliary activity and those which have not".

If all activities are subject to the condition that they have to be preparatory or auxiliary, why do we need such a list at all? Another way to deal with this issue would be to leave para 5.4 as it is and provide for a PE exception unless the tax authority can show that the activity is not of a preparatory or auxiliary nature.

The Draft indicates that the target is internet companies with large warehouses in which a significant number of employees work. Our concern, however, is that also industrial companies with warehouses will be challenged by tax authorities.

Consequently, if option E is adopted, the new commentaries should clarify/give examples of situations in which the activities would qualify as "of preparatory or auxiliary nature". A situation in which a company in state A sells products in state B solely on the Internet and with no presence in state B, other than a warehouse, is different from a situation in which a company in state A uses a warehouse in state B, used for delivery of products sold by an affiliate in state B (or sold by other affiliates in third states, e.g. central warehouse situations).

Although the intention may be to target the first case, tax authorities could argue that the company in state A would have a PE in state B in *both* described situations. In the latter case, a local sales profit resulting from sales activities will be duly taxed in state B and a PE for company A would only add administrative burden and risk of additional disputes for allocation of PE profits (if any). As noted above, for the purpose of amending the current guidelines, it is important to distinguish between situations which create BEPS and those that merely refer to the allocation of taxing rights between the source and the residence state.

The word "delivery" in subparagraphs a) and b) of paragraph 4

In option F the Draft proposes deleting the word "delivery" from subparagraphs a) and b) of paragraph 5.4

We strongly object to the deletion of "delivery". Many companies report an increasing trend and need of having warehouses closer to their customers. It is difficult to understand the purpose of having the exception for storage when deleting the exception for delivery. Having a warehouse for storage without the possibility of delivery makes little sense and would have significant consequences for their business operations. Excluding delivery from the PE exception would also have a much wider impact than on cases where there is a BEPS related concern.

The deletion of delivery would to our understanding effectively put an end to long established and well accepted principal TP-structures maintaining central warehouses in geographically strategic locations for the delivery of goods using local low risk distributors for their sales operation. It would also affect companies maintaining a warehouse for the delivery of spare parts to customers for machinery supplied to those customers even where it does not maintain or repair such machinery (see para 25 of the Commentary to Article 5). To avoid the risk of double taxation and disputes, it is likely that such a principle would lead to costly reorganizations and sub optimizations in cases which are fully business driven. Such a change would thus go far beyond the objective of preventing BEPS. The effect on businesses and trade/investments decisions is unacceptable.

Additionally, if adopted, the altered definition risk to create confusion and/or additional risk for disputes since the wording will continue to include "storage". If warehouses are allowed for storage purposes but not for delivery, when and under what circumstances does storage purpose change into delivery purpose? Obviously, in many situations storage will ultimately lead to delivery. In practice, also sole/primary storage activities which at one point may end up in delivery will constitute a PE. Additional uncertainty and obvious risk for disputes is created if this last delivery activity retroactively re-classifies storage activities.

The Draft also explains that the omission of the word "delivery" is a departure from the OECD Model Convention, reflecting the view that a stock of goods for prompt delivery facilitates sales of product and thereby the earning of income in the *host* country. We acknowledge the fact that there could be a BEPS concern if the goods or the merchandise are delivered to customers in the same country where the goods or merchandise are stored. If, however, the delivery is made in a cross-border circumstance, it is difficult to understand such concern. There may e.g. be situations in which a company has a central warehouse from which *no* deliveries are made to the host country but only to third countries. It needs to be clarified that such a situation should not constitute a PE.

If deliveries are made to the host country as well as to third countries the company would have a PE in the host country. However, it needs to be clarified that only profits from sales to the host country could be attributed to the PE.

We fully agree with the word of caution in the UN Model that "…even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into attributing too much income to this activity if they do not give the issue close

consideration, which would lead to prolonged litigation and inconsistent application of tax treaties".

From this perspective option E would, as indicated earlier, be preferable.

The exception for purchasing goods or merchandise or collecting information

Option G proposes the deletion of "purchasing goods" from subparagraph d) and option H proposes to delete the entire subparagraph, thus both the exception for purchasing goods and collection of information.

We do not support either of these two options. These exceptions are very important for companies and the deletion of these activities would no doubt increase the number of PEs dramatically. Before deciding whether to invest in a new market companies need to be able to examine and "scan" the market. In this respect purchasing and data collection is necessary. In addition, raw data by itself has limited value. Value is created only by the process and interpretation of the data.

Furthermore, we do not agree with example one. It seems to indicate that a purchasing branch which purchases the output of several affiliated manufacturing plants on behalf of the group would be entitled to retain the group's entire volume discount for those purchases. Example one ignores the fact that the volume discounts achieved by a centralized purchasing function are typically shared among those members of the affiliated group that will acquire the goods in question.

All in all, a deletion of these activities from the PE exception would impact adversely on businesses. In our opinion, neither of these activities is sufficient to constitute a PE and they do not by them themselves produce any profits. Considering the cost and administrative burden of running a PE, many companies are likely to shut down existing purchasing offices simply because the costs would outweigh any potential profit from these activities. From a broader perspective such a scenario would have a negative impact on cross border trade and investments.

As in the case of delivery, option E would be preferable compared to options G and H since then at least it would be possible to maintain a fixed place of business for purchasing goods or collecting information without triggering a PE. However, option E would in our view open up for great uncertainty and arbitrariness with respect to the existence of a PE. This would no doubt significantly drive tax disputes and double taxation. Considering that the proposed amendments would arbitrarily hit both BEPS situation and perfectly sound business structures, we strongly advise not to change the current principles in this respect.

C. Splitting-up of contracts

The Draft proposes two alternatives (options K and L) to deal with the splitting-up of contracts.

Since there is a 12 month time threshold to regulate when a building site or construction or installation project constitutes a PE we acknowledge the necessity to

prevent abuse. However, it is reasonable to request rules that are clear and provide some certainty. Companies report having problems interpreting paragraphs 18 and 19 of the Commentary to Article 5 and would welcome additional guidance.

As a general comment concerning contracts, there are situations where the rationale behind regarding a construction site based on several contracts as a single unit can be questioned.

Assume that a company has finalized a construction project within an 11 month period. One year later the same company receives an additional order from the same customer at the same site. This project is finalized in 2 months. The two orders may be considered to be connected but the company had no knowledge of the additional order at the time of the conclusion of the first project. Could this even be considered as splitting-up a contract? Would this constitute a PE? If so, it would be very difficult retrospectively to deal with all the PE administration.

Returning to the two alternative proposals, a principal purpose test, as suggested in option K would presumably deal with the example above, giving the company a possibility to show that no abuse was intended. However, having a principal purpose test would undoubtedly open up for wide application by tax authorities and induce additional uncertainty into the PE test.

However, and as indicated in the Draft, the "automatic" approach in option K has its flaws due to the fact that it applies indiscriminately and would also capture situations where there is no BEPS concern.

In order to narrow the scope of the automatic approach the Draft proposes a minimum presence of 30 days. This period of time is too short. Many construction projects run for several years where a company may need to have specialists on the site a couple of days a month during the entire project. The result would be a PE on every major construction site. In addition, such a threshold could be difficult to monitor, as all parts of an MNE may not be fully aware of all the activities of the group as a whole.

E. Profit attribution to PEs and interaction with Action Points on Transfer Pricing

A major drawback with the Draft is the fact that it does not address the profit attribution implications of the potential PEs created under various options. To the contrary, the Draft seems to dismiss this issue as insignificant. BUSINESSEUROPE fully support the comments made by BIAC on this issue and share the view that countries often are motivated to create PEs in order to attribute profits to those PEs.

If the proposals in the Draft are implemented, corresponding guidance under Article 7 would be necessary in order to avoid numerous cases of double taxation. Any profits to be attributed to a PE based on delivery, purchasing or data collection are likely to be insignificant, but that view may not necessarily be shared by tax authorities.

It is difficult to foresee the full consequences of the proposed amendments. However, it is not difficult to foresee that the impact these changes would have on business would not be positive. Should these proposal be incorporated into the

Commentaries we fear that there will be a dramatic increase in cases of double taxation.

On behalf of the Confederation of Swedish Enterprise

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